PLANNING YOUR LEGACY

A HANDBOOK ON ESTATE PLANNING

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Find Answers to These Questions

- Will or living trust—which is right for me?
- Who will make decisions for me when I'm no longer able?
- How can I reduce the tax liability to my estate?
- What if I require long-term care?

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This handbook is written for educational purposes only and shall not be interpreted to constitute legal advice in any form. Furthermore, the dissemination of this handbook by the author, Landerholm, P.S., its employees, agents or any other person shall not be deemed to establish an attorney-client relationship with the author; Landerholm, P.S. or its attorneys.

PREFACE

This handbook is intended to assist you with the process of developing your personal estate plan. Estate planning is not "one size fits all." It is as individual as you are and must be reflective of your personal objectives while flexible enough to address changes in your life.

Not all of the topics covered in this handbook will apply to your particular set of circumstances, but many of the topics will be appropriate in a comprehensive plan. A good estate plan will consider personal objectives, property rights, marital status, an analysis of one's particular assets and obligations, and basic legal documents.

The Table of Contents is intended to provide an easy means of navigating the chapters of this handbook. Consider reading Chapters 1, 2, 3 and 9. Then select from the other chapters based on your personal situation and planning objectives.

Finally, it is important to remember that neither this handbook, nor any other book, computer program or form, can be a substitute for the advice of an experienced attorney. If you have questions or need documents, contact a qualified estate planning attorney.

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Table of Contents

CHAPTER 1

INTRODUCTION TO ESTATE PLANNING

What is estate planning?

Important decisions in life require at least *some* advance planning. Decisions such as selecting a career, starting a family, and planning for retirement all require careful consideration of your abilities and goals to ensure that your personal objectives can be achieved. Estate planning is no different; in fact, proper and effective estate planning can be more important than many of life's other decisions since it is very difficult (if not impossible) to modify your plan after incapacity or death.

Estate planning is more than just a will, power of attorney, or other document designed to distribute your property. It is a process of identifying your goals and taking steps to achieve those objectives, including the preparation of appropriate legal documents. However, the process does not end there. Certain additional steps are also required to ensure that your objectives are achieved in the most efficient manner. Finally, regular review of your plan and periodic adjustments are necessary in order to take updates in the law into consideration as well as changes in your personal situation and objectives.

Personal planning objectives and the estate planning process

The process of planning your estate must begin with identifying your objectives. It is difficult to plan unless you know where you want to be when the planning is complete. An estate planning attorney who does not start with the client's objectives is unlikely to achieve results that are entirely satisfactory for the client and his or her family. Estate planning objectives vary with the person; however, the ones that I most frequently hear from my clients are:

- Protecting my spouse after I die
- Avoiding probate
- Reducing estate taxes
- Passing on the family business
- Making gifts to my family or to charities
- Protecting my assets from lawsuits or creditors (referred to as "asset protection planning")

- Protecting my assets if I require nursing home care (referred to as "Medicaid planning")
- Managing assets in the event of my disability or incapacity

While each of these is a laudable goal, not all will apply to a client's situation. Consequently, it is important for the client to discuss his or her priorities with the attorney so that the estate plan will be consistent with the client's objectives.

Implementation of the estate plan

Once your objectives are identified, your attorney can prepare documents and take the steps necessary to implement your estate plan. The type and number of documents prepared for one client may be significantly different than for another. The most common estate planning documents are a will, power of attorney (often referred to as a "durable power of attorney"); trusts for children, grandchildren or others; living will; or revocable living trust. At a minimum, a complete estate plan will include *at least* a will, power of attorney for financial matters, power of attorney for health care, and a living will. In Washington (or other community property state), a married couple may have a community property agreement, although such an agreement is not appropriate under all circumstances and you should not sign one without the advice of your attorney. This handbook will review in detail the purpose, advantages, and disadvantages of each of the necessary documents, as well as many others that may be appropriate.

The process of completing an estate plan may take only a few weeks or several months—even years—depending on the client's objectives and circumstances as well as the complexity involved. A basic estate plan (including wills, trusts and powers of attorney) can be implemented in less than a month under most circumstances.

It is very difficult, if not impossible, to make changes to an estate plan after incapacity or death. If the plan is incomplete, outdated or mistakes were made in the planning process, your objectives may not be achieved. In addition, the expense in administering your estate may be substantially greater.

Involvement of professionals in the estate planning process

When preparing your estate plan, it is important to seek the advice and direction of a qualified attorney. It is generally best to select an attorney who emphasizes estate planning in his or her law practice to assist you with the planning process. Attorneys who emphasize other areas of the law, such as business, criminal or divorce law, are not likely to have expertise or experience in the area of estate planning. Only an attorney may legally assist you in the estate planning process, although your financial advisor, banker, accountant, and insurance agent may be significantly involved in the process as well.

Many law firms have entire departments committed to working with clients in the estate planning process and/or the administration of estates and trusts. These law firms will also have other departments devoted to business matters, real estate, or litigation. Other firms (called "boutique law firms") only offer estate planning or estate administration services.

Your estate planning attorney's professional qualifications are very important. However, it is equally important that you select an attorney with whom you are comfortable in the same way you are comfortable with your doctor or financial advisor. The attorney that you select may very well be the lawyer who assists your spouse or your family with a variety of legal affairs in the event of your incapacity or at the time of your death. This relationship may extend for many years—perhaps decades.

The process of identifying your goals and preparing an estate plan may also involve input from other professionals with whom you work. It may be important for your attorney to consult with your accountant, financial advisor, insurance agent, trust officer, or other professionals from whom you seek advice. Keeping the lines of communication open between you and your advisors will ensure that your estate plan will incorporate all of the appropriate considerations and opportunities.

Regular review of your estate plan

Changes in your personal and family situation often warrant review of your estate plan. For example, you should contact your estate planning attorney in the event of the incapacity or death of a spouse or child, retirement, or a substantial change in your financial circumstances.

In addition, your estate plan may be affected by changes in federal laws (such as tax and pension laws), state law (including the state probate code and trust law), and local laws affecting property rights (such as your real estate). When these laws change or new laws are implemented, there may or may not be a resulting need to update your estate planning documents.

It is generally recommended that you contact your estate planning attorney at least once every three years in order to review your current situation and to determine whether any changes in the law will have an impact on your estate plan.

Preparing for the estate planning process

The first step in the estate planning process is the initial conference with your estate planning attorney. Your attorney can be most effective if you prepare for the conference by considering your estate planning objectives (some of the most common are outlined above) and preparing a net worth statement so that your attorney can identify potential tax and other legal considerations. Also, it is helpful to consider who should be appointed as your fiduciaries, such as your executor, trustee, and health care representative.

Preparation for the initial conference also includes considering whether there are any special factors in your personal and family situation, such as the disability of a spouse or child or circumstances involving a family-owned business, that should be taken into account in the estate planning process.

Many attorneys use an estate planning questionnaire to assist their clients in preparing for the initial conference. Completing the questionnaire prior to the initial conference will help your attorney be as efficient as possible which, in turn, will reduce the legal costs in preparing your plan.

A sample estate planning questionnaire is included in the appendix to this handbook. You may also download this questionnaire from our firm's website at www.landerholm.com. Go to the Estate Planning Practice Group page and click on the link to the Estate Planning Questionnaire.

CHAPTER 2

CONCEPTS IN ESTATE PLANNING

Introduction

Before beginning the process of designing your estate plan, it is important to understand the various laws that impact estates and how these laws may apply in your circumstance. This chapter is intended to introduce you to some of these considerations.

Planning considerations for everyone

Of course, the final objective of any successful estate plan is to have property distributed to those people or organizations that you wish to benefit, at the time and in the fashion that you intend with the least possible tax cost. However, it is important to understand that simply signing a will (or other estate planning document) may not achieve this objective. The manner in which you own your property may result in a distribution of your estate that is inconsistent with the written provisions of your will or trust.

A will controls only the distribution of assets that are subject to probate (see Chapter 9). A variety of other methods will control the distribution of non-probate assets. In general, the other methods of distribution fall into one of two categories: operation of law and contract/agreement.

Because only assets subject to probate are distributed in accordance with the terms of a person's will, it is important to have an understanding of how the titling of assets will — or will not — be consistent with the terms of your estate plan. In my experience, it is quite common for an asset to be distributed in a manner that is different than the intent of the client, at least as such intent was expressed at the time the estate planning documents were signed.

Operation of Law

The term "operation of law" refers to a variety of distribution mechanisms that rely on the law (typically the laws of the state where the assets are located) to determine the rightful recipients of the assets following a death. While there are many forms, common examples include joint tenancy with right of survivorship, transfer-on-death accounts, and pay-on-death accounts. These assets will be distributed to those individuals designated as joint owners (referred to as "joint tenants") or death payees immediately upon your death.

Assets held in your name along with another person (referred to as a "joint tenancy") with right of survivorship commonly include bank accounts and accounts held at other financial institutions. United States Treasury instruments (such as savings bonds) may also be held in joint tenancy with right of survivorship, as can real estate. Such assets will not be subject to the terms of your will.

For example, if your will provides for an equal distribution of your estate to children but you name one child as a joint owner with right of survivorship on your bank accounts, your assets will not be distributed equally among your children. The joint tenancy bank account will be distributed to one child, and only the other assets that are subject to probate will be divided equally among all of your children. If the child receiving the joint assets with right of survivorship elects to share a portion of the joint account with others, this will constitute a gift and, if substantial enough in value, may result in adverse tax consequences to the child making the gift.

Joint ownership (with or without right of survivorship) may also be subject to the claims of the joint owner's creditors. Thus, it is generally not recommended to name another person as a joint owner on any of your assets. There are several other estate planning strategies that are available for achieving the same benefits of joint ownership without the risks inherent in such an approach. These strategies are reviewed in detail throughout this handbook.

Contract or Agreement

Your estate may also be distributed by contract. This merely refers to the fact that you and another person (or entity such as an insurance company) have agreed to distribute your assets in accordance with your instructions. The two most common types of distribution plans subject to a contract or agreement are assets that are subject to the terms of a trust and assets that will be distributed according to a beneficiary designation.

The term "trust" refers to a form of legal relationship between the creator of the trust (referred to as the "settlor" or "trustor") and the person responsible for the management and distribution of the trust assets, (referred to as the "trustee"). The trustee must hold the assets of the trust for the benefit of the beneficiary who is the person or persons entitled to benefit from the assets held in the trust. There are many different forms of trusts and these are discussed in greater detail in Chapter 4.

The other common form of distribution under the terms of a contract or agreement is a beneficiary designation. Similar to a payable-on-death or transfer-on-death account described above, a beneficiary designation is an agreement between you and another party to distribute your assets in accordance with your instructions following your death. Common

Caution: It is critically important to recognize that the beneficiary designation on an asset will control over the terms of your will or other estate planning documents. If the beneficiary designation is inconsistent with the terms of your will or living trust, your objectives cannot be achieved or will, at the very least, be compromised.

examples include life insurance policy death benefits paid at your death and retirement plan benefits (including individual retirement accounts). Beneficiary designations may be revocable or irrevocable.

Probate

The term "probate" refers to the legal process of transferring your assets (referred to as the "estate") at the time of your death to those who are entitled to receive your property. Each state has laws regarding probate. Only those assets that cannot be distributed in some other way are subject to probate. The particulars of the probate process are discussed in greater detail in Chapter 9.

If you do not have a valid will at the time of your death, state law controls the distribution of your estate. The process of distributing assets of a decedent who died without a will is called "intestate succession" and is discussed further in Chapter 3.

Planning considerations for married couples

In addition to the factors outlined above, there are several other issues that married couples must take into consideration in the planning process. Some of these questions include: Will the children benefit from the estate at the first death or only after both spouses have died? Are there estate taxes likely to be due at the surviving spouse's death that can be minimized though proper planning now? Are there problems surrounding the children and other beneficiaries from this marriage or from a prior marriage (the blended family)? Are both spouses equally able to manage the estate after the first spouse's death, or should the estate plan consider the need for assistance with the management of assets if the "less capable" spouse survives? All of these questions, and many others, should be addressed in the planning process.

Property ownership considerations

Property ownership is a key component in the estate planning process. Whether the assets of the estate are owned by husband, wife, or both—with or without others—must be determined and factored into the plan.

As a general rule, property rights are determined by state law. The state in which real property is located will control the rights respecting real property, while the law of the state of a person's residence will control rights regarding personal property.

In the marital planning setting, states are either community property states or common law states. Oregon is a common law state and Washington is a community property state. Estate planning in the Northwest can be complicated because Oregon is surrounded by community property states. Washington, California, Idaho, Nevada, New Mexico, and Arizona (along with a few others) are community property states. Alaska has an elective community property regime.

In common law states, the title to the property in question will likely control its ownership. For example, property held in the names of both spouses will be deemed to be equally owned unless there is evidence to the contrary. Property held in the name of only one spouse will, likewise, be deemed to be owned by that spouse.

Conversely, the title to the asset is almost meaningless in a community property state. Instead, community property law considers the "source" of the asset to determine its ownership. For example, under most circumstances, assets acquired during the course of the marriage (including the income earned by each spouse) is community property and is, thus, owned equally by both spouses (the "marital community") regardless of the title on the deed or account.

One common exception to this rule occurs when assets are acquired by gift or inheritance. In community property states, a gift or inheritance received by one spouse during the course of the marriage is the separate property of that spouse and will not become community property unless the owner spouse chooses to convert it to community property. However, some community property states (such as Idaho) nonetheless characterize the income and increase in value (appreciation) of a spouse's separate property as community property.

Assets owned by a spouse prior to marriage is another exception. Such assets may be retained by the spouse as his or her separate property, or converted in whole or in part to community property.

In preparing a comprehensive estate plan the estate planning attorney must consider the source and ownership of the assets owned by the spouses. Whether the couple lives in a community property or common law state, it may be necessary to modify the ownership rights of the spouses to achieve their estate planning objectives.

Similar to the property ownership considerations outlined below, the estate planning attorney must also consider the proper beneficiary designations to be utilized in coordinating the estate plan for the married couple. Assets such as life insurance, annuities, qualified retirement plans, and individual retirement accounts will most likely be distributed in accordance with a pre-established beneficiary designation. An incorrect beneficiary designation will thwart the effectiveness of the estate plan and may result in substantially increased estate and income taxes.

The Blended Family

Second (or more) marriages have become very common in our society over the last fifty years. As a result, it is common that one or both spouses may have children from a prior marriage (step-children to one of the spouses) as well as children together. Special attention is necessary to plan for such situations.

Similarly, your children may also have step-children. It is common that these step-grandchildren are treated the same as grandchildren by blood or adoption. However, step-grandchildren have no legal rights in your estate; therefore, if you wish them to benefit along with your grandchildren, you must name or properly designate them in your will or trust.

Planning to protect children in blended families can be complicated, but many strategies are available that can protect each spouse's side of the family. Many forms of trusts (described further in Chapter 4) may be used to benefit the surviving spouse during his or her lifetime while providing for the ultimate distribution of assets to the children (and their descendants) of the first spouse to die. In some cases giving your surviving spouse the right to live in your home for his or her life (referred to as a "life estate") may be a viable and relatively simple approach. At the end of your spouse's life, the home will pass to your children (or other intended beneficiaries).

Note that making provisions for your descendants (i.e., the step-children of your spouse) is not a matter of whether the spouses trust one another to distribute the accumulated estate to both sides of the family. Instead, this issue is based on individual circumstances and how those circumstances may evolve following your death. If, for example, your spouse has limited contact with your children at the present, it is not likely that the communication between them will increase (or even exist) after your death. Thus, you cannot reasonably expect your spouse to provide for your children in any significant manner at his or her death, especially if your spouse has his or her own children. Your estate plan must provide a sense of security to your spouse and children after your death, rather than being a source of conflict.

Estate taxation considerations

As discussed in greater detail in Chapter 5, the United States Internal Revenue Code ("IRC"), along with numerous states, imposes a tax on a decedent's estate. Generally, the tax is imposed on all assets owned at death. In some cases however, assets that you do not own at your death will also be taxed as part of your estate. These assets include those that may be subject to your control or from which you receive a benefit.

Subject to certain important exceptions, transfers between spouses during life and at death are not subject to gift or estate taxes. The "marital deduction" allows the value of the taxable estate to be reduced by the amount of any assets distributed to a surviving spouse. Outright transfers, transfers to a qualifying trust for the surviving spouse, life estates, and certain annuities will qualify for the marital deduction.

Caution: This discussion and the discussion that follows assumes that the surviving spouse is a United States citizen. The availability of the marital deduction is significantly reduced for non-citizens.

Another important provision of tax law is the applicable exclusion. The applicable exclusion amount may be used at death to partially or completely shield your estate from estate taxes, during lifetime to offset gift taxes otherwise payable, or a combination of the two. Currently the applicable exclusion for gift tax purposes is $1 million, and for estate tax purposes is $3.5 million. The 2001 Tax Act provides for an estate tax applicable exclusion amount to $3.5 million in 2009, a repeal of all federal estate taxes (but not gift taxes) in 2010, and a return to $1 million as the exclusion amount in 2011. (See Appendix 2 for additional information about the 2001 Tax Act and its provisions on other tax issues related to estate planning.)

Caution: If the applicable exclusion is not used at the time of the first spouse's death, it will be wasted and cannot be used when the surviving spouse dies and distributes his or her estate to children or other intended beneficiaries. Thus, if you leave your entire estate to your spouse, there will be no estate tax to pay since the transfer will qualify for the marital deduction. However, your spouse will only have his or her applicable exclusion amount available to offset estate taxes at the time of his/her death.

Estate tax rates begin at 16%. The maximum rate at which estate tax or gift tax is payable is 45% until 2011, when the highest rate returns to 55% .

The applicable exclusion amount is part of federal tax law. Many states also impose an estate (or inheritance) tax of one form or another. For example, in 2009 the applicable exclusion amount available in the Internal Revenue Code is $3.5 million. However, Oregon will only have a $1 million exclusion amount, and Washington will have a $2 million exclusion.

Needless to say, proper tax planning can be a critical component to your estate plan. Seeking advice from a capable attorney with experience in implementing strategies for the purpose of minimizing or eliminating estate tax can have a dramatic impact on the amount of your estate that reaches your intended beneficiaries.

Special considerations for the unmarried cohabitant

The increase in the number of unmarried couples (both heterosexual and homosexual) in our society has given rise to some special and particularly complex issues in estate planning.

Neither Oregon nor Washington recognizes common law marriage. However, both of these states, among others, have passed laws that grant certain rights to domestic partners as though the partners were legally married. The partners must meet specific qualifications and register their domestic partnership with the appropriate state office for the benefits of the laws to apply to their partnership.

Some of the rights that are granted under these laws include hospital visitation, the authority to give consent for medical procedures and the authority to control the disposition of a deceased partner's bodily remains. Furthermore, the laws grant to the surviving partner certain rights to receive a portion of the deceased partner's estate. However, a properly registered domestic partnership should not be viewed as a substitute for proper estate planning. Furthermore, none of the rights granted under these laws will apply to the unregistered domestic partnership.

Furthermore, unmarried cohabitants are not considered married for estate and gift tax purposes. Thus, transfers between unmarried partners during lifetime or at death are subject to gift and estate tax without the benefit of the marital deduction. However, most of the estate tax planning strategies that are utilized to reduce estate taxes are available to the unmarried couple.

More profound and painful are the issues that surround health care and personal decision-making during incapacity. In the absence of a durable power of attorney for health care or a properly registered domestic partnership, an unmarried partner has no legal right to make health care decisions for his or her partner during incapacity. State law presumes that a person would want a family member (such as parents or siblings) to give instructions to physicians and healthcare providers, not the partner. The partner also has no right to be appointed as guardian or to make funeral and burial arrangements.

These concerns can be overcome by a carefully drafted durable power of attorney for health and personal care. This durable power of attorney should include such powers as the authority to consent to medical procedures, to gain access to medical records, to hire and discharge medical personnel, to place a partner in appropriate health care facilities (including convalescent care), and to have the right of first priority for visitation in such facilities. In addition, the durable power of attorney may provide for the authority to take possession of personal property; to make funeral arrangements, and to take custody of human remains, including consenting to an autopsy.

An estate plan (including wills, trusts and appropriate beneficiary designations) will minimize complications in the transfer of an estate to a partner and other beneficiaries. Proper planning should be completed well before incapacity in order to ensure that objectives are achieved and to minimize the likelihood of a will contest or other litigation in the estate.

Incapacity

The term "incapacity" refers to the inability to make informed decisions regarding one's health and personal care, to properly manage one's financial affairs, or both. While the term defies a clear and concise definition, most people know it when they see it. Actions that others may deem to be unusual or eccentric do not necessarily mean that a person is incapacitated. Until we become incapacitated, we continue to have the right to make decisions for ourselves. The right of self-determination is fundamental to living in our society.

However, planning for incapacity is a critical part of any thorough estate plan. The days of living a healthy and physically fulfilling life up to the moment of death are over. Today, each of us must plan for a period of disability or incapacity. Death by accident or as the result of a critical and short-term medical emergency is rare.

If you fail to properly plan for incapacity, it is likely that a guardianship will be required in order to address the management of your financial affairs and give informed consent for your personal and medical care. A conservatorship or guardianship of the estate is used for the former, and a guardianship or guardianship of the person for the latter. One or both may be necessary depending on the gravity of your incapacity.

In the chapters that follow, several relatively simple and inexpensive options to guardianship are discussed.

Types of fiduciaries

The term "fiduciary" means a person (or institution such as a bank) appointed to act for the benefit of another. Common fiduciaries include the executor of your estate (called the "personal representative" in Oregon and Washington) or trustee of a trust. An attorney-in-fact under a power of attorney and a guardian are other types of fiduciaries.

Personal Representative. Commonly referred to as the "executor," this person is responsible for handling the administration of your estate after death. This administration is called "probate." The personal representative may be named under the terms of your will, or if you die without a will or the person or persons named in your will as personal representative(s) cannot serve, the court will appoint an appropriate individual to serve.

The basic duties of the personal representative include taking possession of your assets (called "marshaling"), giving notice of the probate to your heirs and those who are entitled to receive your estate, determining your debts and giving notice of the probate to your creditors (referred to as "notice to creditors"), filing your final income tax return and estate tax return (if required), managing and investing your estate, and distributing your estate in accordance with your will or state law.

Attorney-in-fact. The attorney-in-fact, often called an agent, is the person you appoint under a durable power of attorney to handle your financial affairs. Some durable powers of attorney become effective at the time of execution while others only become effective at the time of incapacity. Some powers of attorney are effective for a defined amount of time or for a specific purpose; however most durable powers are effective from the time of incapacity through the time of death.

An attorney-in-fact can have very broad powers including the purchase and sale of real estate, power to invest your assets, pay your bills, sign tax returns, and make gifts of your assets.

You may also appoint an attorney-in-fact to make health care decisions for you if you are incapacitated. Similar to the person acting under a financial power of attorney, the person acting under a health care power of attorney can have very broad powers, including the ability to give direction regarding the removal and withholding of life-sustaining treatment if you are terminally ill or in an irreversible coma.

Trustee. The term "trustee" is used in many areas of the law. In estate planning, the term trustee refers to the person or entity (such as a bank) that is appointed to manage the assets of another under the terms of a trust. A trust may be established under a will (referred to as a testamentary trust) or during lifetime (known as a living trust). For a more thorough treatment of trusts, see Chapter 4.

As with other fiduciaries, a trustee owes the highest duty of loyalty under the law to those persons entitled to benefit from the trust (called the beneficiaries). Common duties of a trustee include the investment of the trust assets (such as real estate, stocks and bonds, personal property, and businesses), working with the trust's advisors (such as the accountant, lawyer and investment advisor for the trust), filing necessary tax returns, advising beneficiaries on the proper management of the assets distributed from the trust to the beneficiary, and many more.

In addition, it is advisable to name one or more successor trustees. Thus, if your primary trustee is unable or unwilling to serve or dies prior to the time determined for terminating the trust, a successor is named to take over the management of the trust. A third party (often called a "trust protector") or even the beneficiaries of the trust, may be given the authority to remove trustees for proper reasons and to appoint successor trustees.

Unlike a personal representative, whose term of service may only last several months to a few years, a trustee may be required to serve as such for many years, even decades. Therefore, one of the considerations in selecting a trustee is that person's ability to serve during the entirety of the trust. For many long-term trusts, it may be appropriate to name a bank or other financial institution as trustee or successor trustee to ensure that the assets will be properly managed during the entire term of the trust.

Guardian. The law recognizes two forms of guardian: the guardian of the person and guardian of the estate. The guardian is appointed to serve as an advocate, advisor, and often caretaker for a person who lacks the ability to properly manage his or her personal care and financial affairs. The person needing the guardianship is called the "incompetent," "ward" or "incapacitated person." Most states have replaced antiquated terms such as "incompetent" and now use the generic reference "incapacitated person" to identify any person in need of a guardianship.

The guardian of the person is responsible for the personal care of the incapacitated person. This may include ensuring the incapacitated person's living arrangements are proper, seeing to his or her health and personal care, serving as a companion during trips away from home, and acting as an advocate for the incapacitated person's medical care and legal needs.

The guardian of the estate (called the "conservator" in many states) is responsible for the financial affairs of the incapacitated person including handling investments, collecting income, payment of bills, and working with providers of services to the incapacitated person.

Guardianship proceedings are initiated in the court, generally in the county where the alleged incapacitated person resides. The judge will appoint a guardian ad litem to evaluate the case and report to the court regarding the propriety of the guardianship and the appointment of a guardian. Usually, a member of the incapacitated person's family will be appointed as guardian, although at times the appointment of a professional guardian is required. The decision is solely in the discretion of the judge.

An inventory of the incapacitated person's assets must be filed with the court. In addition, the guardian is generally required to file an annual accounting of the income and expenses incurred by the guardian on behalf of the incapacitated person. Guardianships are a matter of public record; thus, the personal and financial affairs of the incapacitated person are available for anyone to review.

Guardianships are also expensive. Due to the complications associated with the legal proceedings, attorneys' fees can be substantial. In addition, accountants and other professionals may be required. The guardian ad litem is also paid from the guardianship. Finally, the guardian must be bonded. A guardianship bond is an insurance policy that protects the incapacitated person if the guardian makes a mistake resulting in a financial loss to the incapacitated person's estate.

Selecting your fiduciaries

Selecting your fiduciaries can be one of the most complicated and difficult parts of the estate planning process. Many clients default to using children or other family members without considering the complexities of such choices.

In selecting your fiduciaries, consider such factors as their background and education; personal temperament and concept of fairness; special abilities and training; and willingness to seek the advice of appropriate experts (such as an attorney, financial advisor and accountant). Individuals who, for example, lack the ability to make reason-based decisions in their own lives or ask for (and listen to) the advice and guidance of professional advisors are not likely to make good fiduciaries.

Each of us has certain talents, capabilities, and weaknesses. As a result, the parties that you appoint to manage assets and financial matters may be different from the parties to make health care and personal care decisions for you. Another factor to be considered is whether the proposed fiduciary will have the time and interest to take on the responsibility of serving in a fiduciary role for you.

You should also consider the use of a professional trustee such as a trust department at a bank or other financial institution. This is especially true if, after considering the factors above and other issues relevant to your situation, you are unable to identify individuals to serve satisfactorily in one or more of the fiduciary roles that will be needed to carry out your estate plan.

The use of a professional fiduciary has many benefits including investment management, bill paying, training minors and adults with limited experience in the proper management of their financial affairs, and the preparation of necessary tax returns. In addition, the professional fiduciary has perpetual existence; it cannot die or become unable to handle your financial affairs.

Also, consider the duration of time that your fiduciaries will likely have to serve. The person you choose as your personal representative may only have to serve for a short period of time—several months to two years in most cases. However, incapacity may last for many years and your trustee or attorney-in-fact will be responsible for your financial and heath care during this entire period.

Logistics matter as well. If you live in the Pacific Northwest, a fiduciary living on the East Coast may find it very difficult to handle your ongoing financial affairs and make your health care decisions from a distance, even with the broad spectrum of communication devices available today. This is less of a concern when it comes to handling your estate. Usually, a trustee or personal representative can administer your estate from a distance with little difficulty.

Careful consideration of the parties to serve in the various roles will be beneficial to you during incapacity and to your beneficiaries following your death. In short, the selection of your fiduciaries may be one of the most important aspects of planning your estate.

CHAPTER 3

ESTATE PLANNING TOOLS

Introduction

Everyone's situation is different—their personal and family situations, financial resources, estate planning objectives, and the particular needs of their family. Therefore, every estate plan is different. There may be common elements such as a will, trust, durable power of attorney, etc., but each plan will be unique. It should be designed to achieve your objectives. Your estate planning attorney, in conjunction with the advice of other professionals, will assist you in making the important decisions regarding the proper legal documents necessary to complete your estate plan.

The purpose of this chapter is to review the basic legal documents and procedures necessary to complete an estate plan. More complicated estate planning strategies, including the use of trusts, estate and gift tax reduction techniques, planning for Medicaid and government assistance, and asset protection planning will be covered in other chapters. If your current estate plan does not cover the basics outlined in this chapter, it is likely that your plan is incomplete and will not achieve your objectives. Poor or incomplete planning, like no planning at all, will result in increased expenses in the administration of your estate and the possibility that your objectives will not be achieved.

What is a will, and why is it so important?

It is helpful to think of a will as a blueprint. It tells your family, the court, and taxing authorities how your estate is to be administered and distributed.

Your will has no effect until your death; it is purely a testamentary document. After death your will is submitted to the court for review and approval and to appoint the personal representative of your estate. This is the beginning of the probate of your estate. Probate is discussed in detail in Chapter 9.

The Personal Representative

An important part of every will is the designation of the person you wish to administer your estate (referred to as the "executor" or "personal representative"). If your personal representative is willing and able to serve, and if the person otherwise qualifies under the law, the court will appoint the person you designate. If there is no person named in your will who is able or willing to serve, the court will appoint someone to serve as the personal representative for your estate. This may be another member of your family, or other qualified person or institution (such as a bank). Persons convicted of certain crimes are not allowed to serve as personal representatives. The person you designate in your will as a personal representative need not be a resident of your state.

Dying Without a Will

If you do not have a will at the time of your death (or if it is otherwise determined to be invalid or ineffective for whatever reason) you are said to have died "intestate." This means that the court will appoint a personal representative for you from a list of potential appointees under state law.

In addition, your estate will be distributed to those individuals who are entitled under state law (called "intestate succession"). This means that certain individuals, and perhaps the state of your residence or wherever you owned property, will receive your estate even if you would have not chosen to benefit them had you written a will.

Creating a Valid Will

The requirements of a valid will are fairly simple. First, a will must be in writing. Oral wills are recognized only under very limited circumstances. Second, the will must be witnessed. At least two witnesses are required. The witnesses should be disinterested, meaning that they will not receive any benefit from the estate. Many states, including Oregon and Washington, have relaxed these requirements but the consequences can be severe, so the use of an interested witness should be avoided.

The will should be signed before a notary public or signed by the witnesses in the form of a declaration that is recognized under state law as having the same effect as testimony in court. This will allow the court to admit your will into probate at your death without further testimony as to the circumstances of your execution of the will. This will reduce the time and cost of having your will entered into probate.

Distributions under the Terms of Your Will

Your estate may be distributed in many ways under the terms of your will. Again, your objectives will dictate how your will is drafted so your estate is distributed to your intended beneficiaries.

Every complete will should include a residuary clause. This is the provision that distributes the residue (also called the "remainder") of your estate to the people that you wish to benefit and in the manner that you wish them to benefit. If there is more than one person to benefit, the distribution of the residue can be made equally among them or by shares or percentages.

Many people also like to include specific gifts (called a "specific bequest") in their will. This can be in the form of a specific asset ("I give my mother's wedding ring to …") or a fixed dollar amount ("I give the sum of $500 to …"). If the particular asset given as a specific bequest (e.g., the wedding ring) is not in your estate at your death, it is said to "lapse" and the person designated will receive nothing from your estate unless you have made an alternative gift to him or her in your will.

Many states allow you to include a provision in your will that indicates your intent to create a list of personal possessions to be distributed to the persons designated on the list. This list may be modified at any time without the need to change your will. This can be an efficient approach to dealing with the distribution of your personal items. The list must be executed with the formality that is required under law; anything short of exact compliance with the law will render the list void. Furthermore, the list cannot be used for the transfer of real estate or intangible personal property such as cash or financial assets. At present Washington State law allows for the use of the tangible personal property list, while Oregon law does not.

As to a specific bequest or a fixed dollar amount, it is important to note that these will be paid before the gift of the residue of your estate. Thus, if you include several specific distribution of large dollar amounts, there may not be much left for the beneficiaries of the residue of your estate.

It is also important to remember that the costs of administering your estate (such as legal fees, funeral expenses, taxes and debts) will need to be paid before your estate is distributed. Thus, using several specific gifts may be complicated if the estate has limited cash to pay these expenses.

Gifts "In Trust"

Usually, the time of death cannot be predicted with any accuracy. Thus, your will must be drafted with enough flexibility to take into consideration changes in circumstances over time. A will needs to be modified from time to time to take into consideration changes in life and in the law that cannot be anticipated.

For example, if your intended beneficiaries are minors or otherwise lack the maturity to handle their inheritance if you died sooner than expected, you do not want to draft your will assuming that you will live your natural life expectancy. Some beneficiaries may never be able to properly manage their inheritance. These beneficiaries include the disabled, especially those who are receiving benefits from a governmental agency due to disability; those facing a major financial crisis such as bankruptcy or other creditor-related problems; and those who, for whatever reason, never gained the skills necessary to properly manage money (often called "spendthrifts").

In these cases and others, the use of a trust is appropriate. A trust is a set of instructions in a will directing that a person's inheritance is to be held in a trust for the benefit of that person and not distributed outright. The will also appoints a trustee who will hold, manage, and distribute the assets (referred to as the "trust estate") for the benefit of the named individual. Trusts are covered in detail in Chapter 4. A trust can be as unique and flexible as necessary to meet the needs of the beneficiary, and as a result, the trust provisions need to provide direction to the trustee as to when and how distributions should be made to the beneficiary. Trusts can last for a term of years, until the beneficiary reaches a specified age or accomplishes certain objectives, or even for the lifetime of the beneficiary and beyond.

Most importantly, it is essential to be realistic about the capability of the persons who will benefit from the estate. Giving an inheritance to a person who is not capable of managing money is not a gift, it is a burden. Most likely, the inheritance will be lost to poor decisions, the beneficiary's creditors, or expenses that would have otherwise been paid by a government program that the beneficiary would have been eligible for had the inheritance not been received.

What Assets Does My Will Control?

A common misunderstanding is what assets your will controls at death. Many people believe the will controls the distribution of all of their assets at death; however, this is not true. A will only controls the distribution of assets that have no other means of being distributed. Thus, for example, bank accounts owned with another person at your death "with right of survivorship" will pass to the surviving joint owner. Likewise, assets with beneficiary designations are not controlled by your will. These assets include annuities, life insurance policies, and retirement accounts.

The community property agreement

The community property agreement, which is a contract between a husband and wife, is available in many community property states. In general, the community property agreement has three prongs. First, it will state that all of the assets owned by the couple are their community property. Second, the community property agreement may include a clause that will convert property acquired after the execution of the community property agreement into community property. Finally, the community property agreement may include a clause that will distribute all community property to the surviving spouse when one spouse dies. The third clause is authorized under Washington law but not necessarily in other community property states.

Community property agreements are appealing to couples because they are simple and will allow the surviving spouse to avoid probate on the death of one of the spouses. However, there are several disadvantages to the community property agreement and you should not sign one without the advice of an estate planning attorney. Some of these disadvantages include:

- Increased estate taxes at the surviving spouse's death. Since the entire estate is transferred to the surviving spouse under the community property agreement at the first death, there is no opportunity to use the estate tax exclusion amount on the first spouse's death. See Chapter 6 for a discussion on estate tax planning for the married couple.
- No planning for the protection of assets and eligibility for Medicaid and other benefits if the surviving spouse requires long-term care. Certain trust provisions can be included in your will that will protect assets on the first spouse's death should the surviving spouse require long-term care and want to maximize the opportunity for eligibility for government benefits such as Medicaid. See Chapter 11 for a discussion regarding eligibility for Medicaid and other government benefits.
- For couples with children from prior to their marriage, the community property agreement may result in the disinheritance of the children of the first spouse to die.
- Conversion of gifts or inheritances into community property. Gift and inheritances received by one spouse during the marriage are generally separate property. A community property agreement with the second prong outlined above will convert these gifts and inheritances into community property. The objectives of the couple must be considered before signing a community property agreement that includes the second prong.

The durable power of attorney

An integral part of any complete estate plan is the durable power of attorney. Planning for incapacity is an important part of proper estate planning. During incapacity, someone needs the authority to manage your financial affairs, including such tasks as paying your bills, filing your tax returns, and managing or selling your assets. Traditionally, a court-appointed guardian has been used for this purpose; however, guardianships are expensive and time consuming.

The durable power of attorney is intended to give you the authority to appoint someone for this purpose before you become incapacitated. In your durable power of attorney you appoint an attorney-in-fact to manage your financial affairs and make decisions for you. Alternate attorneys-in-fact can be appointed, as well, should your primary appointee be unable or unwilling to serve.

Your attorney-in-fact has broad powers and a significant level of authority over you and your property. Carefully consider whom you name to exercise these powers. You do not want the appointment of your attorney-in-fact to be the source of friction in your family or a cause for litigation.

Your durable power of attorney can be revoked at any time during your life and is revoked at your death. Your attorney-in-fact has no authority to manage your assets after your death; this is the responsibility of your personal representative.

In addition, your durable power of attorney may be revoked by a court if a guardian is appointed for you.

Many states also include restrictions on the authority of the attorney-in-fact to engage in certain transactions. For example, the power to change your estate planning documents, transfer assets to a trust for your benefit, make gifts of your assets to others, and certain other powers must be specifically referenced in the durable power of attorney or the attorney-in-fact will not be able to exercise these powers. There may be significant adverse tax consequences to granting these powers to individuals who will also benefit from your estate. Your estate planning attorney can counsel you on the propriety of including these powers and who should be named in your durable power of attorney to exercise them.

Furthermore, the Internal Revenue Service may not recognize the validity of a gift made under a durable power of attorney unless the attorney-in-fact is granted the specific authority in the durable power of attorney to make gifts. The power to make gifts may be important to reduce estate taxes payable at your death.

Health care and personal decision-making

The ability to have health care and personal decisions made during incapacity is a very important part of any thorough estate plan, perhaps the most important part. Certainly, how we are treated during incapacity is at least as important as when we are fully competent.

All states have enacted some form of legislation to address this concern. Most states such as Washington, allow you to execute a health care power of attorney and a living will. Some states, such as Oregon, have combined these two instruments into a single document, know as an Advanced Directive. Regardless of the form, the purpose is the same.

As the name implies, a health care power of attorney authorizes another person or persons to make decisions for you in the event of your incapacity and inability to give consent for treatment. A health care power of attorney will most likely also cover such areas as access to medical records, consent to work with your insurance providers (including Medicare), determining a proper placement care facility, and enforcement of your objectives regarding the use of extraordinary measures to prolong your life (often referred to as "life support").

A living will, referred to as a Health Care Directive in Washington, is your statement regarding the use of extraordinary measures to prolong your life if your health care provider has determined that you are not likely to survive without the use of such measures. Most living wills now cover medical conditions that are certified by your health care provider as terminal as well as an irreversible coma.

Asset ownership and beneficiary designations

The form of asset ownership is very important in achieving your estate planning objectives. Proper designation of your beneficiaries on such assets as life insurance policies and retirement accounts is also critical in achieving your objectives. The reason is that your will or living trust can only control the distribution of your assets if the ownership and beneficiary designations are designed properly.

Many very well-written wills have failed to operate as the testator intended due to poor decisions made during life regarding the ownership of assets. If assets are owned or titled in a manner that is inconsistent with the terms of the will, there may be an increase in estate taxes, inadvertent gift taxes, family conflict, and/or other problems. Poorly planned beneficiary designations can have the same results.

A common example of this is where a parent places a child on the parent's banking or investment account. This is often done to provide for access to the account in the event of the death or incapacity of the parent. Unfortunately, most of the time this creates a joint tenancy with right of survivorship and the parent may be overriding the terms of his or her will by doing so.

The steps of designing the ownership of your assets and proper beneficiary designations are part of any thorough estate plan and you should discuss this matter with your estate planning attorney. Ask that the ownership and beneficiary designations be put in writing for you as part of the planning process.

It may be necessary to re-title assets that you currently own at the time your estate plan is implemented. In addition, it will be very important to follow the instructions with regard to titling when new assets are acquired or new accounts are opened in the future.

CHAPTER 4

TRUSTS

Introduction

In general terms, a trust is the creation of a right to property that is held by one person for the use and enjoyment of another. The person who holds the property is referred to as the "trustee" and the person who will benefit from the property is the "beneficiary." A trustee is a fiduciary under the law and is obligated to manage the property of the trust for the benefit of the beneficiary (and not for his or her own benefit) and to follow the directions of the trust and applicable law. No higher duty of one person to another exists in the law than that of a fiduciary.

In any given trust there can be one or more beneficiaries. The rights of those beneficiaries to distributions from the trust are defined by the trust document as well as applicable law. Some beneficiaries (referred to as the primary beneficiaries) have the current right to benefit from the trust property. Other beneficiaries (referred to as secondary beneficiaries) only benefit after the rights of the primary beneficiaries have terminated under the terms of the trust.

For example, a wife may create a trust that will hold her assets after she has died for the lifetime benefit of her husband if he survives. During his life, the husband is entitled to receive the income of the trust and may receive the trust principal if necessary for his health and general welfare. After the husband dies, the children of the wife receive the assets of the trust. In this case the husband is the primary beneficiary—receiving the current benefit of the trust for his lifetime, and the children are the secondary beneficiaries—receiving the assets only after the husband's death.

There are many types of trusts, some of which will be explored in this chapter and some in other chapters.

Trusts generally fall into two categories: living (or what the law refers to as *inter vivos*) and testamentary. Living trusts, as the name implies, are trusts that are created during the trust creator's lifetime. The creator of a living trust is called the trustor, settler or grantor. Testamentary trusts are established at death under the terms of the decedent's will or as part of a living trust described above. Living trusts can be revocable—that is, the trustor can revoke or change the trust at any time—or irrevocable, meaning that the trust, once executed, is not subject to change or revocation.

Trusts are very flexible and can provide many different benefits based on the client's objectives. For example, certain irrevocable trusts can be used to reduce estate taxes, provide for deferred gifts to charities, protect assets from creditors, or shelter assets in the event the beneficiary requires long-term care or is receiving government benefits. Other irrevocable trusts are used to allow the intended beneficiary more time to develop the necessary level of maturity to properly manage the assets of the trust or for those individuals who may never achieve the necessary level of financial capability. Such trusts may last for the lifetime of the trust beneficiary.

Living trusts

As stated above, living trusts are established during the life of the trustor. Living trusts fall into two categories: revocable and irrevocable.

Revocable Living Trusts

The revocable living trust has become a bit of a phenomenon in the estate planning world over the last thirty years. Revocable living trusts are often referred to as "will substitutes" but they offer many other benefits in addition to the distribution of your estate at death. They are flexible estate planning tools and include the following common benefits:

- The trustor may be his or her own trustee and, therefore, may have complete control over the assets of the trust.
- The revocable living trust allows the trustor to benefit from the trust by receiving all of the trust income and access to the principal of the trust during life.
- The trustor may name his or her own successor trustees; that is, who will become the trustee when the trustor dies or becomes incapacitated.
- If the trustor becomes incapacitated, the revocable living trust can be used to provide for the efficient management of the trustor's assets during the incapacity.
- The trustor may control when and how the trust assets are distributed after the trustor's death.
- Finally, the trust assets will be distributed to the secondary beneficiaries of the trust without the necessity of a probate of the assets.

Many of these benefits may be important in your personal situation. However, the advice of a qualified estate planning attorney is essential to help you reach this decision. The proper implementation of a revocable living trust is difficult and should not be undertaken without considering these difficulties and the available alternatives.

It is also important to remember that no matter how well-drafted a revocable living trust is, it cannot be fully effective if your assets are not contributed to the trust. If you establish a revocable living trust but do not transfer your assets to the trust, it will not work efficiently. For example, if you become incapacitated, a guardianship or conservatorship may still be necessary; and at your death a probate may be necessary for any assets that you own and did not contribute to your revocable living trust.

Depending on your state of residence, there may be some disadvantages to having a revocable living trust. For example, in some states your estate may not take advantage of the notice to creditors procedure that is available in a probate proceeding.

Irrevocable Living Trusts

The irrevocable living trust is used less often and for different purposes than a revocable living trust. Generally, the irrevocable living trust is used where the purpose of the trust would fail if the trustor retained the power to amend or revoke the trust.

In using an irrevocable living trust, the trustor creates the trust and transfers certain property to the trust with the intent that the assets of the trust will be used for the trustor's benefit or for the benefit of another person or persons. As with other trusts, the terms of the irrevocable living trust control the distributions that are made to the beneficiaries.

Frequently, an irrevocable living trust is used as part of a plan to save estate and/or gift tax. For example, the trustor may transfer assets to a trust that incudes the appropriate provisions required under the Internal Revenue Code so that the transfer to the trust will have minimal, if any, gift tax consequences but will transfer the trust assets to the trustor's heirs without estate tax. If the trustor wishes to make a gift to a combination of charities and individuals (including the trustor), certain types of charitable trusts may be used. See Chapters 6, 7 and 8 for further discussion of these planning strategies.

An irrevocable living trust may also be used in circumstances where the trustor lacks the ability to properly manage assets due to mental impairment or poor judgment. These trusts may be established where the trustor is competent or by a third party (such as a court). In these circumstances, the outright ownership of the assets would reduce or eliminate the benefits that the trustor would otherwise be entitled to receive from one or more governmental programs such as Medicaid and Supplemental Security Income. An irrevocable living trust may be used under the proper circumstances to allow the trustor to continue to benefit from the assets of the trust without losing these important benefits. See Chapter 11 for a further discussion regarding these benefits and the use of trusts to preserve them.

Testamentary trusts

In contrast to living trusts, a testamentary trust is not created until the time of death, usually as a result of the provisions of a person's will or living trust. A testamentary trust is irrevocable although it may contain many flexible provisions to allow for appropriate management of the trust assets and distributions for the benefit of the beneficiaries.

Typical provisions of a testamentary trust include the trustee's authority to distribute the income and the principal of the trust based on certain standards and conditions that are set forth in the trust instrument. Although there is no requirement that a trust distribute its income or principal, it is generally a good idea to provide for some mechanism for distributions to or for the benefit of the trust beneficiaries, even for very limited purposes.

The trust may provide for either the accumulation of income or the distribution of part or all of the income earned by the trust assets on a periodic basis. This decision is based on the needs of the beneficiaries and the objectives of the trustor or testator. For example, if the trust is being established for the benefit of a minor or young adult who may lack the proper level of maturity to make sound financial decisions, the trust instrument will likely provide for accumulation of income with the power on the part of the trustee to distribute the income for the beneficiary's health, education and welfare. Such an approach will allow the trustee to make a distribution for almost any prudent purpose without subjecting the trust income to the whims of the beneficiary.

Likewise, the trust instrument may allow distributions of the trust principal for the needs of the beneficiaries. In the example above, trust principal may be distributed for the benefit of the beneficiary for his or her health, education and welfare. As the beneficiary becomes older (and presumably more financially capable), the trustee may be authorized to make additional distributions from the income and the principal of the trust for a broad range of purposes. These might include the down payment on a personal residence, starting a business, travel opportunities and other prudent expenditures.

However, some testamentary trusts must include specific provisions in order to achieve the objectives of the trustor or testator. Some of the trusts that require specific provisions include the following:

Tax-Planning Trusts

A tax-planning trust is a testamentary trust that is established to take advantage of tax savings opportunities in the federal and state tax law. For example, a credit shelter trust established at the death of one spouse for the benefit of the surviving spouse is a form of a testamentary trust.

Frequently, the surviving spouse is designated in the deceased spouse's will (or living trust) to serve as the trustee of the credit shelter trust. If so, certain restrictions must be imposed on the surviving spouse's right to remove principal from the trust. As a general rule, the surviving spouse, as the trustee of the credit shelter trust, may remove principal for his or her health, education, support and maintenance. See Chapter 6 for a thorough overview of tax planning for the married couple.

Trusts to Protect Government Benefits

Often referred to as a "Special Needs Trust," this type of testamentary trust is designed to preserve the beneficiary's right to receive certain government benefits that are need-based. These benefits include Medicaid and Supplemental Security Income (known as "SSI").

A person who owns assets exceeding certain limitations is not eligible to receive certain government benefits, so a special needs trust is often used to shelter the assets that would have otherwise been distributed to the beneficiary. Assets held in a special needs trust are not counted for the purpose of determining the beneficiary's eligibility for the government benefits otherwise available to the beneficiary.

If the special needs trust is not used, the beneficiary will lose his or her government benefits and will be required to spend (or otherwise dispose of) the assets before reacquiring eligibility for the benefits.

Asset Protection

Asset protection is a growing area of the law and estate planning in particular. The term asset protection refers to engaging in certain planning steps during lifetime that will have the effect of protecting your assets from the claims of creditors in the future. Asset protection planning is discussed in further detail in Chapter 10.

In the testamentary trust context, asset protection involves the use of long-term trusts that will allow the beneficiaries of the estate (such as your children) the ability to benefit from the trust assets without subjecting the assets to the claims of the beneficiaries' creditors. Creditors include the typical debts that a beneficiary may incur such as consumer credit, as well as less common ones like those arising from divorce, lawsuits and bankruptcy.

This form of trust is typically established to last for the lifetime of the beneficiary, although a shorter duration may be appropriate in some circumstances (for example, divorce rates decline with age). Distributions of income and principal may be made available to the beneficiary under conditions similar to that which is outlined above.

Many clients desire that the beneficiary also serve as the trustee of the trust. This should be done with great caution as the purpose of the trust (protection from creditors) can be undermined if the beneficiary—as trustee—fails to abide by the terms of the trust. If the trustee ignores the formalities of the trust, a court (bankruptcy, divorce, etc.) may ignore it as well.

If a beneficiary is to serve as a trustee, he or she should have administrative powers only (such as the power to participate in the trust investment decisions) and not the power to make distributions to himself or herself from the trust. This power should be held by a person (or financial institution) that is independent of the influence of the beneficiary.

Conclusion

The use of trusts, both living trusts and testamentary trusts, are an important part of any complete estate plan. Certain trusts, such as the credit shelter trust, may be established to achieve tax objectives . Trusts may also be used to achieve non-tax objectives such as efficient management and distribution of your assets, asset protection, and to preserve government benefits (including SSI and Medicaid). The proper design of any trust in an important part of leaving a legacy.

CHAPTER 5

TAXES AND ESTATE PLANNING

Introduction

Estate taxes and other taxes imposed at the time of death have been an integral part of our federal tax system for more than ninety years. Many states impose some form of estate or inheritance tax as well. Although at the time of this writing there is a significant effort in some political circles towards the elimination of estate taxes, the continued imposition of some form of estate tax seems likely for the foreseeable future.

The federal estate tax is a transfer tax. A person's power to transfer assets at death is the underlying principle of estate tax. Therefore, the type of asset or how it is owned will not avoid the application of estate tax. It is an incorrect assumption by many people that avoiding probate is the same as avoiding estate tax. Many people establish living trusts (discussed in Chapter 4) or add the names of other people to their assets with the belief that this will avoid estate tax. Although these strategies may reduce the expenses of administering a person's estate (such as avoiding the probate process), only a coordinated and oftentimes complex approach will reduce or eliminate a person's estate tax liability at death.

Since the estate tax is a transfer tax, any asset subject to the decedent's control of disposition at death is subject to estate tax. For example, the decedent's banking and other financial accounts, stocks and bonds, annuities, real estate and other interests in real property are subject to estate tax. In addition, the benefits available under a life insurance policy as well as retirement plan benefits and individual retirement accounts are subject to estate tax (except under some limited circumstances). However, there are many strategies available to reduce or eliminate the application of estate tax to your estate.

The following discussion is not intended to be comprehensive. The provisions of the tax code pertaining to gifts and estates are very complicated. You should carefully review your assets and their values on a periodic basis, and contact your estate planning attorney if you have any questions regarding the application of taxes in your situation.

What is included in my estate for estate tax purposes?

As previously mentioned, the estate tax is a transfer tax. Thus every asset over which a person may control the distribution at death will be subject to estate tax. This is what is referred to in the tax law as the "gross estate." The following is a list of the assets that are often found in a person's estate and subject to estate tax.

1. **Assets in the name of the decedent.** These assets include real estate, cash, stocks and bonds, retirement benefits (such as qualified retirement plans and individual retirement accounts), bank and other accounts held in financial institutions, personal property (such as household furniture and furnishings, motor vehicles, collections, artwork, etc.).

2. **Assets held in the name of the decedent with another person.** These assets are the same as those in item 1 above but are held in the name of another person along with the decedent. This is referred to as "joint tenancy." If the joint tenancy is with the decedent's spouse, for estate tax purposes the asset is deemed to be held equally between husband and wife. If the decedent owned the asset with a non-spouse, the entire asset is subject to estate tax unless the surviving joint owner(s) contributed funds (or other assets) at the time the asset was acquired.

3. **Life insurance**. The death benefit paid on a life insurance policy will be included in the decedent's gross estate if the decedent possessed any incidents of ownership at death. Incidents of ownership include the power to change the death beneficiary of the policy, borrow from the policy and exercise other powers over the insurance policy as set forth in the tax law.

   Furthermore, if an insurance policy is given away during lifetime and the insured dies within three years of the gift, the insurance proceeds will nonetheless be included in the decedent-insured's estate. There can also be adverse income tax consequences if an insurance policy is sold to certain other persons or entities.

4. **Annuities.** Annuities (such as tax-deferred annuities) are also included in the gross estate for tax purposes. As with life insurance and retirement benefits, the annuity proceeds will be paid in accordance with the beneficiary designation. However, this designation will not affect the taxability of the annuity in the decedent's estate.

   It should also be noted that annuities, like retirement plan benefits, will likely have untaxed income inherent in the policy at the time of the owner's death. This is income that was not taxed to the annuity owner during his or her lifetime (referred to in the tax law as "income in respect of a decedent" or "IRD"). Therefore, the annuity will be subject to estate tax as well as income tax to the beneficiary. A beneficiary of an annuity subject to estate tax may take a deduction on his or her personal income tax return for the estate tax that was paid on IRD to mitigate the effect of this "double taxation."

5. **Assets controlled by the decedent.** Even though certain assets may not be owned by the decedent, they may still be included in his/her estate. For example, if the decedent establishes a revocable living trust and transfers her assets into the trust, she no longer owns the assets in a strict legal sense. However, her ability to access the assets under the terms of the trust and receive benefits from the trust, as well as her right to revoke or amend the trust, will result in the inclusion of the trust assets in her estate for estate tax purposes.

   In addition, holding a power of appointment over assets may result in the inclusion of the assets in the decedent's gross estate even though he or she was not the owner of the assets.

6. **Assets with retained interests.** If a person transfers assets during his or her life, but then continues to use, enjoy, or derive benefit from those same assets (called assets with retained interests), then the value of the assets will be included in the taxable estate.

The marital deduction

As a general rule, any assets distributed to the decedent's surviving spouse will be exempt from estate tax. The decedent's gross estate will be reduced dollar for dollar by any amount distributed outright to the surviving spouse. In addition distributions to a trust for the benefit of the surviving spouse may qualify for the marital deduction, as will certain life estates.

Of course, assets distributed to the surviving spouse (or to a trust qualifying for the marital deduction) are subject to estate tax at the time of the surviving spouse's death. For this reason, the marital deduction only defers the payment of the estate tax on assets distributed to a surviving spouse, but does not eliminate it (unless the applicable exclusion—discussed below— is greater than the value of the surviving spouse's estate).

The marital deduction is not available for a surviving spouse who is not a citizen of the United States. Legal residency is not sufficient; the surviving spouse must be a citizen to qualify for the marital deduction. However, certain steps can be taken to secure the marital deduction for the benefit of a non-citizen surviving spouse.

The charitable deduction

The estate is entitled to a deduction for all amounts distributable to or for the benefit of a qualified charitable organization. As with the marital deduction, the charitable deduction will result in a dollar-for-dollar reduction of the gross estate subject to estate tax.

The IRS publishes a list of all of the organizations for which the charitable deduction is available. Certain other entities, such as governmental bodies and community foundations, will also qualify.

The applicable credit

Other than the marital deduction, the applicable credit amount may be the most important provision of the federal tax law available to a decedent's estate. This credit is often referred to as the "estate tax exemption amount" but it is really a credit, not an exemption. *For 2006, 2007 and 2008* the applicable credit was $780,800**.** This credit equates to an exemption amount of
$2 million. Thus, in most circumstances, an estate of less than $2 million would not pay any estate tax. In 2009, the applicable credit increased to $1,455,800 resulting in an exemption amount of $3.5 million

FOR EXAMPLE, ASSUME THAT THE DECEDENT DIES IN 2009 AND HAS A GROSS ESTATE AFTER TAKING ALL ALLOWABLE DEDUCTIONS (THE "ADJUSTED GROSS ESTATE") OF $3,500,000. THE APPLICATION OF THE ESTATE TAX RATES TO THIS ESTATE WILL RESULT IN A FEDERAL ESTATE TAX PAYABLE OF $1,455,800. HOWEVER, NO ESTATE TAX WILL BE PAID BECAUSE THE APPLICABLE CREDIT OF $1,455,800 WILL FULLY OFFSET THE TAX OTHERWISE PAYABLE.

Other deductions and credits

Numerous other deductions and credits are allowable in the computation of estate tax. For example, funeral expenses, professional fees incurred in the administration of the estate (such as attorney and accountant fees), and the executor's fees and costs are generally deductible. In addition, the debts of the decedent are deductible. A deduction is also allowed for any estate taxes paid to a state (discussed in further detail below).

Estate tax rates

Once the gross estate is determined and appropriate deductions are subtracted, the Internal Revenue Code applies a tax on the remaining estate. Currently the estate tax rate is 45% on the portion of a person's estate that exceeds $3.5 million.

As discussed in Appendix 2, for 2010, estate taxes will be repealed. However, the provisions of the Economic Growth and Tax Relief and Reconciliation Act of 2001 will sunset on December 31, 2010, with the result that prior law, along with its estate tax rates and exemptions, will once again be in effect.

State death taxes

As previously indicated, each state may impose a separate estate tax as well. This may be in conjunction with the federal estate tax or as a completely separate taxing process. Many states (including Oregon) impose a tax that is equal to a credit formerly allowed under the federal tax law known as the "state death tax credit." The allowance of the credit for federal tax purposes has been significantly modified in recent years, although Oregon applies these tax rules as though the modifications had not been enacted.

It is important to note that although Oregon has elected to impose a tax equal to the state death tax credit once allowed under federal tax law, this does not mean that the credits and deductions allowed for federal tax purposes are necessarily the same for Oregon state tax purposes. For example, the federal applicable credit described above has the effect of sheltering estates of up to $3.5 million from federal estate tax. At the present time, $1 million may be sheltered under Oregon law. Thus, a $2 million estate will pay no federal estate tax but will nonetheless pay estate tax to the state of Oregon.

Washington has adopted a "stand-alone" estate tax that is not tied to the federal tax law. Washington also allows a deduction for estates of up to $2 million. In addition, there is also an unlimited exemption for qualified farm property. Washington's estate tax system uses a graduated rate structure of up to 19% that applies to estates exceeding $9 million.

Both Washington and Oregon will allow a deduction for transfers that qualify for the marital or charitable deduction as described above.

Oregon has adopted an estate tax credit for certain natural resources properties. This credit applies to farms, timberland and fisheries. The credit applies to up to $7.5 million in qualifying natural resources property included in the decedent's estate.

Other "death" taxes

It is important to remember that, in addition to estate taxes, your assets may be subject to certain income taxes as well. For example, your beneficiaries will still have to pay any income tax owed on your retirement plans and individual retirement accounts when they receive distributions. Other examples include the deferred gain on tax-deferred annuities, deferred compensation under employment agreements, and other contract rights (such as a seller's interest in a real estate contract or land sale contract). Certain steps can often be taken to reduce these income taxes.

Gift taxes

The purpose of the gift tax provisions of the Internal Revenue Code is to impose a tax on the transfer of assets during a person's lifetime that would have been subject to estate tax at death had the assets not been gifted. The gift tax provisions of the tax law are substantially similar to the estate tax provisions, although many of these provisions have been substantially modified since 2001 by the Act (see Appendix 2).

The gift tax law includes largely the same provisions regarding transfers to spouses and charities as are in effect for estate tax. Certain exemptions are available for gifts to non-citizen spouses. Gifts to qualified charitable organizations are gift-tax free but are subject to certain limitations for purposes of determining the income tax charitable deduction that is available to the donor.

The applicable credit amount discussed above is also available to the donor of a gift but limited to $1 million. Thus, a gift of up to $1 million may be made without the imposition of a gift tax. Use of this credit during lifetime reduces the amount of the credit available to the donor's estate at death. However, the credit is frequently used to transfer appreciating assets to children and others during lifetime since this will have the effect of reducing the overall tax (gift and estate) payable at the donor's death. Strategies are also available to reduce the value of an asset for gift tax purposes (discussed in Chapter 6), thus making better use of the donor's applicable credit amount.

There are several additional opportunities with regard to gifting that are not available to estates. One of the most important is the annual gift tax exclusion. These gifts are not subject to gift tax and, in general, do not need to be reported to the IRS. For many years prior to 1997, the annual exclusion amount was $10,000 per donee per year. Since 1997, this amount has been tied to inflation and now stands at $13,000. Annual exclusion gifts may be made to an unlimited number of persons each year. Thus, a married couple with three children may make gifts totaling $78,000 per year to their children. Annual exclusion gifts may be made outright to the donee, to a custodial account (known as a Uniform Transfers to Minors Act account), a 529 plan, or to certain qualifying trusts for the benefit of a donee.

In addition to the annual gift tax exclusion, other transfers, such as transfers for payment of uninsured medical expenses and for payment of tuition and related expenses, are not subject to gift tax. However, you must be very careful in how these transfers are made to be sure that you fall within the narrow exceptions that apply.

Generation skipping transfer tax

The generation skipping transfer tax (GSTT) was enacted to prevent large, untaxed transfers to individuals who are two or more generations below that of the donor (referred to in the tax law as "skip persons"). In theory, a donor whose children are already wealthy may avoid having his assets subject to estate tax again in his children's estates by giving certain assets or his entire estate to his grandchildren, thereby skipping a generation. The GSTT was implemented in order to collect the tax dollars that would have been generated if the assets were taxed at each generational level.

The GSTT applies to both gifts as well as transfers to skip persons on death. Certain transfers to skip persons will qualify for the annual gift tax exclusion treatment discussed above. In addition, there is a separate GSTT exclusion for transfers to skip persons. The GSTT exemption is currently $2 million. Proper use of this exclusion can be important in estate planning where a substantial portion of the estate will *or could* be transferred to skip persons (such as grandchildren).

The GSTT tax rate is the highest marginal estate tax rate. Until recently, this was 55%; however, with the enactment of the 2001 Tax Act, this rate has been reduced. Beginning in 2007, the rate is 45%. See Appendix 2.

The GSTT can be a trap for the unwary. For example, if you transfer assets to a trust for the benefit of children (either during lifetime or at the time of your death) and a child dies prior to the termination of the trust, GSTT may apply if the deceased child's share of the estate will be distributed to his or her own children (the donor's grandchildren). Certain steps can be taken to mitigate the consequences of this transfer.

Conclusion

Understanding the impact of taxes on your estate is an important part of effective estate planning. Even in estates that are not large enough to pay estate tax, there may nonetheless be significant income taxes due at death without proper planning.

CHAPTER 6

ESTATE AND GIFT TAX PLANNING

Introduction

An important part of any proper estate plan is to consider the application of estate taxes and the efficacy of making lifetime gifts to minimize the estate tax obligation. As outlined in Chapter 5, estate taxes apply not only to assets owned at death but also to certain assets controlled by the decedent at the time of his or her death.

Many people do not need to include tax-planning provisions in their estate plan due to the exemptions that are available to offset the estate tax that would otherwise be due. However, your estate planning attorney should analyze your individual situation to ascertain whether estate taxes may be applicable.

There are many techniques available to reduce estate taxes. Some are as simple as establishing one or more trusts during lifetime or following death. Other strategies involve the transfer of assets to legal entities, such as a limited liability company, to structure the ownership of assets in a manner that will reduce the value of the entity and its assets for the purpose of calculating estate tax. Several of the more common techniques are discussed in this chapter and in Chapters 7 and 8.

Basic estate tax planning for the married couple

As discussed in Chapter 5, each individual has an estate tax exemption that is the equivalent of a credit against estate taxes that would otherwise be payable. For much of the 1980s and 1990s, this exemption was $600,000. Under the 2001 Tax Act, the exemption was increased to $1 million with further increases throughout the decade. The exemption will return to $1 million in 2011 unless Congress acts to change the law.

Recall from Chapter 5 that the entire amount that passes to a surviving spouse is exempt from estate taxes. However, if the surviving spouse owns the entire estate and the value of that estate exceeds the exemption that is in effect at the time of death, estate taxes will be payable. If the assets of a married couple will exceed the exemption amount, it is important that provisions be included in their estate plan to utilize both spouses' exemptions.

For example, if a husband and wife equally own assets worth $2 million and the entire estate passes to the surviving spouse following the death of one of them, the estate tax would be $435,000 on the surviving spouse's death (assuming the surviving spouse dies after 2010). If the exemption available in the first spouse's estate can be utilized, all $2 million worth of assets will pass to the couple's heirs (such as their children) without estate tax.

One approach for utilizing both spouses' exemption amounts is to have the estate plan provide that the children (and not the surviving spouse) receive the estate of the first spouse to die. Using this technique in the example above, $1 million will be distributed to the couple's children on the death of one of the parents. While this will eliminate the estate tax in the above example, it may not be consistent with the couple's non-tax goals. Most couples anticipate that the surviving spouse may need all of their accumulated assets during his or her lifetime and are not prepared to dispose of a substantial portion of their estate following the death of one of the spouses.

As an alternative, the couple may include provisions for a testamentary trust in their wills or revocable living trust. This trust is commonly referred to as a Credit Shelter Trust. Other names, such as Bypass Trust, Exemption Trust, or Family Trust, are also used.

Typically, the Credit Shelter Trust provides that all of the income of the trust (such as interest on bank accounts and bonds, rent payments on rental property, and dividends on stock) will be distributed on a periodic basis to the surviving spouse. The trust can be drafted to provide for distribution of income to other family members as well (called a "sprinkling power").

In addition to all of the income, the surviving spouse may also have access to the principal of the Credit Shelter Trust. For example, if the surviving spouse incurred a major expense that exceeded the income of the trust, assets of the trust could be distributed from the trust to the surviving spouse to provide the means with which to pay the expense.

The surviving spouse may serve as the trustee of the trust and may be given the authority to appoint his or her own co-trustee or successor trustee. However, if the surviving spouse is going to serve as the sole trustee, he or she may not withdraw the principal of the trust except for his or her health care needs, education, maintenance and support. If principal is distributed to the surviving spouse for other items, the tax savings benefits of the Credit Shelter Trust will be lost. In addition, if the surviving spouse is appointed as the sole trustee, sprinkling powers over income (as described above) should not be used without careful consideration of the income tax consequences.

Since the Credit Shelter Trust does not come into existence until one spouse dies, the couple does not need to dedicate any particular assets to the trust during life. Funding of the Credit Shelter Trust is part of the probate of the will of the first spouse to die or, if a living trust is used, it is part of the administration of the trust.

There are many other provisions that can be included in the Credit Shelter Trust. For example, the surviving spouse may have the power to change the manner in which the assets of the trust are distributed at his or her death (called a "special power of appointment"). Thus, even though the Credit Shelter Trust is irrevocable at the death of the first spouse, the survivor may, if authorized, modify the distribution provisions that will take effect at the survivor's death. This kind of flexibility makes the irrevocable nature of the Credit Shelter Trust more acceptable.

As discussed in Chapter 3, a person may own assets that are subject to estate tax but will not be subject to the terms of the will or living trust and as a result, to the tax-planning provisions included in those documents. Therefore, an important part of the estate planning process is to coordinate the beneficiary designations that will take effect upon death of assets such as retirement accounts, life insurance policies, and annuities so that estate taxes may be minimized following the death of the surviving spouse.

Finally, it is important to remember that the assets of many types of trusts are free from the claims of creditors. Thus, if the surviving spouse incurred a substantial obligation (such as a lawsuit judgment), assets within a properly drafted Credit Shelter Trust may not be subject to the claims of the surviving spouse's creditors.

If the value of the estate owned by the first spouse to die exceeds his or her estate tax exemption amount, the remaining assets—after funding the Credit Shelter Trust—will be distributed outright to the surviving spouse or to one of several types of trusts that will qualify for the marital deduction. Thus, no estate tax will be payable on the first spouse's death regardless of the size of the estate.

Introduction to other estate tax planning techniques

For the unmarried person, or for married couples with assets exceeding two exemption amounts, there are many other strategies available that will reduce or eliminate estate taxes. Many of these are outlined below.

Charitable gifts

There are many charitable giving strategies that can be used to reduce a person's estate tax liability. Some of the approaches involve gifts that are made during lifetime that will remove assets from the donor's estate for estate tax purposes while allowing the donor to benefit from the donated assets during his or her lifetime (and during the lifetime of his or her spouse). Many of these techniques are discussed in detail in Chapter 7.

Gifts to individuals

Gifts to individuals can take many different forms, including an outright gift or a gift to a trust for the benefit of another person. In each case, the gift involves a transfer of assets from one person (the donor) to another person (the donee). The donor must not retain any interest in or right to benefit from the assets gifted to the donee or the gift will not be effective for gift tax purposes.

Certain gifts are not subject to gift tax. These gifts include those that qualify as annual exclusion gifts and gifts for the purpose of paying medical or educational expenses.

Annual Exclusion Gifts

Annual exclusion gifts (currently $13,000 per donee per year) are not subject to gift tax. There is no limit on the number of annual gifts that a donor may make but no donee may receive more than $13,000 worth of assets per calendar year from a single donor. Thus, a married couple with three children and five grandchildren can give a total of $208,000 per year without any gift tax.

If the prospective donee is a minor or is otherwise unable to properly manage the assets to be gifted, several different approaches can be used to provide for the effective management of the assets. These include: 1) gifts to a trust that will terminate when the minor reaches age 21; 2) gifts to a trust that extend beyond the age of 21 and include certain withdrawal provisions (often called a "Crummey Trust" named after the court case that authorized the strategy); 3) gifts to a state-sponsored tuition plan (often called a "529 Plan"); and 4) gifts to a Uniform Transfers to Minors Act account. In each case, however, the donor should not be designated as the trustee (in the case of a trust) or custodian of the funds. Making a gift to such a trust or account while retaining the right to control the distributions may result in the gifted assets being included in the donor's estate when he or she dies.

Gifts for Medical Expenses and Education

Gifts that are for the donee's health care or education are also not subject to gift tax. However, the donor must pay the health care provider or educational institution directly. If the gift is made to the donee who then pays the health care or educational expense, it is a gift and will be subject to gift tax if it exceeds the annual gift tax exclusion amount.

Taxable Gifts

Gifts that exceed the annual gift tax exclusion amount or do not qualify for the exclusion for health care and educational expenses are "taxable gifts." However, this term can be misleading. The mere fact that the gift exceeds $13,000 per year, for example, does not mean the donor must pay gift tax.

The donor may use (in fact, is required to use) his or her applicable credit amount to offset the tax that would otherwise be owed on a taxable gift. This amount is limited to $1 million under current law.

For example, if the donor makes a gift to his children of assets with a value of $1 million and assuming that the donor has already made annual exclusion gifts in that year, the gift tax is $345,800. This tax is offset by the donor's gift tax applicable credit of $345,800. Thus, no gift tax is payable.

However, if the donor in the above example has used all of his gift tax applicable credit amount for his lifetime, no further gifts may be made (other than annual exclusion gifts and gifts for medical and educational expenses) without paying gift tax.

The donor must report all taxable gifts (and the use of his applicable credit amount) on a U.S. Gift and Generation Skipping Tax Return (IRS Form 709). This tax return is due on April 15 of the year following the year of the gift unless an extension to file is granted. This can be very important (even if no tax is payable) where the gifts are made to a trust and there is a possibility that the trust will terminate causing a generation-skipping transfer tax.

Estate Freeze Gifts

Some gifts are made, usually in a trust, that are subject to rigid restrictions regarding the use and enjoyment of the assets by the donor. These gifts, often referred to as estate freeze gifts, have the effect of reducing (or "discounting") the value of the transferred assets for gift tax purposes. These techniques allow the donor to retain the benefit of the assets transferred for a period of years. At the end of the term, the assets are distributed to the trust beneficiaries, often the donor's children.

The primary advantage of these strategies is that the value of the taxable gift is less than the full value of the transferred assets because the donor retains the use of the assets for the term of the trust. The value of the gift is calculated by using a published interest rate to determine the present value of the asset to be transferred to the donee in the future when the trust terminates. The donor must survive the trust term in order to achieve the full benefit of the strategies available.

Grantor Retained Annuity Trust

A common form of estate freeze gift is the grantor retained annuity trust or GRAT. This strategy involves the transfer of assets to a trust in which the donor retains the right to receive a set sum (usually in the form of a percentage of the initial value of the assets contributed) from the GRAT on an annual or more frequent basis. However, at the end of the trust term, the donor's children (or other intended beneficiaries) receive the remaining assets.

For example, if the donor transfers $1 million to a ten-year GRAT and retains the right to receive a five percent (5%) annuity, the donor would receive a $50,000 payment per year (distributed at least annually). The transfer to the trust is a completed gift for gift tax purposes. However, the value of the gift to the trust will be reduced by the present value of the donor's right to receive the annuity for a ten-year period. Assuming that a 65-year-old person establishes the above GRAT when the applicable interest rate is two percent (2%), the value of the gift to the trust would be reduced to approximately $450,000. Therefore, by retaining the right to receive the annuity, the donor may not only benefit from the transferred assets but the value of the gift is reduced as well.

Furthermore, assuming that the value of the assets appreciate in excess of the federal interest rate applicable at the time of the transfer (2% in the above example) the children will receive substantially more than the value of the assets for gift tax purposes at the time of the trust termination. For example, using the same facts as outlined above and assuming that the assets appreciate at an average of seven percent (7%), the value of the GRAT assets would exceed $1.2 million at the end of ten years even though the donor had received $50,000 from the trust each year.

Personal Residence Trust

Another popular estate tax freeze technique is the personal residence trust (the PRT). This strategy involves the transfer of a residence that is used by the donor as a personal residence. Both primary and secondary residences qualify, including vacation residences.

Under the terms of the PRT the donor retains the right to use the residence for a term of years. Like the GRAT described above, the donor's retained use is valued for gift tax purposes and serves to reduce the value of the gift to the donor's children or other intended beneficiaries.

For example, if a 70-year-old donor transfers a residence valued at $1 million to a PRT and retains the right to live in the home for a period of ten years, the value of the retained benefit derived by the donor is approximately $458,000 which, in turn, means that the taxable gift is worth approximately $541,000. Assuming four percent

(4%) annual appreciation in the value of the property, the donor's children (or other intended beneficiaries) will receive the residence worth nearly $1.5 million after ten years. Of course, as with the GRAT, the donor must survive the ten-year term to receive the estate tax savings benefits.

The use of a PRT is a very attractive estate planning tool for people who desire to transfer their residences at a substantially reduced gift tax cost, especially where one of the non-tax objectives is to retain the residence into the next generation.

Family Business Entities

Another popular strategy for making lifetime gifts and reducing the probable estate tax payable at the donor's death is the use of a family business entity (FBE). Most commonly, a limited liability company or family limited partnership will be used for this purpose.

The objectives of the FBE will depend on the circumstances. Common objectives include:

- Providing an efficient means of assuming the management of the family business assets;
- Designating appropriate family or non-family members to manage the FBE;
- Allowing the senior generation to transfer the FBE assets to junior generations while retaining the necessary control over the FBE; and
- Reducing the gift and estate tax consequences of transferring the FBE assets to the junior generations.

The ownership of the FBE is represented by units, similar to the shares of stock in a corporation. In most FBEs the units are divided into two basic types: management units and equity units. Typically, the management units carry the right to vote on most matters pertaining to the operation of the FBE. The equity units carry no right to vote except under extraordinary circumstances (such as the sale of substantially all of the business enterprise held in the FBE or dissolution of the FBE).

Most FBEs are owned only by members of a single family. As such, the equity units and, perhaps, the management units are subject to certain transfer restrictions. This is to prevent the owner of the units from selling his or her units to a non-family member without the consent of the other owners of the FBE. Thus, unlike stock in public corporations or units of public partnerships, the units of a FBE are not traded on any open market and are not generally available to non-family members.

In most cases, the FBE is established by one or more members of the senior generation (parents) contributing certain assets to the FBE. However, it is also common for members of the junior generations (children, grandchildren, etc.) to also make contributions to the FBE. The members making contributions to the FBE receive management and/or equity units in exchange for their contributions.

Once the FBE is established, equity units (and, perhaps, management units) are transferred by gift to members of the junior generations. The value of the gift is based on the "fair market value" of the units that are transferred. Fair market value for gift tax purposes is based on what a willing buyer would pay to a willing seller, both in possession of all the facts surrounding the circumstances of the sale and both under no obligation to engage in the transaction.

The recipient of an equity unit of an FBE cannot sell his or her units and cannot vote or otherwise control the actions of members of the FBE who own the management units. Consequently, the value of an equity unit is likely to be substantially less than a proportionate share of the underlying assets that were contributed to the FBE.

Determining the fair market value of the equity and management units must be ascertained by appraisal. The appraiser will review the agreement that creates the FBE (the limited liability company or family limited partnership documents); evaluate the underlying assets of the FBE (the business that was contributed to the FBE); consider such issues as liquidity and potential for income generation by the business; restrictions imposed on the unit owners (such as the restriction on the right to manage and sell units); and many other factors. The result of this highly technical process is the fair market value of the units.

The use of an FBE can be illustrated by the following simple example:

Bob and Linda Smith own several rental properties worth $1 million. They want to transfer a portion of the ownership of the rentals to their children; however, they want to retain management control with regard to the properties. If they simply transfer fractional interests in the rentals to their children, the Smiths lose the ability to control the rentals because, once owners, the children must consent to the actions that are taken with regard to the rentals.

Instead, Bob and Linda establish the Smith Family Business Entity (likely to be a limited liability company). They contribute the rentals to the FBE and receive both management and equity units in exchange for their contribution.

Some months later the Smith's decide to give most of the equity units (representing 90% of all of the units) to their children. Bob and Linda retain the management units. Although a majority of the units are now owned by their children, Bob and Linda continue to have the management powers by virtue of their ownership of all of the management units.

Following the year in which the gifts of the equity units are made, Bob and Linda must file a federal gift tax return (Form 709) reporting the gifts. The Smiths hire an appraiser who reviews the FBE and reports that the fair market value of the gift of 90% of the FBE is $540,000; that is, 90% of $1 million, reduced by a 40% discount to reflect the fact that the equity unit owners (the children) have no management powers (the lack of control discount) and cannot sell their units to anyone outside the family (the lack of marketability discount).

Thus, Bob and Linda have transferred nearly all of the equity of the FBE to their children at a substantially reduced value for tax purposes. Note that if Bob and Linda had kept the rentals until death, the full value of the rentals ($1 million plus appreciation until the date of their deaths) would be subject to estate tax.

While FBEs are appealing for many reasons, they also have disadvantages and are not for every estate plan. For example, the income of the business (the rental income in the above example) is allocable to the owners of the FBE units in proportion to ownership. In the above example, the children will receive 90% of the income which may, or may not, be acceptable. Bob and Linda can be compensated for their services to the FBE, but cannot ignore the FBE and retain the income as though the FBE did not exist. Furthermore, Bob and Linda, as owners of the management units, are fiduciaries and owe duties to the other owners of the FBE (their children). No one should enter into an FBE without a full understanding of the consequences and a willingness to accept the additional complications associated with using a business entity.

Conclusion

Proper planning to reduce estate taxes involves the use of trusts and other entities and may include gifts to individuals and charitable organizations. While some of the strategies may add some complication to your life, they can substantially reduce—even eliminate—the estate taxes owed at your death.

CHAPTER 7

CHARITABLE GIVING

Contributions to charitable organizations, such as churches, educational institutions, and community foundations, are often an important part of personal, financial and estate planning. Charitable gifts can be as simple as contributions to the charity or charities of your choosing. These are often referred to as "current" or "present" gifts. "Deferred" gifts, on the other hand, involve the contribution of an asset to a charity but the donor (or another person) retains the right to receive some benefit from the asset for a period of time.

The primary objective of most charitable gifts is to benefit the donor's favored charities. Certain income, estate, and gift tax advantages can also be achieved through proper planning. The choice of assets to be contributed to the charitable organization, and the manner and timing of the contribution, will affect the tax consequences.

Charitable gifts may be made during the donor's lifetime, at the time of death, or in combination. As with lifetime gifts, charitable gifts at death may be either outright for the immediate use of the charitable organization or deferred for use at a later date.

Donors who desire to achieve tax advantages from their charitable giving should ask three questions. First, what organizations should be the recipients of my charitable gifting? Second, what assets may I give to these organizations? Third, what are the tax benefits of the gift?

Qualified charitable organizations

Individuals may make tax-advantaged gifts to certain, but not all, charitable organizations. These organizations encompass a broad spectrum of entities, including public charities, educational institutions, hospitals, and religious organizations. In addition, deductible contributions may be made to other nonprofit organizations, such as community foundations and private foundations. Gifts to governmental bodies also qualify for the charitable deduction.

However, not all nonprofit organizations qualify as a deduction for the donor. For example, donations to lobbying groups, political parties and candidates, and most gifts to service and fraternal organizations (such as a Rotary or Elks Club) do not qualify for a deduction. If you have any question as to whether your donation qualifies for a deduction, contact your tax professional. You may also contact the IRS for its Publication 78 which is a cumulative list of qualified charitable organizations. It may be found at a local library or at www.irs.gov.

Assets that may be donated

Virtually any asset owned by the donor may be donated to a charitable organization. Intangible assets such as cash, stock, bonds and life insurance policies are frequently contributed to charities. Likewise, tangible assets such as real estate, artwork, and other collectibles may also be the subject of a charitable gift.

Intangible assets are generally preferred for donation to charity because such assets are relatively easy to transfer and can be put to immediate use for charitable purposes. The value of such assets may be determined from stock market quotations, insurance company records, or other published sources. Tangible assets, though also frequently donated, may be more difficult to value and transfer. For particularly large gifts for which the value cannot be easily determined (such as real estate), additional documentation (such as an appraisal) will be necessary in order to substantiate the value of the gift and the tax deduction available to the donor.

Income tax charitable deduction

The income tax deduction that is available for gifts to a charity depends on the type of asset donated, the organization to which it is given, and the donor's income in the year of the contribution. These rules are complicated but some general guidelines follow.

The starting point is to determine the donor's contribution base, which is the donor's adjusted gross income with certain adjustments. The maximum amount that a donor may deduct for income tax purposes as a charitable deduction in any year is 50% of his or her contribution base. However, this amount may be further limited as described below. If the value of the donor's charitable contributions exceeds the maximum amount he or she can deduct for the year, excess contributions may be carried forward for up to five subsequent tax years.

Donations of cash and most income-producing assets may be deducted up to 50% of the donor's contribution base. However, donations of appreciated property such as stock or real estate, may only be deducted up to 30% of the donor's contribution base. Thus, the type of asset contributed to the charity may affect the amount of the deduction that can be taken in any year. A donor may make contributions of both 50% property and 30% property in the same year.

The percentage limitations described above may be further limited based on the type of organization receiving the donation. Gifts to public charities, including community foundations, qualify for the 50% limit (unless the gift is of 30% property). These organizations are of the kind that qualify under

Section 501(c)(3) of the Internal Revenue Code, and thus are often referred to as "501(c)(3) organizations."

Other organizations such as veterans groups, fraternal orders and cemetery societies, known as semi-public charities, do not receive the same treatment. Contributions to these organizations may only be deducted in an amount of up to thirty percent (30%) of the donor's contribution base.

Finally, contributions to private foundations (often referred to as "family foundations") are further limited to twenty percent (20%) of the donor's contribution base. In addition, the charitable contribution of certain assets contributed to a private foundation may be limited to the donor's tax basis (usually its acquisition cost), rather than its fair market value at the time of the contribution.

Estate taxes and the estate tax charitable deduction

The Internal Revenue Code imposes a tax on the assets of a decedent owned at the time of death. The estate tax may also apply to assets not owned by the decedent but over which he or she had some form of legal control at death. Many states have estate tax as well.

Gifts to charity made at death qualify for the estate tax charitable deduction. Like the income tax charitable deduction, the value of assets transferred to a charitable organization will reduce the value of assets subject to taxation. The types of organizations that qualify for the estate tax charitable deduction are substantially the same as those that qualify for the income tax charitable deduction.

However, unlike the income tax charitable deduction, the estate tax deduction allows the decedent's estate to reduce the assets subject to estate tax on a dollar-for-dollar basis, without limitation. Thus, transfers to charity as part of your estate plan can completely eliminate the estate tax that would otherwise be payable.

Gift taxes and the gift tax charitable deduction

The Internal Revenue Code taxes transfers during lifetime in much the same manner as transfers at death. As with the estate tax, the donor can offset any gift tax by applying his or her gift tax applicable credit amount (currently $1 million) to the transfer.

Consistent with the estate tax rules, a donor will be able to take a charitable deduction for any gift transfer to qualified charities, which essentially makes the gift to the charity tax free. However, depending on the amount and type of transfer, a Gift Tax Return (IRS Form 709) may be required. In addition, certain split-interest transfers, such as to a charitable remainder trust or a charitable lead trust, will result in a gift tax where someone other than the donor and the charity receive some benefit from the trust.

Deferred charitable gifts

Many people desire to make significant contributions to favored charities but wish to retain the right to use or receive income from the donated property. This may be accomplished through a variety of structures. For example, a person may give their home or farm to a charity but retain the right to reside in the residence or continue to use the farm for his or her lifetime (referred to as a "life estate"). Assets may also be contributed to a charitable trust (known as a "charitable remainder trust") allowing the donor to retain a stream of income from the trust for a term of years or life. With these strategies, a current income tax charitable deduction is allowed for such gifts, and the assets will not be included in the donor's estate for purposes of calculating the estate tax due on a donor's death.

Charitable Remainder Trust

A charitable remainder trust (CRT) is a form of deferred giving strategy that allows the donor to make a charitable contribution but retain the right to use the donated property (within certain limitations) for a term of years or for life. The CRT is divided between an income interest, usually for the benefit of the donor, and the remainder interest for the benefit of one or more charitable organizations. A CRT is often referred to as a "split-interest trust" for this reason.

A CRT may be in one of two forms: a charitable remainder unitrust (CRUT) or a charitable remainder annuity trust (CRAT). The choice of CRT to be used will depend on a variety of factors including the benefits to be received by the donor during the term of the CRT and the type of asset contributed to the CRT.

The CRT may be established to pay income to the donor for a term not to exceed 20 years or for the donor's life (which may exceed 20 years). In addition, the CRT may be established to benefit successive lives (for example, for the lifetime of the donor and then for the lifetime of the donor's spouse) or may benefit someone other than the donor altogether (although the income interest for someone other than the donor or his or her spouse will be subject to gift tax).

The income interest reserved by the donor is generally fixed under the terms of the CRT as a percentage of the trust assets. Once fixed, the percentage may not be changed. The minimum percentage payout is five percent of the value of the trust assets. The maximum payout is also fixed based on several factors including the age of the donor, term of the CRT, and prevailing interest rates.

The primary distinction between the CRAT and the CRUT is the determination of the income interest paid to the donor. If the donor selects a CRAT, the trust will pay a fixed annuity to the donor, based on the value of the assets contributed to the CRT at the time it is created. For example, if $100,000 is contributed to a CRAT with a five percent income interest, the donor will receive an annual payout of $5,000. This amount will not change regardless of any change in the value of the trust assets over time. This approach may be preferred when the donor wishes to have an income stream that he or she can rely on for the trust term.

Alternatively, if the donor selects a CRUT, the income interest will be re-determined each year based on the value of the trust assets. If the CRUT increases in value, the income interest will also increase. In the above example, if the trust assets increased from $100,000 in the first year to $120,000 in the second year, the payout year would be $6,000 (five percent of $120,000). The CRAT, on the other hand, will continue to pay $5,000 regardless of any change in value.

When the CRT income interest ends (either at the end of the set number of years or the death of the donor or other designated non-charitable beneficiary) the remaining assets pass to the designated charitable organization(s). Even though the CRT is an irrevocable trust, the donor may retain the right to change the charitable beneficiaries. The donor may also serve as his or her own trustee during the trust term (with certain limitations) or may select someone else to be the trustee.

One of the most significant benefits of the CRT is that the donor receives an immediate income tax charitable deduction even though the assets will not pass to the charity(ies) until some time in the future. This deduction is limited under the same rules set out in this chapter. In essence, the income tax charitable deduction is equal to the value of the assets contributed to the CRT, reduced by the value of the income interest retained by the donor. This value is determined under certain provisions of the Internal Revenue Code. The longer the payout to the donor or the higher the payout percentage, the smaller the charitable deduction.

Another important benefit of a CRT is that the sale of appreciated assets contributed to the trust or purchased by the trustee will not result in taxation of the capital gain. A CRT is a tax-exempt entity. For example, if the donor contributes a highly appreciated asset (such as stock or real estate) to the CRT, the asset may be sold and the donor will not have to pay the capital gains tax on the sale. As a result, the trustee may reinvest the full amount of the sale proceeds from the sale of the appreciated asset. This will likely increase the income interest compared with selling the same asset and reinvesting the sale proceeds after paying capital gains taxes.

The payout of the income interest is taxable income to the recipient (either as ordinary income or capital gain) unless the distribution is from the donor's basis in the property contributed to the CRT. Specific rules apply to the order of priority that apply to the tax characteristics of the payout.

If the CRT terminates at the donor's death, the assets are included in the donor's estate for purposes of determining the estate tax due. However, the donor's estate will receive a charitable deduction for the amount distributed to charity. Thus, the donor's estate tax liability is reduced. As indicated above, if the CRT is designed to benefit a person other than the donor or his or her spouse (either during the donor's lifetime or at death), the value of the income interest that benefits someone other than the donor or his/her spouse will be considered a taxable gift. In turn, the use of the donor's gift tax exclusion will affect the applicable credit amount available to the donor's estate to offset estate taxes.

Charitable Gift Annuity

Similar to a CRAT, a donor may establish a charitable gift annuity with a charitable organization that is authorized to issue annuities. The donor will receive a charitable deduction calculated in a manner similar to that of a charitable remainder trust. However, unlike the charitable remainder trust, the donor may not manage the assets contributed to the charity in the form of a charitable gift annuity. It is nonetheless a valuable alternative to the complexities associated with a CRT, especially for smaller deferred charitable gifts.

Many charitable organizations are qualified to issue charitable gift annuities. The amount of the annuity that is payable to the donor and the amount of the charitable deduction will depend on the donor's life expectancy and the prevailing interest rate environment. Gift annuities may also be established for more than one person; for example, for the lives of both the donor and his/her spouse. Annuity payments may begin immediately or be deferred to a later date. In most circumstances the interest rate offered by a charitable organization on a charitable gift annuity is established by the Committee of Gift Annuities.

The contribution of cash or assets to a charity in exchange for a gift annuity is a complicated transaction since it is composed of both a charitable gift as well as the purchase of an annuity. The gift annuity becomes a general obligation of the organization issuing it. Furthermore, the gift of appreciated assets in exchange for the gift annuity will result in recognition of capital gain by the donor. However, if certain requirements are met, the capital gain is reportable over the life of the annuity, and not all in the year the annuity was acquired. Thus, a portion of each annuity payment will be treated for income tax purposes as capital gain.

Charitable Lead Trust

Another form of split-interest trust is a charitable lead trust (CLT). As with a CRT, a CLT may be either in the form of an annuity or unitrust. However, unlike a CRT, the CLT is not a tax-exempt entity and there is no minimum or maximum payout requirement.

A CLT is the reverse of a CRT. The income interest is paid to a charitable organization for a term of years and the remainder interest is paid to non-charitable beneficiaries (such as the donor's children). The value of the remainder interest payable to the non-charitable beneficiaries is a taxable gift of a future interest.

The determination of the charitable deduction will depend on the type of CLT selected by the donor. If the CLT is designed to be a grantor trust for income tax purposes, the donor receives an income tax charitable deduction for the present value of income interest payable to the charity over the term of the trust. This deduction may be used in the year in which the CLT is established and funded, and is subject to the five-year carry forward rules discussed above. However, as a grantor trust, the income of the CLT will be taxed to the donor as well. If, on the other hand, the CLT is designed to be a complex trust for income tax purposes, the income of the CLT will be taxed to the trust (not the donor) and the income tax payable can be offset by each year's distribution to the charity as a charitable contribution.

The primary advantage of the CLT is that the value of the transfer to the non-charitable beneficiary is reduced by the value of the income interest paid to the charitable organization during the trust's existence. A CLT is beneficial to donors who wish to make a commitment to a charitable organization for a period of years but have non-charitable beneficiaries (such as children) be the ultimate recipient of their estate. An added advantage of the CLT is that the appreciation of the assets in the CLT will pass to the non-charitable beneficiaries without additional gift or estate tax.

Community foundation

In general, a community foundation is a grant-making organization that receives donations from donors and makes distributions to charities on a periodic basis. A community foundation may hold and invest the contributions in either common or separate accounts, and may serve as the trustee of trusts (such as a charitable remainder trust) established by donors. Generally, though not exclusively, a community foundation makes grants to charities in the community in which the foundation is located.

One of the principal advantages of making contributions to a community foundation is that the donor receives the most favorable income tax deduction for his or her contribution since the community foundation is a 501(c)(3) organization. Contributions of cash or income-producing property are subject to the 50% limitation, and contributions of appreciated property are subject to the 30% limitation.

Another advantage of making contributions to a community foundation is that the donor or the donor's family may have a significant level of involvement in the process of selecting the charitable recipients of the distributions from the community foundation. For example, the donor may make recommendations each year regarding how the income from the donor's fund will be used in achieving the donor's charitable objectives in the community. However, the donor's input is in the form of advice only; the final decisions rest with the community foundation's board of directors.

Private foundations

Donors who wish to exercise substantial control over the use of the donor's charitable contributions will often select a private foundation for this reason. Unlike a community foundation, a private foundation is not publicly supported. Generally, a single donor (or a small number of individuals close to the donor) will be the sole source of support for the private foundation. Donors will often establish a private foundation in a year in which the donor wishes to pre-fund his or her charitable giving for several years in advance in order to achieve the most economic income tax result.

The primary advantage of the private foundation is that it will allow the donor almost complete control over the use of the donated funds. The process of selecting the charitable organization to which funds will be distributed from the private foundation is completely within the control of the board of directors of the foundation. The donor, his or her family members, friends and other advisors will often comprise the board of directors of the private foundation. For this reason private foundations are often used by parents to instill in their children the sense of charitable giving and commitment to the community.

However, this level of control and flexibility comes with a cost. Private foundations are subject to a myriad of rules regarding the operation of the foundation, including prohibitions against using the foundation to achieve non-charitable purposes (so called "self dealing"). Private foundations are also subject to certain taxes that do not apply to public charities. In addition, private foundations must file an application with the Internal Revenue Service in order to be approved as a tax-exempt organization. Furthermore, annual reports regarding the financial activities of the private foundation must be filed with the Internal Revenue Service and the state in which the corporation or trust was established.

Private foundations are also subject to special limitations with regard to the income tax deduction available to the donor. Cash and income producing assets are limited to 30% of the donor's contribution base and gifts of appreciated assets are further limited to 20% of the donor's contribution base. Certain contributions (such as stock in a closely held business) are subject to additional limitations.

Finally, if the donor is allowed to participate in the decisions of the board of directors regarding the recipients of the distributions from the foundation, the contributions to the private foundation may be includable in the donor's estate for estate tax purposes. The Internal Revenue Code provides that assets that are gifted but subject to the donor's control will be included in the donor's estate at death. Thus, certain additional steps must be taken to shield the donor's estate from this result if the purpose of the gift to the foundation is to achieve both income and estate tax savings.

Charitable gifts at death

Making charitable gifts at the time of death is a preferred approach for many individuals. During lifetime, the donor may have the full use and enjoyment of the property. At death, the donor's will or living trust must describe the terms of distribution to the charitable organization. For example, a donor's will may set out a specific amount or assets to be distributed to the charitable organization. Alternatively, the donor might state that a percentage of his or her estate will be set aside for charitable purposes. Donors should discuss these options with their advisors.

In addition, the split-interest trust options (charitable remainder trust or charitable lead trust) outlined above may be utilized at death, but with somewhat different tax consequences than as previously discussed. For example, a donor may include provisions in his or her will to establish a CLT at the time of his or her death. The CLT will benefit the designated charity for a term of years. At the end of the term, the CLT terminates in favor of the donor's children (or other non-charitable beneficiaries).

If the contribution meets certain qualifications, the donor's estate is entitled to a deduction for the full fair market value of the assets passing to the charitable organization and is not limited in the same way as the income tax charitable deduction. Thus, the estate tax can be substantially reduced or eliminated by making a contribution to a charitable organization.

Certain assets such as retirement plan benefits, individual retirement accounts, tax-deferred annuities, contracts for the sale of appreciated assets and deferred compensation agreements have income tax consequences that survive the decedent. These assets are known as "income in respect of a decedent" or "IRD."

The heirs of the decedent (or worse, the decedent's estate) must pay the income tax. Often the income tax consequences to the heirs of the decedent will be far greater than if the decedent had paid the tax during his or her lifetime. The income tax on such assets, when combined with the estate tax, can exceed eighty percent of the value of the asset.

One estate planning opportunity for donors with assets that constitute IRD is to designate such assets for charitable purposes. For example, the donor may name a charity as the beneficiary of his or her retirement plan, individual retirement account, or tax-deferred annuity. Since the charity is a tax-exempt organization, it will not have to pay the income tax that a non-charitable beneficiary (such as the donor's heirs) would have to pay.

Coordinating the estate plan to take into consideration assets that constitute IRD is highly complicated, particularly where the donor has both charitable and non-charitable beneficiaries. The donor should seek the advice of a qualified tax advisor before implementing an estate plan under such circumstances.

Conclusion

There are many strategies available to achieve your charitable giving objectives. The tax rules regarding charitable giving are complicated. However, with proper planning, you can promote the mission of your preferred charities and achieve tax benefits as well.

CHAPTER 8

LIFE INSURANCE

Introduction

Though not immediately obvious as part of the estate planning process, life insurance is a very important component of many estate plans. This is often true because the client anticipates that a substantial amount of the value of his or her estate will be in the form of proceeds from life insurance payable following a death. In other circumstances, the insurance may play an important part in providing security to a surviving spouse and family or to provide a simple means by which the estate may pay the taxes owed at the time of the insured's death.

Basic definitions and types of life insurance

Before reviewing the importance of life insurance in the estate planning process, a review of the basic terminology and types of life insurance is important. What follows is not intended to be comprehensive but merely an overview of important definitions and basic forms of insurance. Armed with this basic information, the reader should be able to navigate the estate planning process as it applies to life insurance policies.

Insured The insured identifies the person whose life is being insured under the policy. In some cases, two lives may be insured under the same policy (see definition for Second-to-Die Insurance below).

Owner The owner of the policy is most often the insured. However, in some circumstances the policy may be owned by a different person than the insured. This may occur where the policy is owned by a trust (see the Irrevocable Life Insurance Trust discussion below), or a corporation or other business entity, or a charity.

Policy The policy is the legal contract between the owner of the policy and the issuing insurance company. Most of the rights and responsibilities of the parties to the policy will be contained within the policy document itself. Applicable state and federal law will also control certain aspects of the relationship between the parties to the policy.

Beneficiary As the term implies, the beneficiary is the person, trust or entity (such as a business or charity) that is entitled to receive the death benefit at the time of the insured's death.

Premium The premium is the amount of money that must be paid to maintain the policy in force. Premiums are commonly paid on a periodic basis (such as monthly or annually). Sometimes the premium is paid at the time of the acquisition of the policy or at a later date so that no additional premiums are payable. Premiums may increase over time as the insured ages or may be for a fixed amount.

Incidents of Ownership The owner of the policy holds the incidents of ownership in the policy. These incidents are defined in the Internal Revenue Code and include such powers as the right to designate the beneficiary of the policy, the power to borrow against the cash value of the policy, the power to transfer ownership in the policy, the power to terminate the policy and the like. Where the policy is owned by an individual, it is the possession of these incidents of ownership that will result in the inclusion of the policy value or the death benefit proceeds in the owner's estate for estate tax purposes.

Term Insurance This form of insurance is often referred to as pure insurance in that it is nothing more than a policy of insurance on the life of an individual for a specific death benefit. So long as the premium is paid, the death benefit will be payable at the insured's death. There are no investment or savings opportunities available with this form of insurance.

Group Term Insurance This form of insurance is simply term insurance provided to the insured as a result of his or her association with a group, such as an employer. So long as the insured is associated with the group, the insurance is available and remains in force. On occasion, the policy will provide that if the insured disassociates from the group (such as retiring from employment) the policy may be converted to term or other form of insurance.

Permanent Insurance There are many forms of permanent insurance, including whole life, variable life and universal life. Though these insurance policies differ in many important respects, they all have one factor in common: the policy is designed to include not merely a life insurance component (such as is the case with term insurance) but also an investment component. The investment component may be in the form of the cash value of the policy, investment in mutual funds (owning stocks, bonds and other investments) that the owner of the policy may manage, or other investments.

Second-to-Die Insurance Second-to-die (also known as survivorship) insurance is a specific form of insurance that insures the lives of two individuals, such as a husband and wife. The death benefit is not payable until after both insureds have died. These policies are acquired primarily for the purpose of providing funds to pay estate taxes. Since married couples' estate planning can be designed to avoid estate tax at the first death, the insurance death benefit is not necessary for the payment of estate tax until the survivor's death. The policy may be designed as permanent or term insurance.

Taxes and life insurance

There are a myriad of tax rules that apply to life insurance. With regard to the estate planning process, the primary issues concern the income taxability of the death benefit on the insured's death and the application of estate taxes to the insurance policy.

Although there are some important exceptions to this rule, life insurance proceeds received by a beneficiary will not be subject to income tax payable by the beneficiary or the insured's estate.

A lesser known rule is that the insurance, though not subject to income tax, is subject to estate tax. At the time of the death of the owner of the policy, the value of the policy or the proceeds from the policy will be included in the decedent's estate for purposes of calculating the estate tax payable.

Note that the estate tax implications are determined based on whether the decedent held any incidents of ownership in the policy; merely being the insured is not enough to trigger an estate tax at death. For example, if the insured is also the owner (and, therefore, holds incidents of ownership at death) the full death benefit will be included in the estate of the insured at death for purposes of determining the estate tax owned.

On the other hand, if the owner of a life insurance policy dies (and is not the insured), only the value of the policy as of the date of death will be included in the taxable estate. This may be only a small amount (such as the cash value of the policy) compared to the death benefit.

The irrevocable life insurance trust

As indicated in the proceeding section of this chapter, the proceeds of a life insurance policy will be subject to estate tax at a person's death if the insured is also the owner of the policy. As a consequence, even though there may be no income tax to pay, there may be substantial estate taxes payable on the death of the insured.

One approach to reduce the estate tax liability associated with the ownership of insurance policies is to purchase the policy as owned by, or transfer an existing policy to, the trustee of an Irrevocable Life Insurance Trust (also known by the acronym "ILIT"). If the policy is owned by the trustee of a properly drafted ILIT, the insurance proceeds will not be subject to estate tax at the owner-insured's death. Therefore, the entire death benefit will pass to the insured's intended beneficiaries (such as children) free from any estate tax liability.

The drafting and implementation of an ILIT is complex and proper structuring and management of the ILIT is necessary if the objective of saving estate tax is to be achieved. The insured of the policy held in the ILIT should never serve as the trustee of the ILIT since it is quite likely that the trustee will hold incidents of ownership as trustee which, in turn, will cause the insurance proceeds to be subject to estate tax.

In addition, there are significant gift tax consequences when contributions are made to the ILIT so that it will have the resources necessary to pay the life insurance premiums. Gift tax issues are also present when an existing policy is transferred to the ILIT. These gift tax considerations must be properly managed to achieve the most favorable tax consequences.

Even with the complexities associated with the ILIT, it remains one of the most effective and efficient estate planning strategies available to reduce estate taxes and to provide liquidity which may be needed to transition the family assets to the next generation. An ILIT may also provide benefits to the decedent's spouse and/or other family members in a trust that will be free from the claims of the beneficiaries' creditors.

Conclusion

Understanding the role of insurance as part of estate planning is very important. It is recommended that these issues be discussed with an estate planning attorney and life insurance professional. Please review Chapter 3 for a more detailed discussion regarding the proper designation of beneficiaries on life insurance policies, retirement benefits and other assets that are distributed at death by beneficiary designation in order to maximize the effectiveness of your estate plan.

CHAPTER 9

PROBATE AND THE POST-DEATH ADMINISTRATION OF ESTATES

Introduction

Death marks the final stage in the implementation of every estate plan. In many cases, death results in final distributions of a decedent's assets and the conclusion of the estate plan. In other cases, the estate or trusts created by the estate plan continue for many years for the benefit of the decedent's family or other intended beneficiaries.

Regardless of the form of the estate plan, some kind of estate administration will likely be necessary following a person's death. The estate administration may be in the form of a probate of the decedent's will or the administration of a living trust. The complexity of the estate administration will depend on a variety of factors including the type of assets subject to administration, the decedent's financial obligations and the provisions of the estate plan. Assuming that the decedent died with some assets that must be transferred to his or her intended beneficiaries, the estate administration may take only a few hours or many years.

What is probate?

Probate may be best described as a legal proceeding or process intended to accomplish the following tasks: 1) identify the assets of the decedent, 2) identify the persons entitled to receive the assets of the decedent, 3) identify the creditors and pay the legal debts of the decedent, and 4) distribute the remaining assets of the decedent to those who are entitled. This process may last for several months to many years depending on the circumstances.

The probate is administered by the designated court (often called the probate court) in each state. The requirements of a probate are specific to each state and the rules may be very different in each state. Some states (such as Washington) have simplified probate proceedings. Furthermore, a person may have probate in more than one state depending on the kind of assets owned at death.

Having a will does not avoid probate. Think of a will as a blueprint for the probate court. Your will tells the court how you want your estate to be distributed and who will be in charge of handling your estate (known as the executor or personal representative).

On the other hand, merely having a will does not require that your estate be probated. For example, a decedent may have a valid will, but if all of his or her assets are held in a living trust (see Chapter 4), a probate may not be necessary. The trust provisions will most likely distribute the decedent's assets to his or her intended beneficiaries.

Basic steps in probate

Although state probate laws (and for that matter, the laws in other countries) differ greatly, certain steps are required in every probate. These steps include the following:

- Identification of the decedent's heirs and beneficiaries of the estate

The heirs of a person's estate are those individuals who would receive the estate if the person died without a valid will. This is referred to as intestate succession. As described in Chapter 3, intestate succession assumes that you would want your estate distributed to family members. In effect, the state is writing a will for you if you do not have a valid will at death or if the terms of your will do not completely dispose of all of your assets.

"Beneficiaries of an estate" is a generic term to describe all of the persons who benefit under the terms of your will. Beneficiaries might include a spouse, other family members, certain non-related individuals, and/or charitable organizations.

One of the first steps in the probate of the estate is to identify the heirs and the beneficiaries of the estate. The beneficiaries are normally identified from the decedent's will. Heirs, as indicated above, are identified under state law. For example, a person's heirs include his or her spouse, if any; children and their descendents; parents; siblings; etc. However, under the terms of his/her will, the decedent might have chosen not to benefit any of these heirs but, instead, give his or her entire estate to unrelated individuals or charity at death.

- Commencement of the probate

The probate is commenced by filing the decedent's will (if any) with the court along with certain other documents. One document, commonly called a petition, informs the court of basic information, including the name of the decedent, the date of death, the names of the heirs and the beneficiaries of the estate, and who is requesting to be appointed as the personal representative. If the decedent died with a valid will, the appointed personal representative is most likely the person named in the will.

Once the court reviews the will, petition, and accompanying documents, the court will enter an order that directs that the personal representative be appointed, that the clerk of the court should issue a document that is evidence that a personal representative has been appointed and is authorized to administer the estate. In general, the clerk of the court will issue Letters Testamentary if the decedent died with a valid will or Letters of Administration if the decedent died without a will. Once the personal representative has either Letters Testamentary or Letters of Administration, he or she may act on behalf of the estate in handling the estate's business affairs.

- The creditor claims procedure

Shortly after the commencement of the probate, notice to creditors must be given. This involves a process of notifying all of the decedent's creditors which will include anyone who has extended credit to the decedent while living, such as the outstanding balance on a loan or credit card, unpaid utilities, unpaid services provided to the decedent (such as medical expenses) and the like.

Notification to creditors is made in two ways. First, the personal representative will publish the notice to creditors in a newspaper. This publication is sufficient notice to any creditor who is not known to the personal representative or could not be identified by a search of the decedent's financial affairs. If the personal representative knows of a creditor, the creditor must receive written notice of the decedent's death and the creditor's right to seek payment of the debt from the estate.

After a certain period of time has passed (frequently no less than four months) from the date that the notice to creditors was published, the creditor claim period expires. After this period of time, a creditor may not bring a claim against the estate for payment. This prevents an unpaid creditor from attempting to bring its claim against the beneficiaries or heirs of the decedent.

It is important to note that the protections to the estate and its beneficiaries afforded through the notice to creditors procedure is highly complex and the failure to meet any of the requirements will render the notice to a creditor defective. A defective notice will allow a diligent creditor to seek repayment even after the claim period has expired.

- Assets and liabilities

  The personal representative must inventory all of the decedent's assets and liabilities. Often, professional appraisals are necessary for difficult-to-value assets such as real estate and businesses. This valuation is also important if the estate is subject to estate tax and it is necessary to file estate tax returns with the Internal Revenue Service and/or one or more states.

  An inventory of the estate must be completed in a short period of time following the commencement of the probate. The inventory is usually filed with the court although some states (such as Washington) have eliminated this requirement.

  In addition, the personal representative must account for all income and expenses during the probate process. Some states require that the personal representative file annual accountings of all of the assets, liabilities, income and expenses of the estate with the court.

- Management of the estate

  During the probate, the personal representative has the duty to manage the assets of the estate for the benefit of the beneficiaries. This includes proper investment of estate assets. In some cases the personal representative will be called upon to sell or lease real estate, manage the decedent's business, carry on the decedent's contracts and otherwise to step into the shoes of the decedent with regard to his or her financial affairs.

  Although the personal representative does not need to be an expert at handling the decedent's financial affairs, the personal representative has a duty to seek the advice of appropriate counsel. The use of attorneys, accountants, financial advisors, appraisers and similar professionals are essential to the efficient administration of the estate and to ensure that the personal representative minimizes the likelihood of mistakes in handling the estate.

- Tax returns

  Depending on the value of the estate and the assets involved, there may be several tax returns that must be completed during the probate. First, if the decedent was required to file a personal income tax return with the Internal Revenue Service or in any state, the personal representative is obligated to file these returns on behalf of the decedent.

  The estate will also need to file an income tax return to report the income earned during the period of estate administration. This tax return must be filed on an annual basis. The estate may elect to use a fiscal year instead of a calendar year.

Finally, the estate may be substantial enough in value to require the filing of one or more estate tax returns. These returns report the assets and liabilities of the decedent. The estate tax is imposed on the net value of the estate. Most expenses of administration can be used to reduce the estate tax. In addition, distributions to a spouse or to a charity will also reduce the estate tax otherwise due.

- Closure of the estate

Once the business affairs of the estate have been concluded, the estate may be closed. Depending on state law, this process may take several weeks or longer. In some states, only the court may give permission to close the estate and distribute the remaining assets. Similar to the court order that commenced the probate, the court will enter an order directing the personal representative to distribute the assets subject to probate administration. Other states allow the distribution of the estate assets and closure of the estate by the personal representative without a court order.

As part of the closing process, the remaining assets of the estate are distributed by the personal representative in accordance with the decedent's will or according to the state's applicable intestate succession law. Each beneficiary will sign a receipt for the assets distributed to him or her. These receipts are filed with the court.

Other forms of estate administration

In some cases the formal probate of the decedent's estate is not necessary. During lifetime the decedent may have taken certain steps to avoid the probate of his or her estate. For example, the decedent may have transferred assets to a revocable living trust or other form of ownership that will distribute these assets without requiring a probate of the estate.

However, it is important to note that transfer of assets to a revocable living trust during lifetime is a mere change in the *form of ownership, not a change in the assets themselves*. Therefore, the same complexities may exist in the administration of the estate even though no probate is required. Assets must still be valued, creditors must still be paid and distributions made—all of the steps required in a probate, but without the court's oversight and involvement. In general, the administration of an estate without a probate will require many of the same steps as a probate. The fiduciary (such as a trustee of a living trust) has most, if not all, of the same responsibilities of a personal representative and the same exposure to liability for mistakes in handling the financial affairs of the estate.

In addition, all taxes must still be paid. Unless the decedent transferred assets during lifetime in a manner that has the effect of excluding the assets from the estate for tax purposes, the mere change in the form of ownership will not reduce the estate taxes payable. As a general rule, if the decedent retained the authority to benefit from the asset during lifetime or control the distribution of the asset at death, the asset is subject to estate tax. As discussed in Chapter 5, the application of the estate tax is not dependent on the decedent's ownership of the asset in question but his or her ability to benefit from and control the asset.

Resolution of disputes

Whether in the form of a formal will contest or other dispute arising in the administration of the estate, one of the most important functions of a probate administration is to resolve any disputes arising with regard to the estate. Proper estate planning can minimize the risk of disputes in the estate.

In some cases the probate of at least a portion of the estate may be warranted. One benefit of probate is that it forces persons interested in the estate to bring any potential claim in a timely manner. For example, a will contest must generally be brought within a short period of time following the commencement of the estate or it is barred.

Similarly, in many states the benefit of the creditor claim procedure (described above) is only available as part of a probate. Some states (including Oregon and Washington) allow the creditor claim procedure to be utilized by any fiduciary even if a probate is not commenced.

Conclusion

The administration of a decedent's estate can take on many forms. Not every estate will require probate; however, not every person should attempt to avoid probate either. Proper estate planning during lifetime can reduce the expenses of the administration of your estate, whether or not a probate of your estate is necessary or desirable.

CHAPTER 10

Asset Protection Planning

Introduction

Asset protection planning is a subspecialty of estate planning that involves the implementation of various strategies designed to protect assets from the claims of creditors. Provisions may be made for the protection of assets during the lifetime of the owner, or after the death of the owner, but during the lifetimes of the intended beneficiaries, or both.

Protection from creditors involves a wide variety of potential claimants and depends a great deal on an individual's personal situation. As an example, physicians and other professionals may be interested in taking steps to avoid the personal financial consequences of malpractice claims. Others may be worried about potential lawsuits arising out of the ownership and operation of a business. Still others are less concerned about their own potential creditors but are fearful that the inheritance that they leave to their children will be lost to a child's creditor, failed marriage, or mismanagement.

Asset protection planning is not a substitute for comprehensive estate planning for all individuals and business planning for business owners. Instead it involves a thorough review of the factors that would lead a person to believe that he or she is more susceptible and/or more sensitive to the likelihood of substantial or repeated exposure to the claims of creditors. Furthermore, asset protection planning cannot be implemented in a vacuum; all of the other factors that are relevant in an estate plan (such as proper tax planning) must be considered as part of the process.

It is also important to note that asset protection planning should not be utilized for the purpose of avoiding known creditors or creditors that can be reasonably anticipated. In all likelihood, any effort to avoid the claims of known or reasonably ascertainable creditors will fail and may subject anyone participating in such an effort to additional legal sanctions.

Protected assets

Certain categories of assets are protected without necessity of additional planning. Identifying the exempt assets that you own is the first step in establishing any asset protection plan.

The exempt assets and the maximum value of the exemption vary from state to state, and certain assets are exempt under federal law as well. Some of the exempt assets include:

Retirement Accounts

Qualified Retirement Plans (such as a 401(k) Plan) and Individual Retirement Accounts are protected under federal law. Protections for IRAs are also available in many states.

Life Insurance

The cash value of a life insurance policy is not subject to the claims of the insurance policy owner's creditors. In addition, on the insured's death, the death benefit may, with proper planning, be protected from the deceased owner's creditors as well as the creditors of the beneficiary(ies).

Personal Property

Certain personal property is exempt from creditor claims. The type and value varies from state to state.

Home Equity

A portion (if not all) of the equity of a home is exempt from creditor claims. Again, the amount of the exemption varies from state to state.

Strategies for protecting other assets

For assets that are not exempt from the claims of creditors, there are many strategies available to accomplish your asset protection objectives. Caution must be exercised that the strategies are not be implemented in an effort to avoid known or reasonably ascertainable creditors. Furthermore, many attorneys advise that you should retain sufficient assets to meet your current and anticipated future expenditures. Only excess assets should be included in part of an asset protection plan.

Business Entities

One or more forms of business entities may be used to protect assets. Business assets can include an active business or the passive ownership of assets such as rental real estate. Corporations are commonly utilized for the ownership of active business entities. Limited partnerships or limited liability companies are often used for rental and investment real estate.

The use of a business entity is intended to insulate your personal assets from the claims of any creditors of the business. For example, if a rental home is owned in a limited liability company and a liability arises with regard to the rental property, the claim of the injured party is likely to be limited to the value of the rental.

If a creditor has a personal claim against an individual who owns a business entity, the ownership interest in the entity is merely one more asset that the creditor can pursue. However, certain provisions can be included in the legal documentation creating the entity that makes it very difficult for the creditor to force payment of the claim out of the assets of the entity or to force the sale of the assets held by the business entity in order to satisfy the claim.

Third-Party Trusts

A trust established for the benefit of another person (such as a spouse or child) is free from the claims of the beneficiary's creditors, if properly structured. Third-party trusts are often included in the estate plan to protect an inheritance from the claims of the beneficiary's creditors or divorce.

Sometimes called a "spendthrift trust," a third-party trust can be drafted to provide benefits to the beneficiary for a period of years or for the lifetime of the beneficiary. The beneficiary may also be given the power to control the disposition of the trust property at the time of his or her death (called a "power of appointment"). The beneficiary may serve as a co-trustee of the trust as long as an independent party is appointed as the other co-trustee. The independent trustee should have all of the decision-making authority over the amount and the timing of the distributions from the trust to the beneficiary.

Marital Property Agreements

Marital property agreements (such as premarital agreements or postnuptial agreements) can be used to help insulate the assets of one spouse against the claims of the other spouse's creditors. For example, if a spouse of a physician is concerned that his or her assets might be made subject to a malpractice claim, the couple may enter into an agreement to afford the non-debtor spouse greater asset protection.

Domestic Asset Protection Trusts

Many states have enacted laws that allow for self-settled asset protection trusts. These laws allow, within certain guidelines, a person to establish a trust that allows the assets of the trust to be used for his or her benefit but will not be subject to the claims of the Trustor's creditors.

Generally, the trust must be located in a state that allows for the creation of self-settled asset protection trusts and one of the trustees of the trust must be a resident of that state. Thus, a Washington resident can create a self-settled asset protection trust in Alaska but the trustee must be a resident of Alaska.

The benefits of self-settled asset protection trusts have been significantly limited as a result of the Bankruptcy Reform Act of 2006. However, they remain viable planning tools in many circumstances.

Offshore Asset Protection Trusts

Similar to the self-settled domestic asset protection trust, many foreign countries have favorable rules regarding the establishment of offshore asset protection trusts. Jurisdictions such as the Cayman Islands and Isle of Man have become popular for the establishment of self-settled trusts.

There can be significant tax and non-tax consequences associated with the exporting of assets to foreign jurisdictions. In addition, the location of the assets in a foreign jurisdiction presents a significant hurdle for any creditor wishing to be paid from such assets.

Conclusion

The protection of assets can be a significant part of your estate plan. Asset protection planning can be as simple as properly structuring your will and estate plan in order to take advantage of state and federal laws or may involve more complicated strategies such as transferring assets to other jurisdictions, including foreign countries. Due to the highly complex sets of rules in this area, you should seek the advice of an attorney with experience in asset protection planning before pursuing any of the advanced strategies described above.

CHAPTER 11

PLANNING FOR DISABILITY AND LONG-TERM CARE

Introduction

Planning for disability and long-term care is an important part of most, if not all, estate plans. The days are gone in which we can expect to live a full and healthy life up until the moment of our death. More likely, planning for a period of disability during lifetime is not only prudent, but essential.

Proper planning for disability and long-term care can be as simple as executing a basic estate plan including durable powers of attorney for the management of property and health care matters, and a health care directive to prepare for end-of-life decisions. An in-depth review of powers of attorney and health care decision making is in Chapter 3.

In addition, available long-term care insurance options should be reviewed. With convalescent care costs exceeding $5,000 per month in many places, the likelihood of long-term care and planning for this expense should be considered as part of any thorough estate plan. The advice of an experienced long-term care insurance professional is invaluable in this process.

Planning for Medicaid eligibility

INTRODUCTION

In some circumstances proper planning in anticipation of long-term care may include sheltering assets to promote Medicaid eligibility (often called Medicaid planning). It should be noted that such planning is not intended to protect assets so that children may receive an inheritance. Rather Medicaid planning is designed to ensure that the expenses associated with long-term care that are not covered by the Medicaid program can be met.

WHAT IS MEDICAID

Medicaid is a government program that is designed to provide assistance to many individuals in need of medical care and are unable to pay for such care out of their own resources and income. The Medicaid program is a state and federally funded program. Individuals qualifying for Medicaid apply to the state agency designated for the purpose of administering the Medicaid program in the state where long-term care is sought.

There are certain federal laws that all states must follow in administering their individual Medicaid programs. However, many options are available to the states; therefore, the Medicaid program in one state may be administered in a very different manner than in another state. You should seek the advice of an attorney experienced in navigating the myriad of rules applicable to Medicaid in the state where eligibility is being sought.

Medicaid should be distinguished from Medicare. As most people are aware, Medicare is a medical insurance program which is administered by the federal government (and not by the states) for the elderly and disabled. Medicare provides very little in long-term care benefits; therefore, proper estate planning and planning for disability should not be predicated on the assumption that Medicare will pay the costs of long-term care.

Medicaid Financial Eligibility Criteria

Unlike Medicare, Medicaid has very rigid financial criteria. A person applying for benefits under the Medicaid program must meet the eligibility criteria or Medicaid benefits will not be available. This is one of the areas where there can be significant differences between states. Thus, a person may be eligible in one state but not in another.

Financial eligibility will be determined based on an individual's income and assets. Certain assets (such as a primary residence, an automobile and personal property) may be exempt from consideration in the process of determining Medicaid eligibility. For example, it is generally not required that a person's home be sold before Medicaid will pay long-term expenses. However, after the person's death, the state has the right to recover the costs of the person's long-term care expenses from the assets that were previously exempted from consideration, including the residence. Proper Medicaid planning must take into consideration the state's right of reimbursement.

Other resources such as cash, investments, bank accounts, the cash value of an insurance policy, and other assets are deemed to be available to pay for long-term care expenses under the Medicaid program and must be spent before Medicaid will pay any long-term expenses. These are referred to as non-exempt assets.

In a circumstance where a spouse requires long-term care, it is also important to understand that the state will consider the assets and income of both spouses in determining eligibility for Medicaid. Owning assets as separate property does not protects the assets nor will the presence of a premarital property agreement protect assets.

For a single person, a maximum of $2,000 of non-exempt assets may be retained. For a married couple, the spouse not requiring long-term care may retain additional non-exempt assets.

Income is also taken into consideration. Substantially all of a single person's income must be spent on his or her long-term care. For a married couple, the spouse residing at home is generally entitled to all of the income he or she is entitled to receive (such as pension and social security payments). If this amount is less than a certain amount established under federal law, the spouse living at home may receive a portion of the institutionalized spouse's income.

Transferring Resources

Great caution must be exercised in transferring or gifting assets in anticipation of long-term care. As part of the Medicaid application process, the applicant must disclose all transfers made within the prior five years because Medicaid will assess a penalty against the applicant who has made gifts within this time frame. This penalty, in the form of a period of ineligibility for Medicaid benefits, is calculated based on the value of the assets transferred.

Recent changes in the law have made planning for Medicaid eligibility through transfer of assets more complicated. Since the period of Medicaid ineligibility for asset transfer can be as long as five years, guidance from an experienced attorney is highly desirable before any transfers are made.

There are certain exceptions that apply to the asset transfer rules but they are rarely of much benefit. For example, a gift to a spouse does not affect Medicaid eligibility. However, as described above, the assets of both spouses are considered in determining eligibility. Therefore, transfers between spouses will not accelerate eligibility for Medicaid benefits, although there may be other advantages to transferring assets to the healthy spouse as described below.

Medicaid and Trusts

Transferring assets into a trust will rarely provide any benefit from a Medicaid planning perspective. Revocable living trusts (described in greater detail in Chapter 4) are deemed to be available to the applicant to pay his or her long-term care expenses since the applicant is generally the beneficiary of the trust during life and may revoke the trust. Depending on its terms, an irrevocable trust may exempt assets from consideration as part of the Medicaid application process; however, the transfer of assets to such a trust will be deemed to be a transfer of assets subject to the rules described above.

However, some forms of trusts are beneficial. For example, you may establish a trust under the terms of your will that will shelter assets after your death in the event that your spouse requires long-term care. Known as a "special needs trust," this form of planning is important if your estate is modest in value and you have little or no long-term care insurance available to you.

Conclusion

Planning for disability and long-term care is part of any complete estate plan. Even in circumstances where a person has long-term care insurance or sufficient assets to pay long-term care costs, the use of powers of attorney and trusts should be considered in order to provide for the proper management of the disabled person's financial and personal affairs. In many cases, proper advanced planning for Medicaid eligibility is also important.

Conclusion

I have practiced estate and trust law for nearly twenty years. In that period of time I have seen hundreds of estate plans implemented following the death or incapacity of an individual. Unfortunately in all too many cases, the plan was incomplete or could not be fully implemented.

I have witnessed assets distributed to children, grandchildren, or others when the beneficiary was too young or immature to properly manage or appreciate the benefit of the inheritance; the payment of unnecessary estate or income taxes; charitable intentions gone unfulfilled; and far too many family conflicts (if not pitched battles). These and many other estate planning failures could have been avoided with proper and thoughtful planning.

Not only does an estate plan define the distribution of your assets, but it may also be a message about your values. How do we turn an inheritance into a legacy? Not an easy question to answer. One way to start the process is to ask yourself a rather simple question: "In a hundred years, what would I want to see my financial resources doing for my family, loved ones, and community?"

Many of my clients—some with very modest estates—have established an account with a school or foundation that will provide scholarships for needy and worthy high school students in our community. Other clients have helped build a hospice house for the terminally ill, made contributions that will provide musical instruments for local schools, supported programs for animals, and funded homeless shelters. The list is nearly endless.

Still other clients have set aside a portion of their estate to provide a fund for future generations of their family for education and other worthy causes. This approach, referred to as the family bank, is becoming an increasingly popular way to provide not only the financial benefit of an inheritance but, more importantly, a way to impart your values to future generations.

Being good stewards of our financial resources—whether they are modest or substantial—is important. Those of us who have been blessed with such resources owe a duty, in my opinion, to ensure proper stewardship beyond our deaths.

I wince when a client says, "Why should I worry about what my children do with their inheritance after I am gone?" I think there are very good reasons to, in fact, worry about it! It is part of leaving not just an inheritance, but a legacy. An inheritance can be so much more than just money, the family business or a vacation home. It is a way that each of us can impart our values—the core of what makes each of us who we are—to those we leave behind.

Philip B. Janney
Attorney at Law

Estate Planning Questionnaire

Completion of a questionnaire or similar document is often one of the first steps in the estate planning process. Most estate planning attorneys have some form of questionnaire designed to identify information that will be important in completing the client's individual estate plan.

The questionnaire asks the client to provide basic information about his or her family and financial affairs as well as to briefly describe how the estate should be distributed at death.

In addition, there is a section to briefly describe the fiduciary roles that may be relevant in various situations. The names of the parties who could serve as fiduciaries may be filled in; however this is often the subject of considerable discussion at the client/attorney meeting.

The following questionnaire is available on request by mail, by e-mail or online at http://www.landerholm.com/Practice-Areas/Estate-Planning.

APPENDIX 1:

CONFIDENTIAL ESTATE PLANNING QUESTIONNAIRE

PERSONAL INFORMATION

Date: ____________________

Client 1	Client 2
Name (list name as you want on your documents)	*Name (list name as you want on your documents)*
Home Address (street, city, state and zip code)	*Home Telephone*
Business Telephone	*Business Telephone*
Mobile/Cell Telephone	*Mobile/Cell Telephone*
Email Address	*Email Address*
Social Security Number	*Social Security Number*
Date of Birth	*Date of Birth*
Years lived in State of Residence	*Years lived in State of Residence*
Date of Marriage	
Prior Marriages? ☐ Yes ☐ No	*Prior Marriages?* ☐ Yes ☐ No

OTHER INFORMATION

	Yes	No
A. Client 1: Are you a U.S. citizen? If no, what country?	☐	☐
B. Client 2: Are you a U.S. citizen? If no, what country?	☐	☐
C. Did either of you own a substantial amount of property prior to this marriage?	☐	☐
D. Have either of you made any large gifts? (exceeding $3,000 prior to 1982 and $10,000 during or after 1982)	☐	☐
E. Have you received an inheritance? If yes, indicate amount and year:	☐	☐
F. Do either of you expect to receive any gifts or inheritances in the future?	☐	☐
G. Are either of you the beneficiary of a trust?	☐	☐
H. Do you own any real estate outside your state of residence? ***If so, indicate state and county and include the property address on the attached net worth statement.***	☐	☐
I. Do you own a business which has made an "s" election for income tax purposes?	☐	☐
J. Do you have any dependents with special needs?	☐	☐
K. Have any of your children received (or are likely to receive) any government assistance, such as SSI? If so, who:	☐	☐
L. Has anyone in your family been adopted? ***Please attach explanation***	☐	☐
M. Do you have any deceased children?	☐	☐
N. Do you have any of the following estate planning documents?		
Will	☐	☐
Power of Attorney	☐	☐
Revocable Living Trust	☐	☐
Other Trust	☐	☐
Health Care Durable Power of Attorney/Directive	☐	☐
Oregon Advance Directive	☐	☐
Community Property Agreement	☐	☐
O. Do either of you own a long-term care insurance policy?	☐	☐

If yes, please provide copies of relevant documents

ADVISOR INFORMATION

Accountant/Tax Preparer:

____
Name *Telephone*

____
Address

Investment Counselor:

____
Name *Telephone*

____
Address

Casualty and Homeowners Insurance Agent:

____
Name *Telephone*

____
Address

CHILDREN

(list name as you want it on your documents)

	First Child	Second Child
Name		
Date of Birth		
Address		
Name of Child's Spouse		
Parent (if from prior marriage)		
	Third Child	Fourth Child
Name		
Date of Birth		
Address		
Name of Child's Spouse		
Parent (if from prior marriage)		
	Fifth Child	Sixth Child
Name		
Date of Birth		
Address		
Name of Child's Spouse		
Parent (if from prior marriage)		
	Seventh Child	Eighth Child
Name		
Date of Birth		
Address		
Name of Child's Spouse		
Parent (if from prior marriage)		

RETIREMENT PLAN INFORMATION

Client 1	Client 2
Please indicate current account balance or monthly retirement benefit (not including Social Security benefits): $	Please indicate current account balance or monthly retirement benefit (not including Social Security benefits): $
Please describe the retirement plan which your employer maintains for its employees: Plan 1: Plan 2:	Please describe the retirement plan which your employer maintains for its employees: Plan 1: Plan 2:

LIFE INSURANCE INFORMATION

	Policy No. 1	Policy No. 2
Company		
Face Amount		
Type (variable, whole life, term)		
Loans on Policy		
Owner of Policy		
Beneficiary(ies)		

	Policy No. 3	Policy No. 4
Company		
Face Amount		
Type *(variable, whole life, term)*		
Loans on Policy		
Owner of Policy		
Beneficiary(ies)		

FIDUCIARY CHOICES

Executor/Personal Representative

Your personal representative is responsible for settling the financial affairs of your estate, including the investment of your assets, paying any final bills and distributing your assets in accordance with your Last Will.

	Client 1	**Client 2**
First Choice		
Address		
Phone		
Alternate		
Address		
Phone		
Second Alternate		
Address		
Phone		
Comments:		

Trustee

Your trustee manages your assets for the benefit of your beneficiaries after your death. Trusts are often used to protect beneficiaries, such as young children, from making ill-advised investments and spending decisions or to protect assets from the beneficiary's creditors (including situations involving divorce). Trusts can last for many years. Please consider this when selecting your trustee.

	Client 1	**Client 2**
First Choice		
Address		
Phone		
Alternate		
Address		
Phone		
Second Alternate		
Address		
Phone		
Comments:		

Guardian for Children

After your death, the guardian will be responsible for the care and upbringing of your children (or other dependents in your care) so long as they are minors or otherwise incapacitated.

	Client 1	Client 2
First Choice		
Address		
Phone		
Alternate		
Address		
Phone		
Second Alternate		
Address		
Phone		
Comments:		

Durable Power of Attorney

A Durable Power of Attorney is a document appointing another person (called the "attorney-in-fact") to make financial and health care decisions for you if you become incapacitated or disabled.

A. Attorney-in-Fact (Financial). Powers include the purchase and sale of property, access to financial records and accounts, investment of assets, continuation of business interests, and tax/estate planning.

	Client 1	Client 2
First Choice		
Address		
Phone		
Alternate		
Address		
Phone		
Second Alternate		
Address		
Phone		
Comments:		

B. <u>Attorney-in-Fact (Health Care)</u>. Powers include giving directions to health care providers regarding medical treatment and life-sustaining procedures, access to medical records, and addressing your long-term care needs.

	Client 1	**Client 2**
First Choice		
Address		
Phone		
Alternate		
Address		
Phone		
Second Alternate		
Address		
Phone		
Comments:		

Distribution of Assets

Briefly state how you prefer to have your property distributed upon your death:

NET WORTH STATEMENT

ASSETS

Real Estate	
Home	$__________
Vacation Home	$__________
Business	$__________
Other:	$__________
Personal Property	
Home Furnishings	$__________
Autos/Vehicles	$__________
Jewelry, etc.	$__________
Other:	$__________
Life Insurance	
Client 1 Total Death Benefit	$__________
Client 2 Total Death Benefit	$__________
Cash in Bank	
Checking Account	$__________
Savings Account	$__________
Other Accounts	$__________
Retirement Plans	
Client 1 IRA	$__________
Client 2 IRA	$__________
Client 1 401(k)	$__________
Client 2 401(k)	$__________
Other Investments	
Stocks	$__________
Bonds	$__________
Mutual Funds	$__________
Annuities	$__________
Other:	$__________
Trust Assets	$__________
Miscellaneous	$__________
TOTAL ASSETS	$__________

LIABILITIES

Mortgages/Contracts Owing	
Home	$__________
Vacation Home	$__________
Business	$__________
Other:	$__________
Loans	
Autos/Vehicles	$__________
Personal	$__________
Life Insurance	$__________
Other:	$__________
TOTAL LIABILITIES	$__________

TOTAL ASSETS	$__________
Less total liabilities	$__________
NET WORTH	$__________

Please list the address to any real estate ***(including state and county)*** owned outside your state of residence:

APPENDIX 2:

IMPACT OF THE 2010 TAX ACT ON ESTATE AND GIFT PLANNING

January 2011

I. INTRODUCTION

On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Tax Act"). Though advertised as an extension of the 2001 Tax Act, the 2010 Tax Act contains several provisions that expand the previous law with respect to estate and gift taxes, and provide some significant planning opportunities. This memorandum will only address the estate and gift tax provisions of the 2010 Tax Act.[1]

Certain provisions of the 2010 Tax Act were made retroactive to January 1, 2010, while other provisions became effective January 1, 2011, and still others are not effective until January 1, 2012.

The 2010 Tax Act is set to expire on December 31, 2012. Therefore, many of the estate and gift tax benefits under the Act may no longer be available after this date. However, if history repeats itself, extension of these 2010 Tax Act provisions seem likely. Most certainly, the political tribulations in late 2012 will dictate the extent to which the provisions of the 2010 Tax Act will be extended.

II. ESTATE AND GIFT TAX EXEMPTIONS AND RATES

Historical perspective

Although estate and gift taxes predate the enactment of the Internal Revenue Code of 1986 (the "IRC"), as a practical matter, the modern version of the estate and gift tax continues to be based on the provisions of the IRC. Under the IRC, the estate and gift tax exemption amount[2] was "unified" in that the exemption could be applied to transfers during lifetime or at death, or in combination of lifetime or post-death distributions. In addition, the estate and gift tax exemption amount was set at $600,000 per person until 1997.

Many of the same exclusions applied to the imposition of gift or estate taxes. For example, most transfers to charities and spouses are (and continue to be)

[1] Many transfers during lifetime and at death are also subject to the generation skipping transfer tax. Where applicable, this tax is in addition to the gift or estate tax, and is discussed in further detail in Section III of this memorandum.

[2] The exemption amount is actually based on a credit, known as the "applicable credit amount" and the estate tax or gift tax due is determined by applying the applicable credit amount against the net value of the wealth transferred.

completely exempt from the imposition of gift and estate taxes (other than to non-citizen spouses).

Beginning in 1998, the estate and gift tax exemption amount was scheduled to increase to $1 million by 2006. However, the 2001 Tax Act intervened and raised the exemption amount to $1 million beginning in 2002. In addition, the estate tax (but not the gift tax) was scheduled to increase to $3.5 million by 2009. Under the 2001 Tax Act, the estate tax was repealed in 2010. The gift tax exemption amount remained at $1 million from 2002 thru 2010.

The estate and gift tax rates ranged from 18% to 55% depending on the size of the estate.[3] The application of the exemption amount made the effective tax rates 37% to 55% for most estates until 1998 when the exemption amount was scheduled to increase from $600,000 to $1 million.

With the enactment of the 2001 Tax Act, the tax rates were also scheduled to decline to 45% beginning in 2007. For 2010, during which time there was no estate tax, the gift tax rate was set at the highest marginal income tax rate (35%). For 2010, no estate tax applied but the gift tax remained in effect. Therefore, prior to the enactment of the 2010 Tax Act, deaths in 2010 resulted in no estate tax. Thus, 2010 appeared to be the year to make large gifts (at the historically low 35% rate) or die.

If no legislative action had been taken before December 31, 2010, the gift and estate tax exemption, and tax rates, would return to the pre-2001 Tax Act beginning on January 1, 2011. This changed on December 17, 2010, with the enactment of the 2010 Tax Act.

Estate Taxes under the 2010 Tax Act

In what came as a surprise to many, the estate tax exemption amount was raised to $5 million and was made retroactive to January 1, 2010. However, estates of decedents dying in 2010 are given an option; either apply the $5 million exemption or "opt out" of the estate taxes all together. Clearly, the estates of many wealthy individuals dying in 2010 will choose the latter. In addition, the estate tax exemption amount is indexed for inflation from 2010 beginning in January, 2012.[4] The estate tax rate is set at a flat 35%.

Another important feature of the 2001 Tax Act repealed the step-up in basis rule in 2010.[5] Except during 2010, this rule allows beneficiaries of a decedent's estate to adjust the basis in appreciated assets to the fair market value of the

[3] A 60% rate applied to certain especially large estates but this rate was repealed with the 2001 Tax Act.
[4] Rounded down to the nearest $10,000 increment.
[5] The 2001 Tax Act provides for a limited step-up in basis that can be applied by the estate of a 2010 decedent. For all estates, basis of eligible assets can be stepped up by $1.3 million. Assets passing to a surviving spouse can be stepped up by an additional $3 million.

assets on the decedent's date of death.[6] This was (and remains) a very valuable tax benefit to beneficiaries of a decedent's estate holding appreciated assets. Without a "step-up" in basis, the beneficiary must pay the capital gain on the appreciated asset at the time of the sale of the asset. This could be a significant amount if the asset had been owned by the decedent for many years.

For example, if the decedent had purchased Starbucks at its initial public offering, and the decedent died in 2010, there would not be any step-up in basis (unless a portion of the $1.3 million allotment was allocated to the Starbucks stock), and at the time of sale the estate beneficiaries would pay the capital gains tax that the decedent would have had to pay had he or she sold the stock during lifetime.

As previously mentioned, under the 2010 Tax Act the estate tax exemption of $5 million is made retroactive to January 1, 2010. Unless the decedent opts out of the estate tax, the step-up in basis rule is reinstated and the basis of all of the assets of the estate will be reset to fair market value on the date of the decedent's death; which, in the previous example, would eliminate all of the capital gain on the sale of Starbucks stock. If, on the other hand, the estate elects out of the estate tax for 2010, no estate tax applies but the assets are not allowed to be reset to fair market value. Thus, the beneficiaries of appreciated assets must pay the capital gain at the time of the sale of the asset.[7]

Gift Taxes under the 2010 Tax Act

Under the 2010 Tax Act, the estate and gift tax exemption amount is "re-unified" at $5 million beginning in 2011. As with the estate tax, the gift tax exemption is indexed for inflation from 2010 beginning in 2012. If a donor makes gifts and exceeds his or her $5 million exemption, the gift tax rate is set at 35%.

The 2010 Tax Act does contain a trap for the unwary. As currently written, the 2010 Tax Act provides that the value of the donor's gifts during lifetime will be subject to estate taxes at the donor's death if the estate tax exemption is allowed to decline below $5 million after 2012. For example, if a donor makes gifts of $5 million and dies in 2015, and if the 2010 Tax Act is not extended beyond December 31, 2012 such that the estate tax exemption amount is allowed to decline to $1 million, $4 million of the gifts will be added back into his or her estate for purposes of calculating the estate tax. It does not appear that this was intended by the legislation and it is possible that this problem will be solved with a technical correction to the legislation.

The increased gift tax exemption provides significant opportunities to make transfers of substantial wealth to others without imposition of gift taxes. Wealthy individuals will want to consider making large transfers to children and

[6] Some assets are not eligible for the step-up in basis. These assets include assets held in an IRA or retirement plan, increase in the value of an annuity and contracts for the sale of appreciated assets.
[7] The limited step-up in basis described in footnote 5 applies to estates of 2010 decedents that opt out of the estate tax.

other intended beneficiaries in order to take advantage of this window of opportunity. It is generally recommended that sizable gifts be made to an irrevocable trust that can provide benefits to multiple generations. Using a trust provides many benefits including reduced estate taxes at the death of the recipient of the gift, professional management of the assets where desirable, and the protection of the assets from the claims of the creditors of the beneficiary. As described further in Section III of this memorandum, state law allows trusts to last for many years.

Large gifts can be further enhanced by using a business entity such as a family limited partnership or limited liability company. These business structures allow the donor (typically a parent or grandparent) to transfer ownership of the business entity in a form that will limit the recipient's right to control the actions of the manager (parent or grandparent) and prevents the recipient from selling his or her ownership rights to anyone outside the family. These limitations produce lower values (known as "discounts") when units are gifted and allow more assets to be transferred at a lower gift tax.

For example, a parent establishes a family limited partnership and funds it with $8 million of assets. The family limited partnership has 2% of its units with management power and 98% with no management powers. In addition, the family limited partnership prevents anyone from selling their units outside the family. Parent then gifts the 98% to his children and grandchildren. A 30% discount is allowed on the 98% of the partnership gifted because the children and grandchildren cannot control the management of the partnership and cannot sell their interests in the partnership. The parent's gift tax return will report that he made a gift of $5,488,000, not $7,840,000 (98% of $8 million),[8] as a result of the 30% discount.

"Portability" of the Estate and Gift Tax Exemption.

For many years married couples with estates exceeding the estate tax exemption amount provided for the establishment of an "exemption equivalent trust"[9] under the terms of their wills or revocable living trust. The purpose of the exemption equivalent trust is to preserve the estate tax exemption of the spouse that is the first to die (the "predeceased spouse") so that the exemption amount remains available for the predeceased spouse's children (or other intended beneficiaries) at the time of the surviving spouse's death. During the surviving spouse's lifetime, the assets of the exemption equivalent trust are available to meet his or her living expenses.

Without the exemption equivalent trust, all assets of the decedent's estate would, in many cases, be transferred to the surviving spouse and the predeceased spouse's exemption would be wasted and not available for use at the

[8] The percentage discount will depend on a variety of factors and is determined by independent appraisal.
[9] Also referred to as a "credit shelter trust," "bypass trust" or "family trust."

time of the surviving spouse's death. Thus, more assets would be subject to estate taxes when the couples' estate is transferred to their children (or other intended beneficiaries).

The 2010 Tax Act includes an interesting (though in the author's opinion, not particularly useful) "portability" provision. This provision allows the estate of the surviving spouse to use the remaining exemption of his or her predeceased spouse without having to impose an exemption equivalent trust at the predeceased spouse's death. The portability provision applies to estates of decedents dying after December 31, 2010.

For example, if wife dies with a $3.5 million estate and transfers her entire estate to her husband without the use of an exemption equivalent trust, no estate tax will be due because transfers to spouses are entitled to a deduction and will reduce the estate tax due. If husband dies in 2012 with a $7 million estate, (including predeceased wife's $3.5 million) the estate can use the predeceased wife's exemption and eliminate the estate tax that would have been due.[10] In this way, the exemption becomes "portable."

There are several significant problems with portability, though. First, the estate of the predeceased spouse must file an estate tax return to elect portability. Thus, in the above example, if wife dies and the entire estate is passed to husband, and her personal representative does not file an estate tax return for the wife's estate, it is not possible to take advantage of wife's remaining exemption in husband's estate. The estate tax return must be "timely filed" in wife's estate. Generally, this means that the return must be filed within nine months of wife's death.

Portability is also not a dependable estate planning option where a trust is otherwise viewed by the couple as being beneficial for non-tax reasons. A trust may be desirable where the couple has children who will be the ultimate beneficiaries of the estate but are from prior marriages. Thus, if wife dies and the entire estate is transferred to husband, he may change his estate plan to benefit only his children and effectively disinherit wife's children.

Some surviving spouses also need the benefit of professional money management due to the surviving spouse's limited financial capabilities, or due to a mental or physical disability making it difficult or impossible for him or her to handle the finances. Trusts can beneficial under these circumstances. Furthermore, some spouses may have significant liabilities or are in high-risk occupations that attract litigation (such as physicians). Trusts can also be drafted to protect the predeceased spouse's estate from the creditors of the surviving spouse.

In addition, portability can be lost if the surviving spouse is remarried. The 2001 Tax Act only allows the surviving spouse to use his or her most recent predeceased spouse's remaining estate tax exemption.

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[10] Under the 2010 Tax Act, husband's estate is entitled to a $5 million exemption (assuming husband made no taxable gifts during lifetime that would reduce this amount) and the estate tax on the $7 million estate would be $700,000.

Finally, the deceased spouse's exemption is not subject to the inflation adjustment described in Section II.B of this memorandum above. Thus, while the surviving spouse's exemption will increase with inflation, the beneficiaries of the surviving spouse's estate will not be able to adjust the predeceased spouse's exemption for the affects of inflation. Conversely, the assets of an exemption equivalent trust will be distributed to the beneficiaries of the trust at the surviving spouse's death without imposition of estate taxes regardless of the value of the assets. Therefore, the exemption equivalent trust allows for virtually unlimited appreciation in value after the first spouse's death. In addition, the state estate tax exemption discussed in Section IV of this memorandum is not subject to federal tax laws and, therefore, is not portable.

GENERATION SKIPPING TRANSFER TAXES

In addition to gift and estate taxes, certain transfers are also subject to the generation skipping transfer tax (the "GSTT"). Transfers that "skip" a generation (such as a gift from a grandparent to a grandchild) are subject to the GSTT. The tax rate is the highest rate applicable to a gift or in an estate. Until the 2001 Tax Act, this rate was 55%. The 2010 Tax Act sets the rate at 35% beginning in 2011. Gifts and transfers at death during 2010 were made subject to GSTT but the tax rate was set at zero.

There are several exceptions to the application of the GSTT. Similar to the estate and gift tax exemption, there is an exemption from the GSTT. Under the 2010 Tax Act, this exemption is set at $5 million. Thus, large transfers can be made to individuals who are two or more generations below that of the transferor without GSTT as well as gift or estate tax. This provides a significant opportunity to make large transfers without payment of any taxes.

In addition, if this amount is transferred into an irrevocable trust, the trust assets may be used for the benefit of the beneficiaries for an extended period of time.[11] This approach allows the assets of the trust to appreciate in value without imposition of estate taxes and GSTT as each trust beneficiary (such as a child) dies and a successor beneficiary (such as a grandchild) becomes entitled to receive distributions from the income and principal of the trust. These long-term, tax efficient trusts are often referred to as "dynasty trusts."

Unlike the estate tax exemption, the GSTT exemption of the predeceased spouse is not portable. Thus, if a couple's estate plan calls for the use of long-term trusts to reduce estate taxes as their descendents die, the couple must plan to protect the GSTT exemption of the predeceased spouse or it will be wasted. As with estate and gift the GSTT exemption is indexed after December 31, 2011.

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[11] Most states still apply the "rule against perpetuities" that prevents a trust from lasting forever. In Washington, the rule against perpetuities requires that the trust terminate no later than 150 years after it becomes irrevocable. Some states (such as Alaska) have repealed the rule against perpetuities.

THE 2010 TAX ACT AND STATE ESTATE TAXES

Although many states have repealed their state estate tax, Oregon and Washington continue to impose an estate tax that is separate from the federal estate tax described above. Neither Oregon nor Washington imposes a gift tax or a tax on generation skipping transfers.

Oregon imposes an estate tax at rates ranging from 5.6% to 16% and allows a $1 million exemption.[12] Washington's estate tax is applicable to estates exceeding $2 million and the tax is imposed at rates ranging from 10% to 19%.[13]

There are two important implications of the 2010 Tax Act with respect to state estate taxes. First, although many individuals will no longer be subject to federal estate taxes given the generous $5 million exemption, many decedents' estates will continue to be subject to state estate taxes.

Second, the estate tax exemption portability provisions under the 2010 Tax Act do not apply to a surviving spouse. Therefore, the use of an exemption equivalent trust to preserve the state estate tax exemption continues to be an important part of any couple's estate plan in order to reduce state estate taxes.

CONCLUSION AND SOME PLANNING THOUGHTS

At least until December 31, 2012, the 2010 Tax Act will provide significant relief from estate and gift taxes, and the GSTT. It remains to be seen whether the generous exemptions and lower tax rate will continue beyond 2012.

Individuals with significant wealth will want to consider whether making larger transfers before 2013 makes sense as part of their estate plan. The window of opportunity to make these large gifts may not be extended.

Furthermore, large gifts should almost always be made to a long-term trust for beneficiaries. This approach will reduce estate taxes when a beneficiary dies, provide for professional management of assets when desirable, and protect the trust assets from the beneficiaries' creditors and litigation, among other benefits. These trusts can be designed to last for multiple generations. Giving ownership interests in a business entity such as a family limited partnership or limited liability company can allow for larger gifts at lower gift taxes.

In addition, individuals should review their existing estate plan with their planning professionals to ascertain whether the 2010 Tax Act necessitates modifications to their estate plan. Many estate plans were drafted with the lower exemption amounts under the prior law in mind.

As a general rule, the portability of the federal estate tax exemption is not something that should be relied upon as an estate planning option. The necessity to make an election at the predeceased spouse's death, combined with the lack of

[12] Legislation pending in the Oregon legislature would increase the exemption to $1.5 million as well as increase tax rates.

[13] Both Oregon and Washington allow addition exemptions for agricultural and other natural resource assets in the estate.

state estate tax portability, makes portability nearly useless except under the most unusual of circumstances.

Finally, for estates of decedents dying in 2010, decisions need to be made regarding whether or not to opt out of the retroactive estate tax under the 2010 Tax Act. Generally, estates of less than $5 million will choose the estate tax in order to receive the benefit of the step-up in basis. Larger estates will want to consider opting out of the estate tax and allocating the limited step-up in basis[14] to appreciated assets of the estate.

About the author

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Circular 230 Disclosure

To comply with IRS rules, we are required to inform you that this memorandum, if it contains advice relating to federal taxes, is not intended or written to be used, and it cannot be used, for the purpose of avoiding penalties that may be imposed under federal tax law or for the purpose of promoting, marketing, or recommending to another party any tax related matters addressed herein. Under these rules, a taxpayer may rely on professional advice to avoid federal tax penalties only if that advice is reflected in a comprehensive tax opinion that conforms to stringent requirements under federal law.

Disclaimer

This memorandum is written for informational purposes only and shall not be interpreted to constitute legal advice in any form. Readers should seek the advice of their estate planning professions to review the implications of the contents of this memorandum with regard to their personal planning objectives and existing estate plan.

[14] The limited step-up in basis available to estates of decedents dying in 2010 is described in footnote 5.