

Has Your Estate Plan Kept Up With Changes In The Law?



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- Full service business law firm
- Representing closely-held businesses, entrepreneurs and individuals
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The Speaker

- SNSFE partner
- 30 years experience
- Emphasis on closely-held businesses
- Focus on estate planning
- Experience includes business succession planning, multi-generational estate planning, “non- traditional family” planning.

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Has Your Estate Plan Kept Up With Changes In The Law?

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CPE candidates: Please respond via the Q&A tab to the following poll question:

Have you had an estate plan prepared in the last 15 years?

A. Yes

B. No

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**The Basics:
Estate Planning Definition**

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The Basics – Estate Planning Definition

Will – a legal document or legal instrument designed to cause your property to go to those people to whom you would like your property to go, and to provide for and protect those people appropriately.

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Estate Planning - *A disposition of property to those people to whom you would like property to go with a view towards minimizing unnecessary death taxes and other death expenses.*

Death Expenses

Federal Estate Tax

- Most impressive of the death expenses because it is the most oppressive
- Currently begins at 46% bracket, once credits are exhausted

Death Expenses

Illinois Estate Tax

- **The Economic Growth and Tax Relief Reconciliation Act of 2001**
 - Prior to the Act the total tax bill was not increased - Illinois shared with the federal government and took an amount equal to the credit for state death taxes under the federal system.
 - Now, the Illinois estate tax has been decoupled from the federal estate tax, and it will now be possible to incur an Illinois estate tax even when there is no federal estate tax.

Death Expenses

Probate or Administrative Expenses

- These are expenses incurred in transferring title of assets from decedent to his heirs, including the preparation of proper tax returns with respect thereto.
- This involves judges, accountants, and lawyers.

Death Expenses

Probate or Administrative Expenses contd.

- Most estates in Illinois are now administered under "independent administration" which requires far less court and lawyer involvement.
- However, even the costs incident to independent administration can be lessened by proper planning.

Death Expenses

Generation-Skipping Tax

- A very complex tax system which may come into play when property is transferred to people in a generation level below children.
- It is also possible to back into this tax inadvertently, and thus it is possible to have a combined federal estate tax and a generation skipping tax at a combined rate of 92%.

Illustration of how death tax and expense system works

Illustration

- A. 46% tax bracket
- B. \$3,000,000 taxable estate
- C. Discussion of what's included in taxable estate for federal estate tax purposes:
 1. Total taxable estate far in excess of \$3,000,000
 2. The stock market & real estate values
 3. Insurance proceeds to the extent that insured has any control or "incidents of ownership." Code sec. 2042.
 4. Death benefits under a qualified pension or profit sharing plan.
 - Before 1984 it was possible to exclude such benefits under certain circumstances.
 5. One-half the value of property held in joint tenancy with spouse.
 6. All of the value of property held in joint tenancy with a person other than spouse, except to the extent that the surviving joint tenant can prove contribution.
 7. Property that has been given away, but over which the decedent retained some control during his lifetime. Code secs. 2036 and 2038.

Illustration

D. Two major shields against FET:

1. Credit equivalent

- Every human being has a "credit equivalent" which should be applied against the federal estate tax at death.
- As a result of the change in the law in 2001, the credit equivalent is currently valued at \$2,000,000 this year and through 2008. It will increase to \$3,500,000 in 2009. There will be no federal estate tax in 2010.
- In 2011, the 2001 change in the tax law expires
 - the credit goes back down to \$1,000,000
 - the rate will go back up 55%

CPE candidates: Please respond via the Q&A tab to the following poll question:

Have you questioned what will be the future course of the federal estate tax?

- A. Yes**
- B. No**

Revision or repeal of the estate tax:

- 2001 law is difficult to plan with
 - Continuously changing credit
 - Continuously changing rate
- Congress and mid-term elections in November
- Predictions
 - Credit equivalent and the rate will be set an amount certain

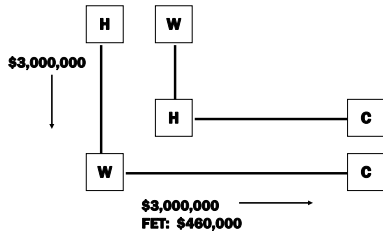
Illustration

D. Two major shields against FET contd.:

2. Marital deduction

- First you need a spouse, and one to whom you are willing to give property.
- Applies to property given to a spouse in a proper or qualified manner – the gift cannot be terminable.
- Since 1981 the Marital Deduction is unlimited, thus one can leave a spouse \$100 or \$30 billion and it will all pass free of federal estate tax.

Exhibit 1



Illustration

E. Simple plan in Exhibit 1.

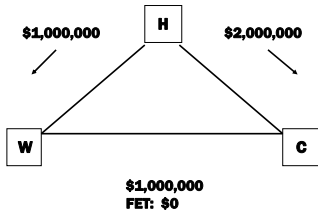
1. If you ask the average person who has never been through the estate planning process where he would like property to go, he will usually say all to spouse, and after the subsequent death of spouse then to children.
2. Assume H & W both want this plan.
3. Assume husband dies first.
4. Three things wrong:
 - a. There is no vehicle for the protection of the children if both parents die while children are too young to properly manage funds. (The appropriate age may vary from case to case.)
 - b. There is no assistance for the surviving spouse if she should need it.
 - c. There is the unnecessary incursion of federal estate tax.

Illustration

How federal estate tax would apply in this case:

- Upon husband's death first, the unlimited marital deduction would totally shelter amounts passing to spouse.
- Upon wife's death second:
 1. Assume same size estate.
 - There may be encroachment.
 - There may be appreciation.
 2. Spouse seeks to pass property to children.
 3. No marital deduction available.
 4. Only unified credit to the extent not previously used.
 5. Exposed to tax: \$1,000,000.
 6. Federal estate tax: \$460,000.
 7. In a taxable estate of \$4,000,000 the federal estate tax would be \$920,000.
 8. In a taxable estate of \$7,000,000 the federal estate tax would be \$2,300,000.

Exhibit 2



Illustration

E. Marital-deduction/credit shelter plan in Exhibit 2.

- Commonly called "marital-deduction/credit shelter" plan or "A-B trust plan."
- Most people who have had estate planning, and who are married, have had some form of this plan.
- Should be reviewed if it hasn't been reviewed since 2001.

Illustration

Design of plan:

1. Again assume husband says he would like surviving spouse to have benefit of all property during continued life.
2. Again assume H dies first.
3. Upon husband's death first:
 - An amount equal to the unified credit (\$2,000,000) passes to credit-shelter trust, tax-free, but will not be taxed in surviving spouse's estate when she dies.
 - Balance of \$1,000,000 goes to spouse, or in trust for spouse, and is sheltered by "unlimited marital deduction."
4. In addition, credit-shelter must be designed so that spouse has benefit therefrom during spouse's continued life although not included in spouse's estate.

Illustration

Dispositive advantage:

- If both parents die while children are relatively young, a vehicle is in place to care for them until they reach a level of maturity where they can care for themselves.
- If the surviving spouse should need investment assistance, that can be provided through a marital trust, especially when a currently competent spouse ages and becomes less competent.

Illustration

Tax benefits:

- Upon husband's death first there is no federal estate tax. There was no federal estate tax in the previous example either.
- Upon the death of the wife second the amount which previously went to the credit-shelter trust is designed not to be included in her estate.
- Thus spouse's taxable estate is \$1,000,000 which is totally sheltered by the credit equivalent of \$2,000,000.
- Thus no federal estate tax on either death – a total savings of \$460,000.
- Same principal would be applicable in larger estate.

Illustration

Why changes are necessary, and why every such estate plan that has not been reviewed since 2001 should be reviewed:

- Assume that an estate plan was prepared before 2001 when the credit equivalent was \$675,000, and was predicted to go to a maximum of \$1,000,000.
- Assume that the family objectives were that the surviving spouse should be the primary beneficiary of the marital efforts during her continued life, and the children should become primary beneficiaries only after the death of both spouses.
- Given that the credit equivalent was then only \$675,000 and expected to increase to no more than \$1,000,000.
- Assume again a \$3,000,000 estate.

Illustration

The family may have felt comfortable designing the Family Trust for the children and the spouse because they felt that no more than \$1,000,000 could go to the Family Trust, and everything else (\$2,000,000) would go to the Marital Trust and be used exclusively for the surviving spouse.

However, now when the credit equivalent is much larger, and increasing, far more than anticipated will go to that Family Trust, and far less than anticipated will go to the Marital Trust exclusively for the spouse.

Illustration

Another necessary change:

- Prior to the 2001 change in the tax law the federal estate tax was coupled to the Illinois estate tax.
- If there was no federal estate tax, there was no Illinois estate tax. If there was a federal tax, because of the mechanism of the "pick-up" tax, Illinois simply shared with the federal government, but the total tax did not increase.
- Because of the 2001 change in the law, in some circumstances it is possible to generate an Illinois estate tax even when there is federal estate tax.
- A small and rather simple change to estate planning documents can avoid this unfortunate result.

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Other Common Estate Planning Techniques

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Common Estate Planning Techniques

Ordinary Lifetime Gifts

Annual exclusion

- A donor can give \$11,000 to each of any number of donees free of gift tax each year. Code sec. 2503.
- If spouse joins in the gift the amount which may be given to each donee is \$22,000.
- This does not infringe upon, or use up, the credit and is thus a good way to reduce estate tax. (If 3 children and 6 grandchildren, a donor could reduce his estate by up to \$198,000 each year.)
- Such gifts are ordinarily not brought back into the estate by the "three-year-gift-in-contemplation-of-death" rule.

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Common Estate Planning Techniques

Gifts of Appreciating Property

- Often makes sense to give appreciating assets to younger generation family members so that the assets won't "balloon" the estate of older generation family members.
- An asset may be worth \$2 million today, but it may be worth \$7 million ten years from now.

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Gifts of Appreciating Property

- The transfer tax on \$7 million ten years from now is more than five times greater than the transfer tax on \$2 million.
- If possible one should try to use the annual exclusion.
- If not adequate one should consider using the unified credit, or even paying tax on the transfer because less credit will be used and less tax will be paid. Also any gift tax paid further reduces the estate.

Life Insurance

Background:

- A very important asset in estate planning.
- Many estates are highly illiquid, especially when there is a closely-held business involved.
- The discussion of the use of the marital deduction illustrates that you can often defer tax at the death of the first spouse, but this will often result in a significant tax upon the death of the second spouse.

Life Insurance

- In many instances, people seek to avoid depleting the estate by providing life insurance to cover this expense as well as other liquidity needs.
- Many people feel that insurance is needed only for liquidity. Even if liquidity is available, in the case of a \$5,000,000 taxable estate the federal estate tax is about \$460,000 even with optimal planning.

Common Estate Planning Techniques

Life Insurance

Taxability of insurance proceeds:

- Insurance proceeds are included in the taxable estate of the insured if at the time of his death he possesses "incidents of ownership" in the policy. Code sec. 2042.
- Powers which are to be considered incidents of ownership include powers to:
 - Change the beneficiary;
 - Surrender or cancel the policy;
 - Assign the policy;
 - Revoke an assignment;
 - Pledge the policy for a loan;
 - Obtain from the insurer a loan against the surrender value of the policy.

Common Estate Planning Techniques

Life Insurance

Planning with insurance policies:

- Transfer insurance policies to spouse – of little use.
 - The proceeds would then be taxable in the estate of second spouse to die.
 - This would only aggravate the fact that the tax is imposed at the time of the death of the second spouse.

Common Estate Planning Techniques

Life Insurance

Planning with insurance policies:

- Transfer insurance policies to children.
 - May not be sufficiently mature to administer policies.
 - Getting money to children to pay premiums may be a problem.
 - Children may not be willing to use insurance proceeds to provide needed liquidity.
 - Even if children are willing to use insurance proceeds as planned, their doing so may have gift tax implications.

Common Estate Planning Techniques

Life Insurance

Planning with insurance policies:

- Transfer insurance policies to an irrevocable life insurance trust.
 - An irrevocable trust, if properly structured, is a separate legal entity.
 - Incidents of ownership are thus removed from the insured.
 - The spouse can be trustee, but if properly structured the proceeds will not be included in her estate either.
 - Because this is a trust the use of the insurance proceeds can be pre-determined.
 - If properly structured, the insurance proceeds can be used for the intended purposes and yet not taxed in the estate of either spouse.
 - The more modern insurance product "the survivorship policy" can also be used successfully in a specially designed irrevocable insurance trust. Thus, insurance proceeds can be used to pay the estate tax and the insurance proceeds themselves will not increase the tax.

Common Estate Planning Techniques

Cutting Edge Techniques

- Since the late 1980s the trend in estate planning techniques has been to suppress the value of a client's assets.
- The less the value of assets transferred at death, the less the Federal estate tax

CPE candidates: Please respond via the Q&A tab to the following poll question:

Do you have a Family Limited Partnership in place?

- A. Yes**
- B. No**

Common Estate Planning Techniques

Family Limited Partnership (FLP)

- By using this device older generation family members may assign assets to a FLP.
- If the partnership is structured correctly, so as to impose certain restrictions on liquidation, etc., requiring the consent of other partners who are also family members, significant discounts of between 30% and 40% may be realized.
- Four tax court cases and a Fifth Circuit Appellate Court case during the summer of 2005 seriously attacked the utility of Family Limited Partnerships to obtain discounts.
- However, in some circumstances Family Limited Partnerships can be modified to fit within the holdings of these cases, especially where:
(1) the contributing partner is willing to give up control, or
(2) where the partnership is engaged in an active trade or business.

Common Estate Planning Techniques

Grantor Retained Annuity Trust (GRAT)

- The grantor places valuable property in a trust for other family members, but he retains an annuity interest for himself for a period of years.
- The grantor is thus permitted to deduct from the value of the property transferred the value of the retained annuity, determined pursuant to government tables.
- For example if the grantor retains an annuity for a period of ten years he may deduct approximately 60% of the value of the property transferred.
- In this example if the grantor were to transfer property valued at \$1,000,000, he would be taxed as if he transferred property valued at \$400,000.

Common Estate Planning Techniques

Qualified Personal Residence Trust (QPRT)

- Similar to the GRAT, but uses a primary personal residence which does not produce income.
- Special rules apply.

Intentionally Defective Irrevocable Trust (IDIT)

- Used when the client has a low basis, highly appreciated asset, which he wants to transfer to younger generation family members
- Asset produces a significant income stream (enough to service debt), and client wishes to sell the asset so that other family members will have a high basis when they resell.
- Client does not want to recognize gain on the sale.
- He can establish an irrevocable trust for other family members and sell to that trust.
- However, if the trust is carefully structured to contain certain defects, the client will realize no capital gain.

Charitable Giving – Planned Giving

- Charitable giving is may take on a simple structure.
- Planned giving is giving to a charity in such a manner that the donor derives an economic or tax benefit for the donor.
- Incidentally, in some estate plans the charitable gift may so benefit the donor that some that donors, with no specific charitable intent, may seek out a charity to participate so that they can achieve a plan benefiting themselves.

Charitable Giving – Planned Giving
Economic and tax benefits resulting from charitable giving:

- An income tax deduction at the time of the gift.
- An estate or gift tax charitable deduction so that the value of property given to the charity is deducted from the value of the donor's gross estate.

Ordinary Gifts

- An outright gift
- A gift of appreciated property.
 - The donor receives a deduction for the current fair market value.
 - The donor does not realize the gain on sale of the asset.

Common split interest gifts to charity:

- Charitable Lead Trust
- Charitable Remainder Trust

Charitable Lead Trust (CLT)

Relies on a principal similar to that of the GRAT above – an income interest for a period of years is deducted from the value of the transfer.

Example of how a CLT may used:

1. A taxable estate of \$10,000,000.
2. A husband and wife and two adult children.
3. Assume husband and wife feel comfortable that they have access to investments that will provide a yield in excess of federal government's assumed rate of return.
4. Husband and wife establish normal estate plan providing fully for the survivor. No Federal estate tax until the death of the second of husband and wife to die.

Common Estate Planning Techniques

Charitable Lead Trust (CLT) contd.

5. After the second death \$5,000,000 goes to the children in a normal fashion, and \$5,000,000 goes into a CLT with a 10 year annuity, for the charity, and after 10 years this trust is distributed to the children as well.
6. There will now be a deduction of approximately 60%, and the federal estate tax will be similarly reduced.
7. The government assumes that with an annuity, all of the income will be distributed to the charity, and the children will receive only the original \$5,000,000 at the end of the annuity term.
8. However, if the trust is able to realize a greater investment return than the government assumes, more than \$5,000,000 will be distributed to the children at the end of the annuity term.

Common Estate Planning Techniques

Charitable Remainder Trust (CRT)

The opposite of a CLT. The donor and his family retain the income for their lives, or a period of years, and the remainder is then distributed to charity. Very useful when dealing with a highly appreciated asset.

Example of how a CRT may used:

1. Assume Mrs. A, a widow, owns low basis, but high value real estate, that produces little or no income – perhaps vacant land.
2. She would like to sell the real estate in order to convert to high income yield investment, but she is concerned about the inherent capital gain.

Common Estate Planning Techniques

Charitable Remainder Trust (CRT) contd.

3. Instead she establishes a CRT for the benefit of a charity and contributes the property to the CRT. The trustee of the CRT may now sell the real estate and invest in a high yield investment without realizing a capital gain. Mrs. A will receive significant income for the balance of her lifetime, and the remainder will be distributed to the charity.
4. She will receive an immediate income tax deduction upon the establishment of the trust and the contribution of the property, equal to the actuarial value of the remainder.
5. If Mrs. A is concerned about the loss of the remainder for her children, it may be possible to use the income tax savings from the initial contribution of the property to the trust to buy a single premium life insurance policy equal to the value of the remainder.

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Conclusion

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