

A SIMPLE GUIDE TO HIGH NET-WORTH ESTATE PLANNING (ESTATE PLANNING TECHNIQUES FOR WEALTHY INDIVIDUALS)

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SUMMARY: A well crafted estate plan can transfer property to your heirs at your death, protect the inheritances that you leave to your loved ones, reduce estate taxes to the lowest possible level, completely avoid probate, appoint the right decision-makers in the event of incapacity, and provide stability and financial peace of mind to the loved ones you leave behind. This article explains some of the common techniques used in estate planning for high net worth individuals to accomplish these goals.

3 Levels of Estate Planning

Estate planning can generally be broken down into three distinct categories:



LEVEL 1: BASIC ESTATE PLANNING

LEVEL 1 focuses on the goals of protecting you in the event of incapacity, getting property to the right people after you die, and deferring estate taxes for as long as possible.



LEVEL 2: ESTATE TAX AND LIQUIDITY PLANNING

LEVEL 2 focuses on determining your eventual estate tax liability, and assuring that you have the liquidity to pay those taxes.



LEVEL 3: ESTATE TAX REDUCTION PLANNING

LEVEL 3 focuses on reducing the size of your current and future estate tax liability through a variety of sophisticated wealth transfer tax planning strategies.

Each level involves a variety of estate planning documents and strategies, which are discussed in this article.

You will notice there are two things that all three levels of estate planning have in common: asset protection and tax reduction.

ASSET PROTECTION: Estate planning is pointless if the inheritance that you have worked to build and protect is lost by your surviving spouse or child because the inheritance was not adequately protected. An inheritance can be lost as the result of poor decisions, addiction, bankruptcy or other financial hardship, lawsuits, or failed relationships.

Specific protections should be built into all of your estate planning documents to protect against the most likely threats to your loved one's inheritances.

TAX REDUCTION: There are four different layers of taxes that must be considered at each level of your estate plan – (1) income taxes, (2) gift taxes, (3) estate taxes, and (4) generation-skipping transfer taxes. Everyone is familiar with income taxes, which are essentially taxes that you pay on your annual income. Income taxes are paid to the federal government and, in most states, to the state government. The other three forms of taxes are probably not as familiar to you.

Gift taxes are paid when you make gifts of money or property during your lifetime. The federal gift tax rate is 35% of the value of the gift. The first \$5M of gifts that you make are not taxable, as they are covered by your *lifetime gift tax exemption*. Additionally, you can make gifts of up to \$13,000 to as many



people as you wish each year without paying any gift taxes. These gifts are called *annual exclusion gifts*. Annual exclusion gifts do not count toward your \$5M lifetime gift tax exemption. Some states also impose state gift taxes.

Estate taxes are paid on the value of your estate at your death. The federal estate tax rate is 35% of the value of your taxable estate. As with gift taxes, the first \$5M of value can be transferred free of tax. This is called your *estate tax exemption*. Your estate tax exemption is reduced by the amount of any gifts made during your lifetime. Thus, if you give away \$2M during your lifetime using your lifetime gift tax exemption, your estate tax exemption will be reduced by \$2M, leaving you with an estate tax exemption of \$3M. Some states also impose a state level estate tax, often with a lower exemption amount.

Generation-skipping transfer (GST) taxes are paid anytime you give property to a grandchild or great-grandchild, either during your lifetime or at your death. The GST tax rate is 35% of the value of the property that passes to a grandchild. The purpose of the GST tax is to prevent people from avoiding estate taxes by leaving property to their grandchildren, thus skipping one generation of estate taxes. Similar to the gift and estate taxes, the first \$5M of value subject to the GST tax can be transferred free of tax. This is called your *GST exemption*. Some states also impose a state level GST tax.

POINT OF INTEREST: Together, gift, estate, and GST taxes are referred to as “**wealth transfer taxes**,” because they are paid when you transfer your wealth. The \$5M exemption amount (in 2011 and 2012) for each type of tax is often referred to as the “**unified credit**,” because the same dollar amount is exempted from each type of tax. These wealth transfer taxes are independent of income taxes, and have very different rules.

Annual exclusion gifts do not count against your lifetime gift tax exemption, your estate tax exemption, or your generation-skipping transfer tax exemption.

For purposes of this article, you should assume that the laws in effect for 2011 and 2012 apply to all situations, unless otherwise stated. See the chart on page 25 for more information on wealth transfer taxes.

Level 1 Estate Planning

There are several goals that should be considered as part of your Level 1 estate planning:

- Provide for the care minor children if you become incapacitated and after your death.
- Appoint decision-makers in case you become incapacitated.
- Provide for an orderly management of your property if you become incapacitated.
- Specify your wishes regarding end-of-life treatment if you are in a permanent vegetative state.
- Pass property to your loved ones and charities when you die.
- Completely avoid probate.
- Protect the inheritances you leave to your loved ones from creditors, predators, and failed marriages.
- Appoint trustees to manage property for the benefit of the loved ones you leave behind.
- Fully utilize your estate tax exemption.
- Defer estate taxes until the death of the surviving spouse.

Everyone needs Level 1 estate planning to some degree, although the documents needed by high net worth individuals are much more sophisticated than those required for everyone else.



INCAPACITY PLANNING: Incapacity can occur as the result of accident, illness, physical deterioration, or simply because of age. It is important to have the proper documents in place to ensure that your family and assets are cared for if one of these unfortunate events occurs. The following documents should be considered as part of your incapacity plan:

- (1) *General Durable Power of Attorney:* A general durable power of attorney appoints an agent to make decisions regarding your finances if you become incapacitated. The agent appointed under this document will have the power, among other things, to manage your bank accounts, buy and sell property on your behalf, manage your other assets, and open your mail.
- (2) *Healthcare Power of Attorney:* A healthcare power of attorney appoints someone to make medical decisions for you if you are unable to communicate or if you are otherwise incapacitated. Your healthcare agent will be able to make decisions regarding your routine medical treatment, specific courses of treatment, which doctors and hospitals treat you, long-term care, and many other important issues.
- (3) *HIPAA Release:* A HIPAA Release allows the agents appointed under your other documents the ability to access your protected medical information (i.e., your patient files and insurance information). This ensures that they have the right information to make the right decisions. Many healthcare providers will not discuss your condition with your loved ones unless they are listed on this document.
- (4) *Living Will:* If your condition deteriorates to the point that you are in a permanent vegetative state, are terminally ill without the ability to communicate, or have no higher brain function, a living will tells doctors what your final wishes are. Generally, you can choose to have a

feeding tube removed, or cease other treatment to allow for a natural death.

- (5) *Revocable Trust:* A revocable trust is an entity designed to manage your personal assets during your life and after your death. A revocable trust appoints a successor trustee to manage any property owned by your trust if you are no longer able to serve as trustee because of your incapacity.
- (6) *Guardianship Declaration:* If you have minor children, it is important to specify who should take custody of your children if you are no longer able to care for them. Generally speaking, if your children have a surviving biological parent, that person will have priority in guardianship.

INCAPACITY QUESTIONS:

- Who will care for my minor children?
- Who will manage my assets and pay my bills?
- Who will make healthcare decisions for me?
- Who should have access to my medical information?
- How long should I be left on life support?

PLANNING FOR DEATH: As previously mentioned, Level 1 estate planning also covers the basics of what happens to your assets after you die. The following documents should be included in your Level 1 estate planning:

- (1) *Revocable Trust:* As previously mentioned, a revocable trust can manage your property after you die. This is generally done by dividing the property in your trust into separate trusts to accomplish specific tax and family goals. These divisions are discussed in more detail below.
- (2) *Pour-Over Will:* Any assets that were not transferred to your revocable trust during your lifetime will need to be transferred to



your revocable trust at your death. A “pour-over” will dumps any assets left in your individual name at the time of your death into your revocable trust. Once in your revocable trust, the property will enjoy all of the tax reduction and asset protection benefits of the trust.

PROBATE AVOIDANCE: Each state has an established procedure for administering the estates of people who die. This procedure is called probate. Probate is overseen by the court system, although the level of oversight can vary greatly depending on the relationship of the survivors and the state of administration. Although the probate process can be helpful in some cases, the cost and hassle of probate usually outweigh any benefits.

The only property that passes through probate at your death is property that is owned in your individual name. Certain types of property are specifically exempted from probate, allowing them to pass to your heirs without court supervision. Examples of property that do not pass through probate include: retirement plans, life insurance, and annuities (all of which generally have beneficiary designations that bypass probate), property owned in joint tenancy, bank accounts with a pay-on-death feature, and property held in trust. These assets are called *nonprobate property*.

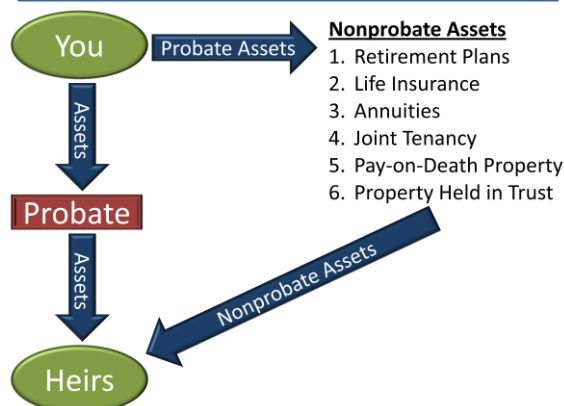
probate property into a revocable trust (a nonprobate asset) prior to your death, there will be nothing left in your name to pass through probate. This can be accomplished without giving up control or use of your assets.

BASICS OF REVOCABLE TRUSTS: In its simplest form, a trust is like a business entity formed to manage your personal assets. Just as a business generally has shareholders who receive any profits earned by the company, a trust has *beneficiaries* who receive the economic benefit of the trust property. Additionally, just as a business has officers who manage the affairs of the business on the shareholders behalf, a trust has one or more *trustees* who are responsible for managing trust property. Unlike a trust, however, a beneficiary does not have the right to transfer their interest in a trust the way that a shareholder has the right to transfer his or her stock.

A revocable trust can be amended, modified or revoked entirely by its creator at any time. The creator of a trust is often called a “grantor,” “settler,” or “trustor.” Additionally, a revocable trust qualifies as a *grantor trust* under the Internal Revenue Code, which means that it is not a separate taxpayer. As such, any income, capital gains, losses or deductions related to the trust flow through to the grantor of the trust. The grantor’s social security number serves as the taxpayer identification number of the trust. This allows the grantor to put property into the trust, and remove property from the trust at any time without triggering taxes.

Once the grantor dies, the trust becomes irrevocable, which means that it can no longer be amended or revoked. In short, whatever the trust states at the time of the grantor’s death is how it will remain ever after. Often times an unrelated third party known as a “trust protector” can be given the right to amend the trust after the grantor’s death, in certain limited circumstances, to allow greater flexibility in administering the trust. This is especially helpful where changes in state laws or tax laws make it

PROBATE AVOIDANCE



The good news about probate is that it can be avoided completely. By transferring



necessary to alter the trust agreement after the grantor's death.

REVOCABLE TRUSTS AND ASSET PROTECTION:

Many different asset protection features can be built into your revocable trust. As previously mentioned, your trust should protect the inheritance you leave to others from creditors, predators, and failed marriages. This can be accomplished by including certain restrictions on how much control the beneficiaries of a trust can exercise over trust property.

All trusts have distribution standards, or conditions under which a beneficiary is allowed to receive property from the trust. In some circumstances, a beneficiary may be allowed to use property for any purpose. More often, however, limitations are placed on a beneficiary's use of trust property. The most common set of distributions standards allows for property to be distributed to a beneficiary for that person's health, education, maintenance, or support. That means that a beneficiary can only pull property out of the trust for those limited reasons. This is important because a creditor of a beneficiary generally has the right to access whatever trust property the beneficiary has the right to access. Limiting the beneficiary's ability to access trust property is a very common method of protecting the assets of the trust.

Another common method of asset protection is to appoint an independent trustee that must approve any distributions that are made from the trust to a beneficiary. Subjecting distributions to the discretion of a third party means that a beneficiary does not have the unilateral right to access trust property, and therefore, neither do the beneficiary's creditors.

It is common for a revocable trust to require a beneficiary to sign a valid marital agreement before the beneficiary can serve as a trustee of the trust. If the beneficiary chooses not to sign a marital agreement, then the beneficiary would not be allowed to have unfettered access to the property in the trust. This is a

very effective method of protecting trust property from a divorce.

COMMON LAW MARRIAGE

Many allow for common law marriage. Unfortunately, many people are unknowingly married. In some states simple acts such as introducing someone as your spouse, filing a joint tax return, or listing someone as a spouse on an insurance application (including health insurance) can result in an unintended common law marriage. There is often no time limit associated with a common law marriage. There is no such thing as common law divorce, however, so it can be very messy and expensive to undo a common law marriage. For this reason, a cohabitation agreement should be entered into before a couple decides to live together. With a little bit of knowledge and common sense most common law marriages can be avoided.

It is important to understand that the asset protection features of a revocable trust only kick-in after the grantor has died. During the grantor's lifetime, the grantor's creditors can access the property held in the revocable trust as easily as they can access any other property owned by the grantor. This is especially true if the grantor pledges trust assets as security or collateral for a loan.

If the grantor desires asset protection during his or her lifetime, the grantor should consider other options and strategies, such as:

- sign a marital agreement;
- segregate liabilities by holding different items of investment property in limited liability entities, such as LLCs;
- acquire an umbrella liability insurance policy to cover liability arising from lawsuits;
- form an off-shore trust; or
- form a domestic asset protection trust (see detail on next page).



DOMESTIC ASSET PROTECTION TRUST

The newest, and perhaps the most intriguing asset protection strategy is a domestic asset protection trust. These trusts are especially beneficial for professionals such as doctors, lawyers, engineers, architects, or business owners who face personal liability for malpractice or other service that they render.

A domestic asset protection trust is a special type of irrevocable trust designed and created by a grantor, for the grantor's own benefit. Normally, a grantor cannot create a trust for his or her own benefit (usually called a self-settled trust) which is protected from the grantor's creditors. Certain states (such as NV, AK, UT, WY, and DE) have passed specific statutes that allow for the creation of this type of trust, so long as the trust agreement complies with certain requirements. First, the trust must generally have a trustee that lives in the state of creation. This is often accomplished by using the services of a corporate trustee based in the state of the trust's formation. Second, the trust must be subject to the laws and courts of the state of creation. Third, there is a statute of limitations, during which property transferred to the trust is not protected, which lasts anywhere between two and five years. Fourth, the assets of the trust will not be protected if they are listed as collateral for loans made to the grantor. Finally, notice must usually be given to creditors of the grantor.

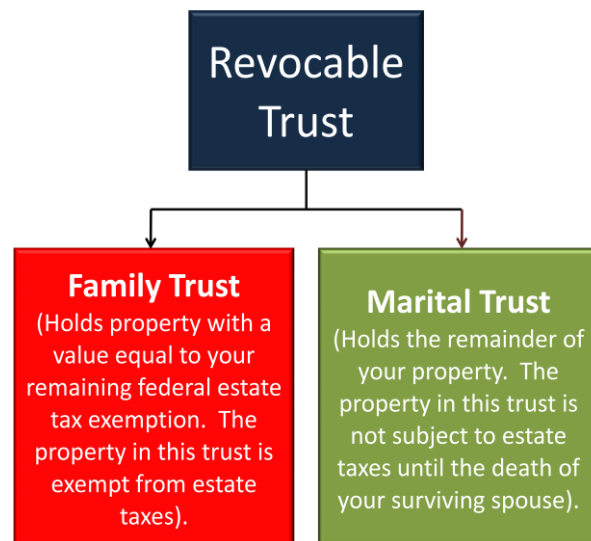
Because of these requirements, a *domestic asset protection trust will generally only protect against liabilities that arise after the trust is formed, not against current liabilities.* It is necessary to plan ahead when using a domestic asset protection trust. One other item to consider is that, due to the newness of this strategy, there is very little case law to guide the formation or operation of these trusts.

While none of these options is bullet-proof, there are many alternatives that a grantor can consider to protect assets during his or her lifetime.

REVOCABLE TRUSTS AND WEALTH TRANSFER TAXES: A revocable trust is usually your first line of defense against estate and GST taxes. Your revocable trust should accomplish three wealth transfer tax related goals:

- (1) Completely use your remaining estate tax exemption;
- (2) Defer the payment of any estate taxes until the death of the surviving spouse; and
- (3) Allocate GST exemption to any property passing in trust to your descendants.

If your spouse is still alive at the time of your death your revocable trust will generally divide property into a number of different trusts to accomplish these goals. At its most basic level, a revocable trust will divide into a Marital Trust and a Family Trust, as illustrated below:



FAMILY TRUST: The family trust is designed to hold an amount of property equal to your remaining federal estate tax exemption. (Remember, any lifetime gifts reduce your available estate tax exemption). Because the Family Trust is designed to hold estate tax exempt property, it is exempt from estate



taxes. Thus, the property in the Family Trust will pass to the beneficiaries of the Family Trust free of estate taxes. The beneficiaries of the Family Trust are generally the surviving spouse and children of the grantor, however this does not have to be the case. The beneficiaries of the Family Trust can receive distributions of trust income and principal under the terms that you outline in the trust. You can be as creative as you want to be, and can even use the Family Trust as a way to encourage your family members to accomplish specific goals, such as obtaining an education, or maintaining gainful employment.

In most cases your remaining GST exemption will be allocated to the Family Trust. If you have more estate tax exemption left than GST tax exemption, which is very rare, the Family Trust may be divided into two different shares – one that is *exempt from* GST taxes, and one that is *subject to* GST taxes.

Your surviving spouse will generally serve as the trustee of the Family Trust, subject to the asset protection restrictions discussed above.

MARITAL TRUST: Any property that cannot be squeezed into the Family Trust (using your remaining estate tax exemption) will be allocated to a Marital Trust. The Marital Trust is specifically designed to qualify for the estate tax marital deduction, which has the effect of deferring the payment of any estate taxes for the remainder of your surviving spouse's lifetime.

A Marital Trust is often referred to as a QTIP trust, which is an acronym for “qualified terminal interest property,” a term used by the IRS to describe trust property that qualifies for the estate tax marital deduction. As a QTIP trust, the Marital Trust must distribute all of the income produced in the trust to your surviving spouse at least annually. Furthermore, the surviving spouse is the only permissible beneficiary of the Marital Trust (although property from the Marital Trust can be used by the surviving spouse for any reason once it is removed from the trust).

If you have any remaining GST exemption left after the formation and funding of the Family Trust, the remaining GST exemption will be allocated to the Marital Trust. This sometimes happens when lifetime gifts are made that use gift tax exemption (and thus reduce the amount of available estate tax exemption) but do not use GST tax exemption. If there is not enough GST tax exemption to make the entire Marital Trust GST tax exempt, then the Marital Trust will be divided into two separate trusts – one that is *exempt from* GST taxes, and one that is *subject to* GST taxes.

POINT OF INTEREST: To recap, the Family Trust is estate tax exempt, which means that estate taxes will never be due on the property in the Family Trust. The Marital Trust, on the other hand, is estate tax deferred, meaning that no estate taxes are due on the property held in the Marital Trust until the death of the surviving spouse. To take advantage of this distinction, your surviving spouse should spend down the property in the Marital Trust first (thus reducing the eventual estate tax liability), before using the property in the Family Trust.

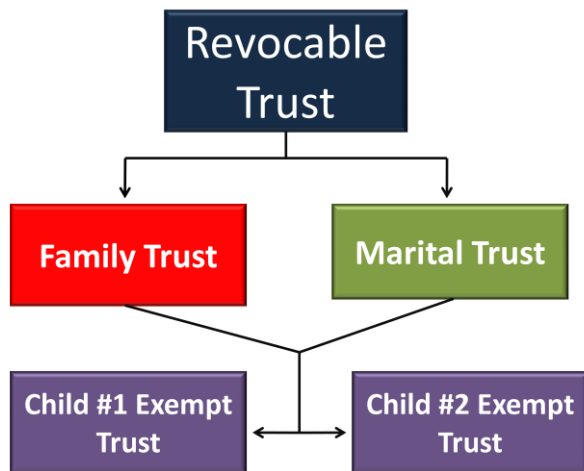
As with the Family Trust, your surviving spouse will generally serve as the trustee of the Marital Trust, subject to the asset protection restrictions discussed above.

Many of the asset protection features listed above can be used in both the Marital Trust and the Family Trust. Another common asset protection feature is to eliminate the surviving spouse's right to use the principal of the trust (as opposed to the income of the trust) if the surviving spouse remarries. This restriction prohibits the surviving spouse from draining the trust for the benefit of his or her new spouse to the detriment of your children.

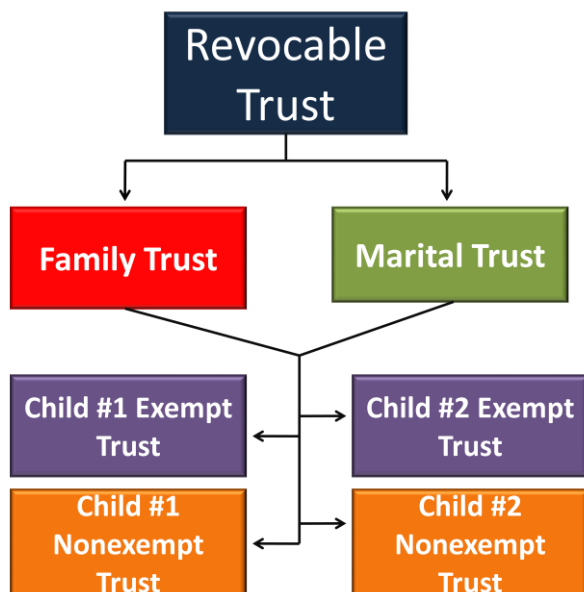
AFTER THE DEATH OF THE SURVIVING SPOUSE: Upon the death of the surviving spouse, both the Marital Trust and the Family Trust terminate. Any estate taxes will be paid out of the surviving spouse's separate assets and the assets held in the Marital Trust.



The surviving spouse generally has the power to specify in his or her estate plan which of your remaining family members or charities should receive any property left in the trusts. This ability is known as a “limited power of appointment.” If the limited power of appointment is not exercised by your surviving spouse, then the property in the Marital Trust and the Family Trust will be divided into shares for your remaining beneficiaries – usually your descendants.



If, however, the combined value of your estate and your surviving spouses estate exceeds your combined available GST tax exemption, the remaining property will be divided into two piles, a GST tax exempt share, and a GST nonexempt share.



Thus, each remaining beneficiary would have both an *exempt* trust, and a *nonexempt* trust.

These separate trusts for your descendants can be designed to incorporate the asset protection features discussed above. Any property held in a GST tax exempt trust is also referred to as a dynasty trust, because it can pass down through the generations without ever being subject to wealth transfer taxes again. In some states this can last up to 1,000 years. A GST tax nonexempt trust, however, will be subject to either estate taxes or GST taxes at each generation.

If you have minor children at the death of the survivor of you and your spouse, you may consider forming a “*common trust*” for your children, before breaking the trust into separate trusts for your children. A common trust is a single trust created for the benefit of all of your children. This allows your younger children to have all of the same benefits as your older children, without having to spend down their individual inheritances.

By way of example, imagine a family with 3 children, ages 21, 17, and 14. Imagine further that both parents are tragically killed in an automobile accident, with a combined estate of \$15M. If the property is divided at the time of the parents’ death, the 21 year-old child will probably have to use very little, if any of the property in the trust for her education. The 14 year old, however, will have to use a significant portion of his inheritance to get through high school and college. The result is that the 21 year old would start adulthood with close to \$5M in assets, while the 14 year old could spend up to \$1M of his inheritance just to make it to adulthood. This inequitable result can be avoided with a common trust.

With a common trust, the above situation would change as follows: a single trust would be formed, with the purpose of getting each child through college. Any distributions to a child other than for education or living expenses would be counted against the recipients’ ultimate inheritance. At the time the youngest child graduates from college (or



reaches a predetermined age) the trust will be divided into equal shares. Any distributions taken by the older children before the division of the trust will be counted against their ultimate share, giving each child an equal benefit from your wealth, and an equal inheritance.

Level 2 Estate Planning

The primary purpose of Level 2 planning is to determine your expected estate tax liability and figure out how to pay it. For this reason, Level 2 primarily deals with estate taxes and liquidity. To begin with, Level 2 planning requires you to have an approximate knowledge of your net worth, and be able to identify which of your assets are likely to appreciate. This information will be used to run projections regarding your current and future estate tax liability.

NET WORTH: To determine the value of your taxable estate, it is necessary to have an understanding of your net worth. This can be more difficult than it seems, especially where your estate contains privately-held business interests or any property that qualifies for valuation discounts. It is generally not necessary to have your property appraised to determine its fair market value, as an experience estate planning attorney, accountant, or investment banker should be able to provide a rough estimate about the value of these assets. Keep in mind however, that the closer you get to actual current values, the easier it will be to figure out what steps need to be taken as part of your Level 2 planning. For married couples, it is necessary to consider the combined assets of both spouses to get a true idea of your current estate tax liability.

PROJECTED NET WORTH: Once you have an idea of your current net worth, the next step is to consider the growth potential of each asset. Some assets may cash-flow well, while other assets may be more long term investments. Some assets, like business

interests may have an enormous upside potential that is anything but certain. For this reason, calculations of your projected future net worth are an inexact science at best. More truthfully, you will be trying to determine projections based on your assumptions of what is most likely. An experience estate planner or accountant will be very helpful in running the numbers to determine your expected future estate tax liability. It is often helpful to run multiple sets of numbers, based on worse-case scenarios, middle-of-the-road scenarios, and best-case scenarios. This will give you a better idea of the range of possibilities.

By way of example, a \$10M estate with annual growth of 7%, will reach almost \$30M in value in a 15 year period. The larger the initial value, and the longer the time frame, the more dramatic the growth can be.

| Year | Beginning Value | Growth | Ending Value |
|------|-----------------|--------|--------------|
| 2010 | \$10,000,000 | 7% | \$10,700,000 |
| 2011 | \$10,700,000 | 7% | \$11,449,000 |
| 2012 | \$11,449,000 | 7% | \$12,250,430 |
| 2013 | \$12,250,430 | 7% | \$13,107,960 |
| 2014 | \$13,107,960 | 7% | \$14,025,517 |
| 2015 | \$14,025,517 | 7% | \$15,007,304 |
| 2016 | \$15,007,304 | 7% | \$16,057,815 |
| 2017 | \$16,057,815 | 7% | \$17,181,862 |
| 2018 | \$17,181,862 | 7% | \$18,384,592 |
| 2019 | \$18,384,592 | 7% | \$19,671,514 |
| 2020 | \$19,671,514 | 7% | \$21,048,520 |
| 2021 | \$21,048,520 | 7% | \$22,521,916 |
| 2022 | \$22,521,916 | 7% | \$24,098,450 |
| 2023 | \$24,098,450 | 7% | \$25,785,342 |
| 2024 | \$25,785,342 | 7% | \$27,590,315 |
| 2025 | \$27,590,315 | 7% | \$29,521,637 |

LIQUIDITY: Many high net worth individuals suffer from the same malady – a chronically undiversified portfolio that is highly illiquid. Liquid investments are those that can be readily converted to cash, such as marketable securities. Privately-held business interests and real estate, for



example, are illiquid assets, because there is not always a market where you can readily sell the assets for a fair price.

CASE STUDY: John and Jane have a combined net worth of \$25M, mostly invested in a real estate. John and Jane have three minor children to whom they intend to give their property at death.

Unfortunately, John and Jane are tragically killed in an automobile accident, leaving their children behind. After using their combined estate tax exemptions, they owe a combined \$6.75M in estate taxes, which must be paid within 9 months of the date of their death.

The real estate market at the time was very depressed. Additionally, there was a very short time frame in which they could leave the property on the market. The only way to get the cash needed to pay the taxes was to sell the property at a significant discount. At the end of the day, it was necessary to sell \$11M worth of real estate to pay \$6.75M in estate taxes.

The question of how to create liquidity in an illiquid estate is a daunting one. There are options available to those who plan ahead, to ensure their estate does not end up in a cash crunch. For instance, agreements can be structured to require business partners to buy your business interests at a fair price upon your death. These agreements are often called “*buy-sell agreements*.” Additionally, if you own a family business, you may qualify for a special program that allows your estate to pay estate taxes over an extended period of time. Finally, the most obvious method of creating liquidity is life insurance, which can provide valuable infusion of liquidity at the very time that it is most needed – your death.

BUY-SELL AGREEMENTS: If you own part of a business, it is almost always advisable to have a buy-sell agreement. At its most basic level, a buy-sell agreement will create a market to sell your business interests to your

business partners at an agreed upon price. Buy-sell agreements often require the sale of property in a variety of circumstances, including death, disability, termination of employment, bankruptcy, or divorce. For that reason, many people choose to think of a buy-sell agreement as a prenuptial agreement with their business partners, in case their business relationship doesn’t work out. For purposes of this article, we will focus on a sale at your death.

A buy-sell agreement that requires your business partners to purchase your business interest at your death will help provide your estate with the liquidity it needs to pay estate taxes and other debts. You should give careful consideration to the valuation and payment terms of the buy-sell agreement.

Determining the value of your interest in a business can be difficult. Some buy-sell agreements require an independent appraisal to establish value for purposes of a buy-out. More frequently, however, the owners mutually agree on some formula for calculating value.

The payment terms of the buy-sell agreement often provide for a payout over a number of years. This will not help with short-term liquidity needs, however. It is preferable to negotiate for a quicker payout, which can be funded with life insurance to avoid placing the business in a cash crunch.

DEFERRAL OF ESTATE TAXES ATTRIBUTABLE TO A CLOSELY-HELD BUSINESS: If more than 35% of the value of your estate consists of an interest in a closely-held business, the IRS allows you to defer paying any estate taxes attributable to the value of the closely held business for up to five years. After five years, the estate taxes are paid in 10 equal annual installments. This has the effect of deferring at least a portion of your estate tax liability for up to 15 years, with no payments due until year six. The deferred amount accrues interest at a modest rate.

A closely-held business interest can be either a corporation, an LLC, a partnership, or a sole proprietorship, although the



requirements to qualify as a closely-held business vary depending on the type of entity involved.

There are several caveats to this deferral, however. First, the deduction is only available for operating businesses, not for passive business interests. Second, if your estate's interest in the closely-held business is sold the estate taxes may need to be paid at the time of the sale, depending on the specifics of the sale. Finally, if too much cash is withdrawn from the business, the estate taxes may be accelerated.

LIFE INSURANCE IN GENERAL: The most common method of providing liquidity for your estate is to purchase life insurance. There are dozens of different types of life insurance policies, each with its own set of benefits and drawbacks. You should not attempt to navigate the treacherous waters of life insurance without the help of an experienced life insurance agent.

In general, life insurance can be divided into two categories: term insurance and permanent insurance.

Term insurance has a built-in expiration date and never acquires any cash value. Think of it as renting insurance from the insurance company for a specific number of years. Term insurance is by far the cheapest type of insurance. The obvious drawbacks of term insurance are that you may live beyond the term of the policy (in which case it pays you nothing), and you can never get your premiums back. Despite these drawbacks, term insurance may play a valuable part in your estate plan, especially if your need for liquidity is short term.

Permanent insurance comes in a variety of forms, under a number of different labels. Some examples are whole life policies, variable whole life policies, universal life policies, and variable universal life policies. The common feature in all permanent insurance is that the policy builds up an internal cash value, which can be drawn upon (or borrowed from) by the owner of the policy at some future time. The cash value is

generally invested, and can increase (or decrease) with the value of the underlying investments. Permanent insurance products require higher premium payments than term insurance, although this can fairly be looked upon as an investment as opposed to an increased expense.

A second-to-die policy, which pays a death benefit upon the death of the second spouse, is often used in estate planning. These policies are usually less expensive because the insurance company can delay the payment of the death benefit longer, and thus collect more premiums and benefit more from the internal growth in the policy.

LIFE INSURANCE REVIEW

If you purchase any type of permanent insurance product, you need to carefully review the terms of the policy. Some policies are based on unrealistic assumptions about the potential growth of your investment. Often times, people stop paying premiums, and just allow the policy to live off its built up cash value. While this may work for a while, a policy can quickly cannibalize itself, wasting your entire investment.

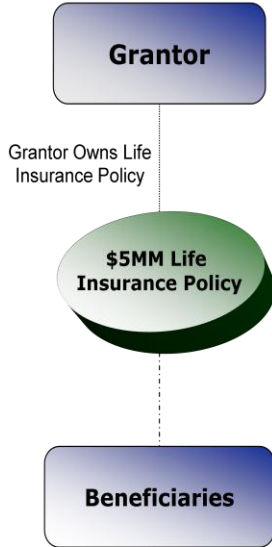
If your policy is more than three years old, it should be reviewed by your insurance agent to make sure the policy is still performing according to the projections, and that the death benefit is still guaranteed.

OWNERSHIP OF LIFE INSURANCE POLICIES: Some seemingly simple decisions about an insurance policy, such as who owns the policy, who receives the death benefit, and who pays the premiums, can have a huge impact on the taxation of your life insurance policy. For instance, if you make a mistake on the ownership documents of a policy, a \$10M insurance policy may become subject to tax, resulting in an estate tax obligation of an additional \$4.5M. For this reason, make sure that your estate planning attorney and your life insurance agent are on the same



page before you pay any premiums on a policy.

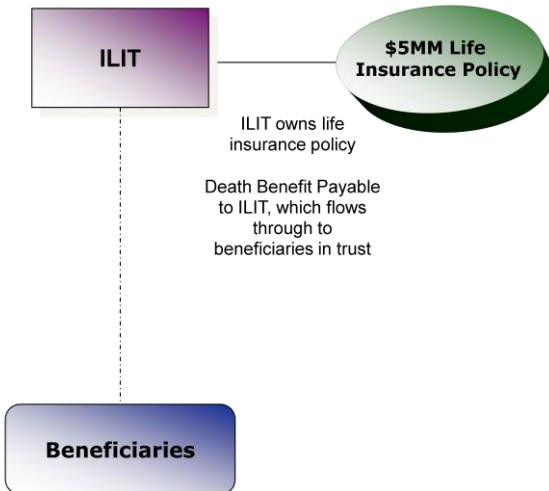
Option 1



Consider Option 1, as shown to the side. If you own a policy in your own name, the entire death benefit of the policy will be included in your taxable estate. That means that 45% of the death benefit will be paid in taxes. Thus, in Option 1, of the \$5M death benefit, \$2.25M will be paid in estate taxes.

If you currently have a policy owned in your own name (regardless of who the beneficiary is), you should talk to your estate planner about transferring that policy into an irrevocable trust. Please note that there is a three year waiting period before the transferred policy will be excluded from your taxable estate.

Option 2



Now consider Option 2. In Option 2, where the life insurance policy is owned by an irrevocable trust, the entire death benefit is

protected from estate taxes, thus saving \$2.25M, or 45% of the \$5M death benefit.

Here are a few simple rules of thumb to use with regard to your life insurance policies:

- The owner of the policy should not be you, it should be an irrevocable life insurance trust (ILIT).
- Your estate should not be the beneficiary of the policy.
- You should not have the ability to personally borrow from or against your policy, to withdraw money from your policy, or to make any other decisions regarding your policy. These decisions should be made by the trustee of the ILIT.

IRREVOCABLE LIFE INSURANCE TRUST

An irrevocable life insurance trust, often referred to as an ILIT (pronounced "eye lit"), is a special kind of trust designed to hold life insurance without having the insurance included in your taxable estate. By virtue of the fact that the policy is owned by the ILIT, and not by you, the value of the policy is not added to your taxable estate when you die.

The trustee of the ILIT makes all decisions over the policy, and has all of the "incidents of ownership" (i.e., the right to borrow against the policy, the right to pledge the policy as collateral, etc.) which you are prohibited from having.

When you die, the death benefit is paid to the ILIT. The ILIT can then use the insurance money to buy illiquid assets from your taxable estate, giving your estate the liquidity that it needs to pay estate taxes. The beneficiaries of the ILIT (who benefit from any property owned by the ILIT) can be anyone that you choose. Most often, this would be your surviving family members. The ILIT can also be designed with asset protection features, such as those discussed on pages 5-6 of this article, to protect the property in the ILIT for the benefit of your remaining family members.



PAYING FOR LIFE INSURANCE: As previously mentioned, the price of insurance policies can vary dramatically, depending on the type and features of a policy. For this reason, it is important to consider where the cash will come from to pay the ongoing premiums before the policy is acquired. There are a variety of available choices, including your own personal bank account, cash flow from other investments, your business, or third parties.

For most people, the most affordable way to pay life insurance premiums is out of their own pocket. Actually, if the insurance is owned by a trust, this is not quite as simple as you may think. Instead of writing a check to the insurance company, you actually need to make a gift to the trust that owns the life insurance policy, and allow the trust to write the check to the life insurance company. This ensures the IRS will treat the trust as the owner of the policy. It is typical to make this type of gift to the trust each time a premium payment is due. Of course, with any gift, there may be gift tax consequences.

As discussed on page 1, you can give away \$13,000 per year to as many people as you want, without paying any gift taxes. These gifts are called “*annual exclusion gifts*”. Thus, depending on the amount of the premium that is due, you may be able to make a gift to the trust as an annual exclusion gift and avoid dipping into your lifetime gift tax exemption.

CASE STUDY: John and Jane have 3 children. They form an ILIT, and make their 3 children the beneficiaries of the trust. John’s brother serves as trustee of the ILIT. The trust buys life insurance with an annual premium payment of \$75k. John and Jane can each gift \$13,000 to each of their 3 children, for a total of \$78k (i.e. \$13,000 x 6) in annual exclusion gifts. Thus, with annual exclusion gifts of \$75k to the trust each year, the trust has enough money to pay the insurance premiums without using any of their lifetime gift tax exemption and without paying any gift taxes.

There is one additional requirement that must be considered to keep the IRS happy. For gifts to the trust to qualify as annual exclusion gifts, the IRS requires that the beneficiaries have the option to pull the money out of the trust and spend it on something other than life insurance. Realistically, no beneficiary in their right mind would pull \$13,000 out of the trust now, and forego millions in death benefit later. The trust should, however, allow the beneficiaries a short window of time after any gift is made to the trust to withdraw the money if they so choose. This withdrawal right is often referred to as a “*Crummey power*,” both because the whole idea is crummy, and because the requirement comes from the case *Crummey v. Commissioner*. To document this right, the beneficiary should sign a statement on an annual basis declining to exercise the withdrawal right. This signed statement is called a crummey notice.

To summarize, here is the procedure that should be followed to pay life insurance premiums on a policy held in a trust:

1. You make a gift to the trust, equal to the amount of the premium payment that will be due.
2. The trustee of the trust deposits the gift in the trusts bank account.
3. The trustee informs the beneficiaries of the trust that they can make a withdrawal from the trust (and explains what they will be giving up if they exercise that right).
4. The beneficiaries sign the crummey notices.
5. The trustee writes a check to the insurance company for the premium payment.

In some circumstances, annual exclusion gifts simply do not allow you to get enough money into the trust to pay the life insurance premiums. It is still possible to self-fund the premiums, however, it requires another level of complexity. Split-dollar life insurance agreements allow you to pay the premiums on the life insurance policy without having the policy included in your taxable estate. In short, you treat the premium payments as an



investment, that will be paid back to you (or your estate) with interest at some future date. The payments that you make are tracked, and eventually paid back to your estate from the death benefit of the policy after your death. This can be structured a couple of different ways, however, the result to you is the same – your trust gets the money it needs to pay the life insurance premiums, and your estate gets paid back the money that it invests in the policy.

CASE STUDY: John and Jane have 3 children. John forms an ILIT, and makes his wife and children beneficiaries of the trust. Jane serves as trustee of the ILIT. The trust buys life insurance with a face value of \$20M, and an annual premium payment of \$450k. John enters into a split-dollar life insurance agreement with the trust, and pays the annual premium from his personal account. At the time of John's death he has paid \$4.5M in insurance premiums. The trust reimbursed John for those premium payments (plus some) from the death benefit of the policy.

The final requirement is that the trust must actually pay a small portion of the premium payment (known as the cost of insurance – which is equivalent to the cost of term insurance with the same death benefit). Generally, this will be a few thousand dollars at most.

If you do not have the money to make the split-dollar premium payments from your own account, the trust can enter into a split-dollar agreement with your business. In such a case, the business would be paid back its investment in the policy once the death benefit is paid.

Another option that you may wish to consider is to transfer an asset to the trust that produces enough cash to make the premium payments. This can be a business interest, rental real estate, or other assets. The cash flow from the transferred assets can then be used to pay the insurance premiums. This

strategy is effective if: (1) you have an asset that cash flows enough money and you no longer need the asset or the cash it produces to live, and (2) you can get the asset into the trust without paying gift taxes or using too much of your lifetime gift tax exemption. Several of the strategies discussed in Level 3, such as GRATs, and sales to dynasty trusts can be useful in transferring assets to the trust.

Some companies specialize in financing life insurance premium payments. Similar to other lenders, they expect to receive their investment back with growth. This type of arrangement is often called “*premium financing*.” Generally speaking, this type of an arrangement should only be considered if you have no other way to finance the policy.

ADDITIONAL USES FOR LIFE INSURANCE: Life insurance has many valuable uses besides the liquidity that it provides. Here are just some of the things that a life insurance policy can do for you:

- Income Replacement – If your family relies on your income to pay the bills, life insurance is an excellent way to ensure that your family will continue to live at their accustomed standard after your death.
- Estate Equalization – If you have a large asset, such as a business, that you want to leave to one child, you can use life insurance to make sure that your remaining children get an equal inheritance.
- Investment – Certain life insurance products are simply a good investment, because they offer guaranteed returns that often outperform the rest of your portfolio.
- Charitable Gift Replacement – If you make a gift to a split-interest charitable remainder trust (see discussion on pages 18-19), you can use the annuity payments to fund a life insurance policy which will replace the value of the gift made to the trust in an estate tax free way.



Level 3 Estate Planning

As mentioned on page 1, Level 3 estate planning focuses on reducing the size of your current and future estate tax liability through a variety of sophisticated wealth transfer tax planning strategies. The first goal in Level 3 is to reduce the value of your taxable estate. The second goal of Level 3 is to “freeze” the value of your taxable estate, so that any future appreciation in your assets occurs on a tax-free basis.

REDUCING THE VALUE OF YOUR TAXABLE

ESTATE: Reducing the value of your taxable estate is generally accomplished through a combination of three different methods:

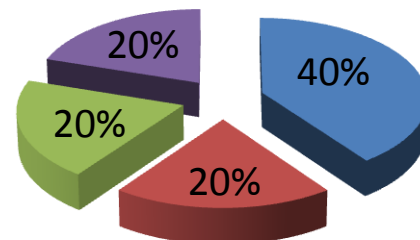
1. Valuation Discounts – Changing the way your assets are owned, and giving away some control over your assets can result in valuation discounts, which dramatically reduce the value of your estate in the eyes of the IRS.
2. Charitable Giving – Each dollar you give to charity during your lifetime reduces the value of your taxable estate, and qualifies for an income tax deduction.
3. Family Giving – Giving away assets to family members using your lifetime gift tax exemption, annual exclusion gifts, and limited taxable gifts can make a big difference in the size of your taxable estate.

VALUATION DISCOUNTS: Suppose that your favorite candy bar costs \$1. You are willing to pay \$1 for that candy bar, because that is the going rate – the fair market value. How much would you pay for one-half of your favorite candy bar? \$0.50 perhaps? What if you were told that the owner of the other half of the candy bar gets to make all of the decisions about the candy bar, including when you get to eat your half. How much would you be willing to pay now? The likely answer is nothing. If, however, you really

wanted the candy bar, you may still be willing to pay something for it, although it would be less than the fair market value. If half of a candy bar costs \$0.50, maybe you would require a 40% or 50% discount in the price, and only be willing to pay \$0.30 or \$0.25 for the half of the candy bar. This reduction in price is called a “*valuation discount*”.

Consider another example, this time with real estate. Suppose a couple owns a piece of investment real estate with a value of \$1M. If the couple transfers a 20% interest in the property to each of their three children, the value of their remaining 40% interest will be heavily discounted, because they no longer own a majority interest, and no longer have sole control of the property. Thus, their 40% may be worth \$250k instead of \$400k.

Ownership of Family Real Estate



- Mom & Dad
- Child 1
- Child 2
- Child 3

In the business world, assets qualify for valuation discounts for a variety of reasons:

- Lack of Marketability – If an asset is not readily marketable, such as a minority interest in a piece of real estate or a privately held business, the value is generally discounted.
- Lack of Control – If an asset is subject to the control of another person, it will be



difficult to convince someone to pay fair market value for that assets.

- **Blockage** – If it is unreasonable or unlawful to sell an asset in one piece, such as certain controlling interests in publicly-held securities, the asset may qualify for a discounted value.

Some estate planning strategies have the added benefit of qualifying assets for valuation discounts. If, however, the only reason for engaging in a transaction is to qualify for valuation discounts, it is generally inadvisable to go through with the transaction.

FAMILY LIMITED PARTNERSHIPS (FLP) AND FAMILY LIMITED LIABILITY COMPANIES (FLLC):

The most common estate planning strategy that utilizes valuation discounts is the formation of a family limited partnership (FLP), or a family limited liability company (FLLC). These strategies are common because they will allow you to give away property, and thus qualify for valuation discounts, while still retaining almost complete control of your assets. This is accomplished through a few simple steps:

1. You form an FLLC. The FLLC should have both voting and nonvoting interests.
2. You contribute property to the FLLC. An FLLC can hold any type of property, however, you should take care not to contribute personal use assets (such as your primary home or your vehicles).
3. You gift or sell interests in the FLLC to your family members, or to a trust that you have created for the benefit of your family members.
4. You have the gifted interests appraised, and report the value of the gift on a gift tax return.

Most estate planning attorneys choose to use an FLLC instead of an FLP because of the liability protection that comes with an FLLC.

A typical FLLC is designed, as mentioned above, with a 1% voting interest, and a 99% nonvoting interest. This allows you to give

away up to 99% of the economic value of the FLLC without losing control. Furthermore, you are allowed to serve as the manager of the FLLC, which gives you further control. The formation and operation of FLPs and FLLCs is highly scrutinized by the IRS, so it is necessary to have an estate planning attorney that is familiar with the pitfalls that many practitioners fall into when preparing these highly complicated documents.

DIFFERENT METHODS OF CHARITABLE GIVING:

If you are charitably inclined, giving to your favorite charities is a simple and altruistic way to reduce your estate tax liability. Many people choose to “zero out” their estate tax liability entirely through charitable giving (i.e., fully using their exemption amounts and leaving everything else to charity).

There are many different techniques that can be employed in charitable giving, including split-interest trusts, private foundations, and donor advised funds. Each method comes with its own unique set of benefits and challenges.

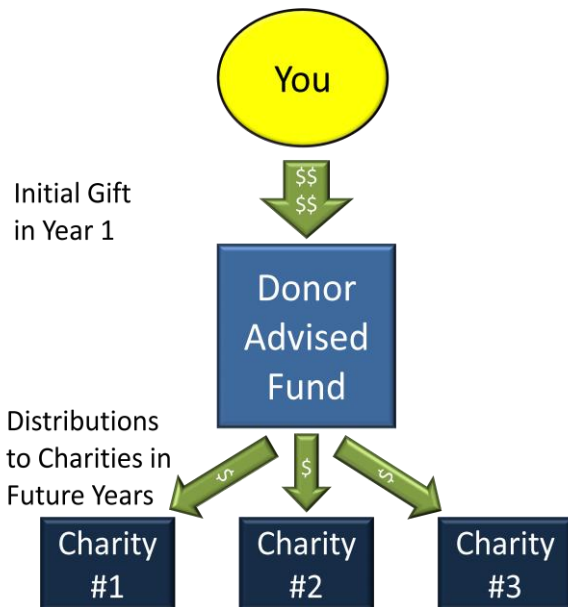
DONOR ADVISED FUNDS: A donor advised fund is similar to an investment account that is set aside for charitable purposes, which allows you to determine the timing of charitable gifts, and which charities will be benefited. In simple terms, it works like this:

- You form a fund with an existing charitable organization that offers donor advised funds.
- You have complete control over the name of your fund, which you can use to maximize name recognition (i.e., the Smith Family Fund”), or to provide anonymity in your giving.
- You transfer money or assets to the fund, realizing that whatever you transfer to the fund can only be used for charitable purposes thereafter.
- You receive a current income tax deduction for any money or property that you transfer to the fund. Thus, you get



the tax benefit now, but can actually dole the cash out to charity over many years.

- The charitable organization that manages the fund for you generally charges a small investment management fee.
- When you decide to make a distribution, you simply notify the charity that runs the fund, and they take care of the rest.
- Donations can be spread out over a number of years, so long as minimum donations are made each year.
- When you die, your family members can retain ownership of the fund, continuing to benefit your favorite charities.



The benefits of a donor advised fund include: simplicity of operation, little or no administrative oversight on your part, comparative low cost of operation, the ability to maximize name recognition or anonymity, and of course, the immediate income tax deduction.

The drawbacks of a donor advised fund are relatively few, so long as you are willing to limit your giving to other charitable organizations. A donor advised fund is not a separate charitable organization that can host its own events. In short, if you want to actively operate a charitable organization, you may need something a little more

involved than a donor advised fund. If however, you are simply looking for a tax advantageous way to make charitable gifts, a donor advised fund is probably your best option.

PRIVATE FOUNDATIONS: Starting a private foundation is a more hands on approach to charitable giving. A private foundation is a nonprofit business (although it can be formed as either a nonprofit corporation or a trust) that has a specific charitable mission. After the nonprofit is formed, it can apply for tax exempt status with the IRS.

For a private foundation to qualify as a 501(c)(3) organization, it must have a specific charitable purpose, that must be related to one of the following categories: religion, charity, science, testing for public safety, literature, educational, to foster national or international amateur sports competition, or prevention of cruelty to children or animals.

A private foundation generally begins with a vision of what the creator wishes to accomplish. This can be as simple as raising money for other charities, similar to a donor advised fund, or as complex as operating a homeless shelter or an educational institution. Once the vision is in place, the legal documents must be prepared to form the entity, and to qualify the entity as tax exempt. This is a very involved process that will require the creator to have a clear vision of what the foundation hopes to accomplish, and how the foundation will operate.

As with a donor advised fund, donations to a private foundation are tax exempt, although the amount of the deduction is usually limited by certain provisions of the Internal Revenue Code. For this reason, it is important to have your estate planning attorney and your accountant involved at all stages of the foundation's formation and operation.

In the past, many people have formed private foundations for the sole purpose of providing cushy high-paying jobs for their relatives. While there are no specific prohibitions against employing family members, the IRS closely monitors the finances of private



foundations, including the salaries paid to executives. There are very specific self-dealing rules, designed to prevent abuse of a foundation's tax exempt status. Additionally, private foundations must make minimum distributions for charitable purposes each year. To ensure compliance with these complicated rules, private foundations must make very thorough reports to the IRS on a periodic basis to keep their tax exempt status. These disclosure statements (and tax returns) are made public, so that potential donors know what they are getting into. Failure to comply with the reporting requirements can result in a loss of the foundation's tax exempt status. Finally, private foundations are subject to excise taxes on investment income, so they are not fully tax exempt (at least as it relates to some types of income).

As you may have guessed, running a private foundation is not for the faint of heart. The administrative and reporting requirements can be stifling if you do not have the proper help. Fortunately, there are organizations that specialize in providing back office support for private foundations – for a fee.

PRIVATE FOUNDATIONS

Benefits:

- Control over board of directors.
- Control over operations.
- Name exposure and recognition.
- Benefit your favorite charitable causes.
- Involve children in charitable intentions.

Drawbacks:

- Limits on income tax deductions.
- Burdensome and expensive operations.
- Reporting requirements to the IRS.
- Excise tax on investment income.
- Self-dealing rules and penalties.

PUBLIC CHARITIES: One step up from a private foundation is an actual public charity. A public charity must have a specific charitable purpose, similar to a private

foundation. The main difference between a public charity and a private foundation is that the former generally relies on the public at large for its support, while the latter relies on a small pool of donors. This means that public charities must engage in targeted fundraising to meet their charitable mission and to maintain their tax exempt status.

Most national charities that you can think of are organized as public charities. Running a public charity is truly a full-time job, that requires a team of experienced advisors to assist you. Public charities operate on a higher level than private foundations, and thus have similar reporting requirements, which are also made public.

A public charity should be considered only if you are really serious about charitable giving, and desire to make your charitable activities a significant part of your daily life.

SPLIT-INTEREST TRUSTS (CHARITABLE LEAD TRUSTS AND CHARITABLE REMAINDER TRUSTS):

In some situations, it makes sense to run your charitable giving through an irrevocable trust to accomplish the goals of reducing your taxable estate, giving to charity, and providing for your surviving family members. This type of trust is often referred to as a “*split-interest trust*,” because the beneficial interest in the trust is split between a charitable organization and private beneficiaries. Split-interest trusts can be formed either during your lifetime or at your death. Here are a few examples of split-interest trusts, and how they operate:

- Charitable Remainder Annuity Trust (CRAT) – With a CRAT, money is transferred to a trust. The trust then pays an annuity amount to private beneficiaries that you choose (usually family members) for up to 20 years. Whatever is left over after that time period passes to the charity of your choice. The value of your initial gift is divided into two parts, an annuity interest (which is paid to private beneficiaries), and a remainder interest (which is paid to charity). You receive an up-front deduction for the calculated value



of the remainder interest. Thus, a CRAT has the dual advantage of saving income taxes, and removing the remainder interest from your taxable estate.

- Charitable Remainder Unitrust (CRUT): Just like a CRAT, a CRUT provides an income stream to your family members, with an eventual gift to charity. The main difference, however, is that the payments under a CRUT are equal to the greater of an annuity payment, or a fixed percentage of the value of the trust. Thus, a CRUT can protect the income stream passing to your family members from inflation. The tax advantages of a CRUT are the same as with a CRAT. The main drawback of a CRUT is that annual appraisals are required to determine payment amounts.
- Charitable Lead Annuity Trust (CLAT) – A charitable lead annuity trust is basically the opposite of a CRAT. In essence, the charity receives the annuity payments, and the remainder interest passes to your family members. This is a very effective way to push value out of your taxable estate while preserving the underlying assets for your family members (although they must wait until the annuity term has expired before they receive their portion of the trust property). The main drawback of a CLAT is that it only qualifies for an up-front income tax deduction if the grantor agrees to pay the income taxes for the trust (i.e., a grantor trust, as discussed on page 4).
- Charitable Lead Unitrust (CLUT) – A CLUT is basically the opposite of a CRUT. The charity receives payments equal to the greater of an annuity amount or a percentage of the value of the trust, while your family members receive the remainder interest. This is a very effective way to push value out of your taxable estate while preserving the underlying assets for your family members (although they must wait until the annuity term has expired before they

receive their portion of the trust property). A CLUT requires an annual valuation to ensure that the annual payments are calculated correctly.

**COMPARISON OF CHARITABLE
SPLIT-INTEREST TRUSTS**

| TYPE OF TRUST | PAYMENT OF INCOME INTEREST | AMOUNT OF INCOME PAYMENT | RECIPIENT OF REMAINDER INTEREST |
|---------------|----------------------------|--|---------------------------------|
| CRAT | Family Members | Predetermined Annuity Amount | Charity |
| CRUT | Family Members | Greater Of Predetermined Annuity Amount Or % Of The Value Of The Trust | Charity |
| CLAT | Charity | Predetermined Annuity Amount | Family Members |
| CLUT | Charity | Greater Of Predetermined Annuity Amount Or % Of The Value Of The Trust | Family Members |

CHARITABLE GIVING SUMMARY: As previously mentioned, each type of charitable giving comes with its own set of tax advantages and pitfalls. At its most basic level, however, most people do not give because of taxes, they give because they want to make a difference. You shouldn't be discouraged from giving because of the complexity of different giving techniques – an experienced team of advisors can ensure that your charitable visions are realized in a way that keeps you out of trouble and provides generous tax savings.

FAMILY GIVING: Giving property to family and friends during your lifetime is also an effective way to reduce the value of your taxable estate. Every dollar you give away during



your lifetime is eliminated from your taxable estate, along with any appreciation in the value of that dollar.

CASE STUDY: John and Jane have 3 children. They gift 10% of a FLLC to each of their children when the value of the business is \$1M. Subsequently, the value of the FLLC appreciates to \$10M. The value of the initial 10% held by each child is ultimately worth \$1M each, because the initial gift also includes any future appreciation in the value of the gift.

As with any gift, the issues of gift taxes and asset protection must be considered. (See page 1 for an explanation of gift taxes, lifetime gift tax exemptions, and annual exclusion gifts). Thus, the amount of lifetime giving that you can use to reduce your estate tax liability is limited by your lifetime gift tax exemption amount (along with yearly annual exclusion gifts). In almost all cases, a wise use of your lifetime gift tax exemption will be more beneficial than waiting and using that exemption amount at your death.

The key is to gift assets which will give you the most bang for your buck – i.e., assets with the greatest potential for appreciation. Keep in mind that any assets you give away should be assets you no longer need. The benefits of lifetime giving can be augmented if used in connection with other strategies, such as an FLLC, valuation discounts, or crummey gifts.

CASE STUDY: Jane has two assets that she does not need for her support, a vacation home, and a minority interest in a business. Each asset is currently worth \$1M. In deciding which asset to gift, Jane should consider, among other things, which asset has the greatest potential for appreciation, and which asset can be of the most use to her descendants.

Giving to family members should also consider asset protection. An outright gift to a child can quickly disappear if the child is party to a lawsuit or gets a divorce. For this

reason, you should at least consider giving to your children through a trust. A trust can offer significant asset protection, while still allowing your children use and some measure of decision-making authority over trust property.

DYNASTY TRUSTS: A dynasty trust is simply an irrevocable trust that has received a gift of property, either during your lifetime or at your death, and has received an allocation of GST tax exemption equal to the value of the trust. The net effect of this strategy is a trust that can last for generations (up to 1,000 years in some states), without ever being subject to wealth transfer taxes.

If you form a dynasty trust during your lifetime, you can choose to make the trust a “grantor trust” as discussed on page 4. This will allow you to pay any income taxes attributable to the trust’s income. This is comparable to making additional tax-free gifts to the trust equal to its annual income tax liability. Because the dynasty trust will not have to shell out money for its own income taxes, the value of the trust increases more rapidly. The net effect can be dramatic tax-free growth in the trust. Furthermore, if you ever grow tired of paying the trust’s income taxes, you can simply elect not to pay the taxes anymore, at which point the dynasty trust would become its own taxpayer, and be responsible for its own taxes.

CASE STUDY: Jane forms a dynasty trust that qualifies as a grantor trust. Over 5 years, Jane pays \$1M in income taxes on behalf of the dynasty trust. Because the dynasty trust is able to reinvest that \$1M rather than paying taxes, the value of the trust increases substantially through the first 5 years. In year 6, Jane decides to toggle off the grantor trust status, and forces the trust to pay its own income taxes.

One additional benefit of having a dynasty trust which qualifies as a grantor trust is that the IRS views you and the trust as one single



taxpayer. This opens up a whole world of possibilities for you to engage in tax free transactions with the dynasty trust without ever triggering income taxes. Many of the “estate freeze” techniques discussed in the coming pages rely on this advantage.

DYNASTY TRUST AS A GRANTOR TRUST

There are several advantages of having your dynasty trust qualify as a grantor trust:

1. You pay income taxes for the dynasty trust, which allows the property in the trust to grow income tax free. At the same time, your taxable estate is reduced by the amount of the taxes that you pay on behalf of the dynasty trust.
2. You and the dynasty trust are treated as one taxpayer, which allows you to sell property to the trust without triggering capital gains. Also, there is no interest income if the sale uses a promissory note.
3. You can create a private annuity with the trust, and no portion of the annuity payments made by the trust are taxable.
4. You can toggle off the grantor trust status at any time.

As with any other type of gifting, once property is transferred to a dynasty trust it is no longer your property. Thus, you should not serve as the trustee of your own dynasty trust.

BENEFICIARY CONTROLLED TRUSTS (BCT): A BCT is simply a variation on the concept of a dynasty trust that qualifies as a grantor trust. Simply stated, instead of the income taxes begin paid by the grantor (i.e., the person creating the trust), the income taxes are paid by the beneficiary. Here is how it works:

- You create a trust for the benefit of your child. As part of the trust agreement, you allow your child to have specific powers that will force the child to pay income taxes on behalf of the trust.

- You make an initial gift of property to the trust, using a portion of your lifetime gift tax exemption.
- Your child serves as trustee of the trust (which is allowed because your child did not create the trust), and as a beneficiary of the trust – thus, your child manages the trust for her own benefit.
- Your child and the trust are treated as one single taxpayer, which allows your child to sell property to the trust without triggering any income tax liability.
- Your child can toggle off the income tax obligation, and thus force the trust to become its own taxpayer.

DYNASTY TRUST

INCOME TAXATION COMPARISON

| Action | Grantor Trust | BCT |
|-------------------------|------------------------|------------------------|
| Taxpayer | Grantor | Beneficiary |
| Tax Free Transactions? | Grantor | Beneficiary |
| Trustee | Anyone but the grantor | Anyone but the grantor |
| Beneficiary | Anyone but the grantor | Anyone but the grantor |
| Investment Limitations? | None | None |

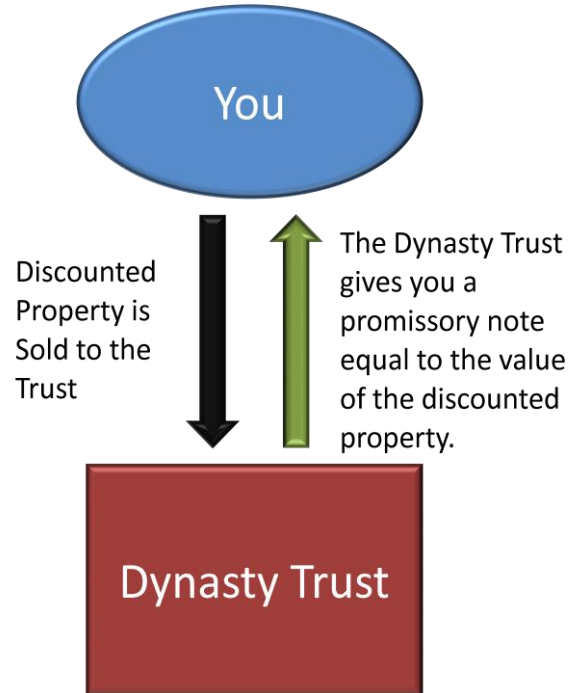
ESTATE FREEZE TECHNIQUES: Once you have done all that you can to reduce the current value of your taxable estate the next step is to keep your taxable estate from growing due to the natural appreciation of your assets. In essence, the more your wealth grows, the more of an estate tax problem that you will have. Fortunately, hiding your money under your mattress is not the only option for preventing growth in the portion of your estate that is taxable.



Certain transactions, such as selling property to a dynasty trust, creating a private annuity, or transferring your home to an irrevocable trust will allow you to “freeze” the value of your estate at its present level, while capturing any future appreciation outside of your taxable estate.

DYNASTY TRUST SALES: As previously discussed, a dynasty trust that qualifies as a grantor trust allows you to engage in income tax free transactions with the trust. By way of comparison, if you have an asset that you purchased for \$100k, and you sell the asset for \$1M, you have \$900k of gain that you will recognize on the sale, resulting in about \$135k of capital gains taxes; if however, you sell the same asset to a dynasty trust which qualifies as a grantor trust, there are no capital gains taxes triggered, because the IRS views you and the dynasty trust as the same taxpayer. In short, you don't pay taxes when you sell an asset to yourself. With that result in mind, consider the following example:

Suppose you form a dynasty trust, and make an initial gift of \$1M to the trust. You then sell additional property with a value of \$9M to the trust in exchange for a promissory note (where the trust promises to pay you \$9M in 10 years). No income taxes are triggered by the sale, because the dynasty trust qualifies as a grantor trust. After the sale is complete, you still have the same net worth – the only thing you have given up is the initial gift of \$1M. Imagine further that the asset you sold to the trust appreciates over the term of the promissory note, to be worth \$15M. When the note comes due, the trust pays you back \$9M, leaving the \$6M of appreciation in the trust. As a result, 10 years have passed, and your estate tax liability has not changed. At the same time, you have socked away an additional \$6M toward your children's inheritance without paying any income taxes. Imagine further how much more powerful this tool can be if you sell property that is subject to valuation discounts, thus allowing you to transfer even more money to the trust in the initial gift and sale.



A sale of this type occurs in the following steps:

1. You form a dynasty trust, making sure the trust qualifies as a grantor trust. You are able to choose the trustee and the beneficiaries of the dynasty trust.
2. You make an initial gift of property to the dynasty trust using a portion of your lifetime gift tax exemption. A gift tax return will need to be filed.
3. The trust purchases assets from you for their fair market value. The property sold should be appraised to substantiate the sales price and to determine the applicable valuation discounts.
4. The dynasty trust gives you a promissory note payable in a balloon payment at the expiration of the note (usually 9 years or longer). The trust must pay a modest rate of interest on the note.
5. No gain is triggered on the sale of the property, because you and the dynasty trust are one for income tax purposes. Likewise, you will not have to report interest income from the interest



payments you are paid under the promissory note.

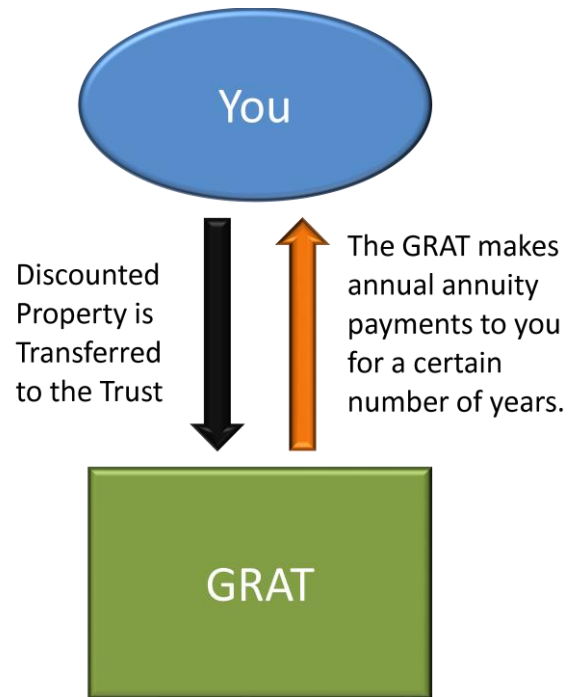
6. At the end of the promissory note term, the trust pays you back the total value of the promissory note. The trust can make the payment in cash or in property of equivalent value.
7. After the promissory note is paid off, any appreciation left in the trust is outside of your taxable estate. This property can be held or invested in your trustee's discretion. This makes a very nice vehicle to pay life insurance premiums if future policies are acquired.

As with any sophisticated tax transaction, there are some risks involved. Enlisting the help of an experienced appraiser and a qualified estate planning attorney should help minimize these risks. In the end, the biggest risk is that the IRS could change the way that it treats certain aspects of this transaction – an unlikely but not unheard of result. The other main risk is that the property sold to the trust may still be included in your taxable estate if you die before the promissory note is paid in full. While these risks are real, the benefits of this transaction far outweigh the risks for many people.

GRANTOR RETAINED ANNUITY TRUSTS (GRAT): You may have heard about the concept of an annuity – where you pay a lump sum now in exchange for a future stream of income. At its most basic level, a commercial annuity allows you to pay money to a company, which then promises to make future payments to you. Using this same logic, you can create your own annuity using an irrevocable trust, and achieve fantastic estate tax savings at the same time.

Consider the following: You have an asset that produces large amounts of cash (such as a piece of commercial real estate). You transfer the asset to a trust in exchange for a promise to pay annual annuity payments over the next 5 years. For the next five years, the trust makes annual annuity payments back to you. At the end of the five year period, you have received back the entire value of your

initial investment, with a modest rate of interest. The trust keeps the benefit of any appreciation in that asset over the five year period.



This transaction is accomplished in the following steps:

1. You form an irrevocable trust (a GRAT), making sure that the GRAT qualifies as a grantor trust. You can select the trustee and the beneficiaries of the GRAT.
2. You transfer discounted property to the GRAT. The property should be valued at the time of the transfer.
3. The GRAT makes annual annuity payments back to you. If the total value of the annuity payments equals the value of the initial transfer, no gift has been made, and you are not required to use any of your lifetime gift tax exemption. Conversely, if the value of the annuity payments is less than the value of the initial transfer, you will need to use a portion of your lifetime gift tax exemption.
4. The annuity payments made by the GRAT can be in the form of cash, or if the GRAT does not have sufficient



cash, in other property. If annuity payments are made using property, the property will need to be revalued prior to each annuity payment.

5. At the expiration of the annuity term, any appreciation of the underlying assets stays in the GRAT, and is captured outside of your taxable estate.
6. You should allocate GST tax exemption to the property left in the GRAT at the conclusion of the annuity term to make the GRAT qualify, at least in part, as a dynasty trust.
7. Your trustee can reinvest the money or property left in the GRAT however he sees fit, including in life insurance (which creates a very efficient way to pay life insurance premiums).

There are certain risks associated with a GRAT. First, because of complicated tax rules, GST tax exemption cannot be allocated to the GRAT until the expiration of the annuity term. Second, if you die during the annuity term the value of the GRAT can be included in your taxable estate. Third, if the property in the GRAT does not appreciate, the GRAT does not accomplish much. Finally, the IRS can, as with any transaction, challenge the valuation that you attach to the transferred property. All of these risks, as well as others not mentioned in this article, should be considered in depth before forming a GRAT. Most people agree, however, that a well planned out GRAT is a routine and fairly safe estate planning transaction. As with any transaction, you should consult with your estate planning attorneys about your specific situation before attempting to form a GRAT.

QUALIFIED PERSONAL RESIDENCE TRUSTS (QPRT): A QPRT (pronounced “Q – pert”) is a transaction designed to transfer your primary home to your children. In short, you form a trust, and transfer your home to the trust. You reserve the right to live in your home for a certain number of years. At the end of the QPRT term, the home passes to the beneficiaries of the trust (usually your descendants). The value of the initial transfer

is broken into two components – (1) the value of the retained interest, which allows you to live in the home, and (2) the remainder interest, which passes to your loved ones. Gift taxes only apply to the remainder interest.

CASE STUDY: Jane owns a piece of vacation property worth \$1M that she wants to keep in the family. She forms a QPRT, and transfers the home to the QPRT. She reserves the right to live in the home for a certain number of years. From an accounting perspective, the total value of the home is divided between the right reserved by Jane (i.e. to live in the home for a certain number of years), and the right of the beneficiaries to live in the house at the termination of Jane’s interest. It works out that the value of Jane’s retained interest is \$600K, while the value of the remainder interest is \$400k. When the gift is made, Jane uses \$400k of her lifetime gift tax exemption to transfer the house to the trust. Once Jane’s time for living in the home has expired, the trust owns the entire home free and clear. In short, Jane was able to transfer an asset worth \$1M while only using \$400k worth of lifetime gift tax exemption.

This transaction is completed in the following steps:

1. You form a QPRT. You are able to choose the trustee and the remainder beneficiaries of the QPRT.
2. You transfer your home to the QPRT. The home must be valued as of the date of the transfer, and the value of the remainder interest must be calculated up front as well.
3. A gift tax return should be filed, reporting the value of the remainder interest.
4. You live in the home for the remainder of the reserved period.
5. At the end of the reserved period, the trust has full ownership of the home.
6. If you wish to continue living in the home, you can pay rent to the trust – another



way to transfer money out of your taxable estate without having to pay gift taxes.

The disadvantages of this transaction are relatively few. For instance, the trust is irrevocable, so you must prepare yourself mentally for the fact that you are giving away your home. If you choose to stay in your home, you will need to pay rent. Also, your children will be your landlord. Additionally, once the property is transferred to your children, they will not take a stepped-up basis at your death, which means they could pay income taxes in the future if they ever choose to sell the home. Finally, if you die during the reserved term, the total value of the home may be included in your taxable estate.

Conclusion

Estate planning for high net worth individuals is a very complicated topic. There are many pitfalls for the unwary. Thankfully, however, creative estate planning attorneys can help you implement strategies, including those discussed in this article, to help you meet your estate planning goals in the most tax efficient manner. The opportunities available to those who are willing to plan ahead and be creative can bless your families lives for generations to come.

| Year | Gift Tax Exemption Amount | Gift Tax Rate | Extate Tax Exemption Amount | Estate Tax Rate | GST Tax Exemption Amount | GST Tax Rate |
|------|---------------------------|---------------|-----------------------------|-----------------|--------------------------|--------------|
| 2005 | \$1M | 47% | \$1.5M | 47% | \$1.5M | 47% |
| 2006 | \$1M | 46% | \$2M | 46% | \$2M | 46% |
| 2007 | \$1M | 45% | \$2M | 45% | \$2M | 45% |
| 2008 | \$1M | 45% | \$2M | 45% | \$2M | 45% |
| 2009 | \$1M | 45% | \$3.5M | 45% | \$3.5M | 45% |
| 2010 | \$1M | 35% | Unlimited | N/A | Unlimited | N/A |
| 2011 | \$5M | 35% | \$5M | 35% | \$5M | 45% |
| 2012 | \$5M | 35% | \$5M | 35% | \$5M | 45% |
| 2013 | \$1M | 55% | \$1M | 55% | \$1M | 55% |
| 2014 | \$1M | 55% | \$1M | 55% | \$1M | 55% |
| 2015 | \$1M | 55% | \$1M | 55% | \$1M | 55% |

ABOUT THE AUTHOR

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