An Overview of Estate Tax Planning[1]

This memorandum summarizes the basic estate planning strategies utilized by most persons who undertake estate tax planning. More advanced tax concepts certainly exist and should be used after a case by case evaluation. However, the concepts discussed below are common to almost all tax-planned estates. Our goal is to develop and implement an estate plan which is appropriate for your family. Tax planning strategies should help to implement the appropriate plan but should not dictate a disposition of your property which is not best for you and your family.

Although a married couple may often coordinate their estate plans to achieve a unified goal, each person in reality has their own estate plan. If fact, every person has a plan whether they have personally engaged in estate planning or not. If you have not done your own plan, the state government of the state of your residence has made a plan for you. Since it is unlikely that the state's plan will be your plan of choice, it is important that you spend the time and effort to develop your own plan and to keep it current through the years.

A comprehensive estate plan will employ various strategies designed to (i) enable your agent to make health care decisions on your behalf in the event of a lifetime disability, (ii) provide for the management of property when appropriate, and (iii) provide for the division and distribution of your property at death. You should also think of an estate plan as including three distinct periods of time: (i) the joint lives of a married couple, (ii) the lifetime of the surviving spouse, and (iii) after the death of the surviving spouse. Different strategies will be appropriate during each of the time periods.

This memorandum is divided into two Parts. Part I explains basic tax planning strategies used in the proposed estate plan. Part II discusses some of the non-tax related issues which should be addressed.

I. Estate Tax Planning Strategies

A. Taxes Relevant To An Estate Plan

A thorough discussion of gift, estate and generation-skipping taxes are beyond the scope of this memorandum. However, as you review the draft documents, keep in mind the following basic tax concepts:

- *Gift Tax Annual Exclusion*: Each person may give up to $11,000 per donee per year. In addition, gifts unlimited in value may be given for health care and

education purposes provided that payment is made directly to the health care provider or educational institution.

- *Applicable Exclusion*: Each person currently has a lifetime exclusion from both the gift and estate tax of $1 million. The estate tax exclusion will increase to $1.5 million in 2004, to $2 million in 2006 and to $3.5 million in 2009. The lifetime gift tax exclusion is to remain at $1 million. If gifts during lifetime exceed the gift tax annual exclusion, the excess is sheltered by as much of the $1 million exclusion as is needed. Any part of the gift tax exclusion used during lifetime will reduce the applicable estate tax exclusion.

- *Marital Deduction*: Gifts unlimited in value may be given to a spouse (if a U.S. citizen) both during lifetime and at death and deducted for both gift tax and estate tax purposes. Gifts to a spouse in trust must meet special requirements to qualify for this deduction

- *Charitable Deduction*: Gifts unlimited in value may be given to both U.S. and foreign qualifying charities and deducted for both gift and estate tax purposes.

- *Generation-Skipping Tax Exemption*: The gift and estate tax apply to transfers by you. Sometimes property is given in such a form that it will not be owned by the generation immediately younger than you and so will not incur a second gift or estate tax at that next younger level. For example, suppose you leave property in trust for your child for life and then to a grandchild at your child's death. No estate tax would be imposed at your child's death. To frustrate use of this technique as a tax avoidance strategy, a separate tax (at a flat rate of 50%) is imposed when the skip occurs (at the child's death in the example). There currently is a $1.1 million exemption per transferor which can be used to structure gifts so that they will not be subject to the generation-skipping tax. Effective use of this exemption is quite complex and various provisions in the draft documents are designed to effectively utilize this exemption.

B. Tax Planning Strategies

1. Basic Tax Planning For a Married Couple

The most common and effective tax planning strategy for a married couple is to plan for the effective use of both spouses' $1 million applicable exclusion. If each spouse simply leaves his or her entire estate to the survivor, no tax will be paid at the first death because of the unlimited estate tax marital deduction. However, no use will have been made of the first decedent's $1 million exclusion and the entire combined estates of both spouses will be taxed at

the second death with only the survivor's exemption available to shelter property passing to children or others.

To effectively use the first decedent's exclusion, a gift is made of the available exclusion which will not qualify for the marital deduction. Of course, a gift can be made to persons other than the survivor and use will be made of the exclusion. However, if a couple desires that the survivor have the benefit of the property during his or her lifetime, a special form of trust can be used. This trust is funded in an amount equal to the available exclusion. It is available to the survivor and can be designed with several different variations, but it's essential characteristic is that it will not be included in the survivor's estate for estate tax purposes regardless of its value at the time of the survivor's death. This trust is named in our documents as the "Family Trust."

If the first decedent's property exceeds the available exclusion, the excess is left to the survivor in a form which will qualify for the estate tax marital deduction. In this way, no estate tax is paid at the first death. A marital gift may be made either outright or in a separate trust which we call the "Marital Trust." Estate tax will be paid at the second death to the extent that the survivor's estate exceeds his or her available exclusion. The Family Trust will not be counted as a part of the survivor's property for tax purposes. Using the Family Trust as a part of your estate plan will effectively reduce your estate tax liability at the death of the surviving spouse by at least a quarter million dollars!

2. Assets With Unique Tax Problems and Opportunities

a. Life Insurance

Life insurance is a frequently misunderstood asset but is one which offers unique estate tax planning opportunities. Life insurance is often misunderstood for two reasons: (i) although life insurance proceeds are usually income tax free they are not estate tax free, and (ii) life insurance is the only asset which has a different value during the insured's lifetime than it does at his death.

If the insured dies owning any interest in a life insurance policy, even if that ownership is limited to the simple right to name the beneficiary, the entire proceeds are included in his estate as an estate taxable asset at his death. However, the value of the policy during his lifetime is only the cost of replacing the policy. Therefore, taking advantage of this difference in pre- and post-death valuation, an insured frequently gives ownership of the policy away during his lifetime so that it is not owned at death. If he does not own it at death, the proceeds are not included in his estate.

In order to permit a surviving spouse to have the use of the insurance proceeds during his or her lifetime, ownership is gifted during the insured's lifetime to a separate irrevocable trust. The trust must be irrevocable to cause the gift to be complete. The surviving spouse can be the

beneficiary of this trust and upon his or her later death the property can pass to other persons either outright or in further trust.

Effective use of an irrevocable life insurance trust can permit the insurance proceeds to be gift, estate and generation-skipping tax free. The proceeds can also be income tax free although income earned on the trust's investments after the proceeds are received and invested is subject to income tax. The trust can be designed to preserve these tax benefits through multiple generations.

b. Income Tax-Deferred Assets

Employee benefit plans and individual retirement accounts enjoy income tax advantages in that the income tax is deferred until withdrawals are made. The death of the owner of income tax-deferred assets does not extinguish the income tax liability and distributions are received by future beneficiaries as taxable income.

Two tax problems are associated with income-tax deferred assets which must be considered during estate planning. First, the entire account balance is included as a part of the taxable estate at the account owner's death. The value of the account is not reduced by the fact that income tax must eventually be paid on the asset when distributed. Thus, an estate tax will likely be paid on an unpaid income tax!

Second, lump sum distributions will accelerate the income tax payment. Frequently, it is necessary to consider use of income-tax deferred assets for estate planning purposes such as funding the Family Trust as discussed above. Without careful planning, distributions for estate tax planning purposes can cause acceleration of income tax liability.

c. Joint Ownership of Assets

Assets owned as joint ownership with right of survivorship can be a convenient form of ownership and can facilitate transfer of title to the survivor at the death of one joint owner. If the survivor is the spouse, the marital deduction will apply to prevent estate taxation at the death of the first joint owner. However, joint ownership of assets of any significant value is discouraged in tax-planned estates because those assets cannot be used for estate tax planning strategies such as funding the Family Trust.

II. Non-Tax Related Issues

A. Health Care and Disability Planning

In the event that you suffer a disability during your lifetime such that you are unable to make health care decisions on your own behalf or are unable to effectively deal with your property, you estate plan can provide solutions.

With respect to health care decision making, you should appoint one person (probably your spouse) as your primary agent to make health care decisions for you if you are incapable of making those decisions yourself. You should also appoint an alternate agent. The powers of your primary and alternate agent are set out in a health care power of attorney and in a living will.

You should also appoint an agent to make decisions with respect to your property during a lifetime disability. You should appoint a primary agent (again usually your spouse) and perhaps an alternate agent. Frequently, the authority of the alternate agent only arises only after your disability occurs and only if your primary agent cannot act. The powers of your primary and alternate agent for property matters are set out in a durable power of attorney.

B. The Use of Trusts For Family Reasons

1. Marital Trusts

Property left to your surviving spouse can be left either outright or in further trust. A Marital Trust can be used whenever it is desirable to impose some amount of continuing control over the use and disposition of property left to the spouse. This frequently occurs, for example, where there are children of prior marriages where it is necessary to balance the needs of the surviving spouse with preservation of the property for eventual use of the children. There are technical tax reasons to use a Marital Trust even where control is not a factor whenever there is an effort to make maximum use of the generation-skipping tax exemption available to both spouses. A Marital Trust will not benefit children nor any person other than the spouse during the surviving spouse's lifetime.

2. Trusts for Children and Grandchildren

Trusts should always be used as the recipient of gifts for minors or even young adults. A trustee will be able to manage the property and to use it on behalf of the minor beneficiary as appropriate. Without a trust arrangement, a court-supervised guardianship or a simple custodianship would be required for gifts to minors.

When considering the appropriate duration for a trust for a child or grandchild, consider what you know of the beneficiary's special needs, if any, and what you know of the individual

characteristics of the intended beneficiary which give you clues as to his ability to manage money in his own best interests. Often, and especially with very young children or grandchildren, you will have to rely on your own experience and philosophy in setting an age when the beneficiary will receive the property free of any further trust.

There are reasons other than simple property management which cause many people to consider long trust terms. For example, you can direct that the trust not be subject to the beneficiary's creditor's claims nor may the beneficiary be able to pledge the trust's assets for personal debt. A beneficiary cannot generally create a trust for himself which gives these protections. Further, a trust will provide considerable protection in the event of the beneficiary's divorce or bankruptcy. Finally, in order to effectively use the generation-skipping tax exemption and preserve property for multiple generations, lifetime trusts or children are required.

C. The Selection of Executors, Trustees, Agents and Guardians

The modern term for an executor is personal representative. You name your personal representative in your last will. Your personal representative has many important responsibilities which include (ii) managing the probate of your estate if required, (ii) filing all required tax returns, (iii) identifying and managing property before turning it over to beneficiaries or a trustee, and (iv) paying your final expenses. The role of a personal representative usually continues for a few months to as much as two or three years. Longer terms are usually required because of problems closing tax issues. A personal representative has no authority until appointed by a court during the probate of your last will. If there is no probate because most or all of your property is owned at your death by a trust, the trustee will perform the functions of the personal representative.

A trustee is in charge of managing property owned by a trust in accordance with instructions given in the trust document. Your original revocable trust will require a successor trustee who will be responsible for coordinating the administration of your estate and payment of taxes with your personal representative. This trustee is also responsible for selecting and dividing property among various trusts created after your death such as the Family Trust, a Marital Trust or trusts for children or grandchildren. Trustees will also be required for these trusts.

As discussed above, an agent is someone who acts for you during your lifetime with respect to your property. If your disability is short term, the agent may simply act under the power of attorney. If your disability is long term, the agent may elect to transfer title to property to the trustee of your revocable trust so that the property can be managed more effectively by the trustee of the trust. The agent acts under a durable power of attorney. The authority of the agent terminates at your death.

Finally, if you are the parent of a minor child or incapacitated adult, you may nominate one or more guardians for the person of the minor or incapacitated person. Your nomination is subject to approval of a court which will always act in the child's best interests. However, your

nomination carries great weight and will generally be followed unless there is an overriding reason to appoint some other person. Rather than nominate a couple as co-guardians, you should generally nominate the person who you would choose as guardian should the couple divorce.

NONE OF THESE APPOINTMENTS OR NOMINATIONS SHOULD BE HONORARY! All of these appointments are time consuming, require assuming some amount of personal liability and none are easy chores. If you are considering an individual, the minimum characteristics which the individual should have are: (i) good common and business sense, (ii) a reputation for honesty and good character, (iii) the time and interest necessary to perform the job. If ALL of these characteristics are not present in the same person, seriously consider appointment of a corporate entity (generally a bank).

Even if an individual has all of the desired characteristics, also consider the family relationships involved. It is our experience that siblings generally do not like to have a sibling acting as trustee of a trust for their benefit. Also, step-parents generally make poor choices as trustees for step-children and vice versa. If you are considering such an appointment, remember that one of the most important jobs of a trustee is to say no when appropriate. This can put the family member/trustee in the awkward position of choosing between their relationship with the beneficiary and their duty to you to follow the restrictions of the trust.

There may be serious tax problems associated with the appointment of a person as trustee who is also a beneficiary, especially if the person is one of several eligible beneficiaries. Tax reasons also prohibit an insured from serving as trustee of a life insurance trust.