Selecting the Best Estate Planning Strategies

MOORE STEPHENS TILLER LLC
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ESTATE PLANNING BASICS

When you hear the phrase "estate planning," the first thought that comes to mind may be taxes. But estate planning is about more than just reducing taxes. It's about ensuring your assets are distributed according to your wishes. In addition, as of this writing, there continues to be much uncertainty surrounding estate taxes: A one-year repeal of the estate tax went into effect Jan. 1, 2010, but in December the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 retroactively brought back the estate tax for 2010, with some enhancements for 2010 through 2012. (See Planning Tip 1 on page 3.) Then in 2013, the exemption and top rate are scheduled to return to levels prescribed by pre-2001 tax law — the levels that would have gone into effect in 2011 without the 2010 Tax Relief act.

Given the unsettled nature of the laws, it's more important than ever to have an estate plan that's flexible enough to allow for all possibilities.

If you haven't prepared an estate plan, this guide will help you get started. And if you already have a plan in place, the guide may offer strategies that you currently may not be employing — including strategies that will help you leverage the 2010 Tax Relief act changes.

Certainly this guide is no replacement for professional financial, tax and legal advice. As mentioned, Congress is likely to make further estate tax law changes that could affect the issues discussed here — or your estate plan. So work with a qualified estate planning advisor before implementing any estate planning strategies or making any changes to your current plan.

FUNDAMENTAL QUESTIONS

Because estate planning isn't just about reducing taxes but also about making sure your assets are distributed as you wish both now and after you're gone, you need to consider three questions before you begin your estate planning — or reconsider them if you're reviewing your estate plan.

1. Who should inherit your assets?

If you're married, before you can decide who should inherit your assets, you must consider marital rights. States have different laws designed to protect surviving spouses. If you die without a will or living trust, state law will dictate how much passes to your spouse. Even with a will or living trust, if you provide less for your spouse than state law deems appropriate, the law may allow the survivor to elect to receive the greater amount.

If you live in a community property state or your estate includes community property, you'll need to consider the impact on your estate planning. (See page 27.)

Once you've considered your spouse's rights, ask yourself these questions:

- Should your children share equally in your estate?
- Do you wish to include grandchildren or others as beneficiaries?
- Would you like to leave any assets to charity?

2. Which assets should they inherit?

You may want to consider special questions when transferring certain types of assets. For example:

- If you own a business, should the stock pass only to your children who are active in the business? Should you compensate the others with assets of comparable value?
- If you own rental properties, should all beneficiaries inherit them? Do they all have the ability to manage property? What are the cash needs of each beneficiary?

3. When and how should they inherit the assets?

You need to focus on three factors:

- The potential age and maturity of the beneficiaries,
- The financial needs of you and your spouse during your lifetimes, and
- The tax implications.

Outright bequests offer simplicity, flexibility and some tax advantages, but you have no control over what the recipient does with the assets. Trusts are more complex, but they can be useful when heirs are young, immature or lack asset management capabilities. They also can help save taxes.

Planning Tip 1

BE AWARE OF 2010 TAX RELIEF ACT CHANGES

Here's a brief summary of the most important provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 that relate to estate planning:

- Reinstatement of the estate tax for 2010 with a top rate of 35% and a $5 million exemption (compared to 45% and $3.5 million for 2009)
- Option for estates of taxpayers who died in 2010 to elect to follow the pre–Tax Relief act regime — no estate tax but limits on step-up in basis for transferred assets
- Reinstatement of the generation-skipping transfer (GST) tax for 2010 at a 0% rate with a $5 million exemption (compared to 45% and $3.5 million for 2009)
- Decrease in the top estate and gift tax rates and the GST tax rate to 35% for 2011 and 2012
- Increase in the estate, GST and gift tax exemptions to $5 million for 2011, indexed for inflation in 2012
- Ability of the estate of a taxpayer who dies in 2011 or 2012 to elect to allow the surviving spouse to use the deceased's unused estate tax exemption

These changes are discussed in more detail later in this guide where applicable.

TRANSFERRING PROPERTY AT DEATH

There are three basic ways for your assets to be transferred on your death: the will, which is the standard method; the living trust, which offers some advantages over a will; and beneficiary designations, for assets such as life insurance and IRAs. If you die without either a will or a living trust, state intestate succession law controls the disposition of your property that doesn't otherwise pass via "operation of law," such as by beneficiary designation. And settling your estate likely will be more troublesome — and more costly.

The primary difference between a will and a living trust is that assets placed in your living trust, except in rare circumstances, avoid probate at your death. Neither the will nor the living trust document, in and of itself, reduces estate taxes — though both can be drafted to do this. Let's take a closer look at each vehicle.

Wills

If you choose just a will, your estate will most likely have to go through probate. Probate is a court-supervised process to protect the rights of creditors and beneficiaries and to ensure the orderly and timely transfer of assets. The probate process has six steps:

1. ***Notification of interested parties.*** Most states require disclosure of the estate's approximate value as well as the names and addresses of interested parties. These include all beneficiaries named in the will, natural heirs and creditors.

2. ***Appointment of an executor or personal representative.*** If you haven't named an executor or personal representative, the court will appoint one to oversee the estate's liquidation and distribution.

3. ***Inventory of assets.*** Essentially, all assets you owned or controlled at the time of your death need to be accounted for.

4. ***Payment of claims.*** The type and length of notice required to establish a deadline for creditors to file their claims vary by state. If a creditor doesn't file its claim on time, the claim generally is barred.

5. ***Filing of tax returns.*** This includes the individual's final income taxes and the estate's income taxes.

6. ***Distribution of residuary estate.*** After the estate has paid debts and taxes, the executor or personal representative can distribute the remaining assets to the beneficiaries and close the estate.

Probate can be advantageous because it provides standardized procedures and court supervision. Also, the creditor claims limitation period is often shorter than for a living trust.

Living trusts

Because probate is time-consuming, potentially expensive and public, avoiding probate is a common estate planning goal. A living trust (also referred to as a revocable trust, declaration of trust or inter vivos trust) acts as a will substitute, although you'll still also

need to have a short will, often referred to as a "pour over" will.

How does a living trust work? You transfer assets into a trust for your own benefit during your lifetime. You can serve as trustee, select some other individual to serve, or select a professional trustee. In nearly every state, you'll avoid probate if all of your assets are in the living trust when you die, or if any assets not in the trust are held in a manner that allows them to pass automatically by operation of law (for example, a joint bank account). The pour over will can specify how assets you didn't transfer to your living trust during your life will be transferred at death.

Essentially, you retain the same control you had before you established the trust. Whether or not you serve as trustee, you retain the right to revoke the trust and appoint and remove trustees. If you name a professional trustee to manage trust assets, you can require the trustee to consult with you before buying or selling assets. The trust doesn't need to file an income tax return until after you die. Instead, you pay the tax on any income the trust earns as if you had never created the trust.

A living trust offers additional benefits. First, your assets aren't exposed to public record. Besides keeping your affairs private, this makes it more difficult for anyone to challenge the disposition of your estate. Second, a living trust can serve as a vehicle for managing your financial assets if you become incapacitated and unable to manage them yourself. A properly drawn living trust avoids guardianship proceedings and related costs, and it offers greater protection and control than a durable power of attorney because the trustee can manage trust assets for your benefit.

Who should draw up your will or living trust?

A lawyer! Don't try to do it yourself. Estate and trust laws are much too complicated. You should seek competent legal advice before finalizing your estate plan. While you may want to use your financial advisor to formulate your estate plan, wills and trusts are legal documents. Only an attorney who specializes in estate matters should draft them.

Planning Tip 2

TITLE ASSETS CORRECTLY

When you create a trust, make sure you direct your legal advisor to change the title of all assets you want managed by your trust's provisions. Otherwise, those assets may unexpectedly be included in your probate estate.

Selecting an executor, personal representative or trustee

Whether you choose a will or a living trust, you also need to select someone to administer the disposition of your estate — an executor or personal representative and, if you have a living trust, a trustee. An individual (such as a family member, a friend or a professional advisor) or an institution (such as a bank or trust company) can serve in these capacities. (See Planning Tip 3 on page 6.) Many people name both an individual and an institution to leverage their collective expertise.

What does the executor or personal representative do? He or she serves after your death and has several major responsibilities, including:

- Administering your estate and distributing the assets to your beneficiaries,
- Making certain tax decisions,
- Paying any estate debts or expenses,
- Ensuring all life insurance and retirement plan benefits are received, and
- Filing the necessary tax returns and paying the appropriate federal and state taxes.

Whatever your choice, make sure the executor, personal representative or trustee is willing to serve. Also consider paying a reasonable fee for the services. The job isn't easy, and not everyone will want or accept the responsibility. Provide for an alternate in case your first choice is unable or unwilling to perform. Naming a spouse, child or other relative to act as executor or personal representative is common, and he or she certainly can hire any professional assistance needed.

Finally, make sure the executor, personal representative or trustee doesn't have a conflict of interest. For example, think twice about choosing a second spouse, children from a prior marriage, or an individual who owns part of your business. The desires of a stepparent and stepchildren may conflict, and a co-owner's personal goals regarding your business may differ from those of your family.

Selecting a guardian for your children

If you have minor children, perhaps the most important element of your estate plan doesn't involve your assets. Rather, it involves who will be your children's guardian. Of course, the well-being of your

Planning Tip 3

PROFESSIONAL VS. INDIVIDUAL EXECUTOR, PERSONAL REPRESENTATIVE OR TRUSTEE

Advantages of a professional executor, personal representative or trustee:

- Specialist in handling estates or trusts
- No emotional bias
- Impartiality — usually free of personal conflicts of interest with the beneficiaries
- Independence — sensitive to but not hindered by emotional considerations
- Financial expertise

Advantages of an individual executor, personal representative or trustee:

- More familiarity with the family
- Potentially lower administrative fees

children is your top priority, but there are some financial issues to consider:

- Will the guardian be capable of managing your children's assets?
- Will the guardian be financially strong?
- Will the guardian's home accommodate your children?
- How will the guardian determine your children's living costs?

If you prefer, you can name separate guardians for your child and his or her assets. Taking the time to name a guardian or guardians *now* ensures your children will be cared for as you wish if you die while they're still minors.

OTHER FACTS ABOUT ESTATE SETTLEMENT

You also should be aware of the other procedures involved in estate settlement. Here's a quick review of some of them. Your attorney, as well as the organizations mentioned, can provide more details.

Transferring property

When thinking about transferring your property, what probably first comes to mind are large assets, such as stock, real estate and business interests. But you also need to consider more basic assets:

Safe deposit box contents. In most states, once the bank learns of the death, it will open the box only in the presence of the estate's executor or personal representative.

Savings bonds. The surviving spouse can immediately cash in jointly owned E bonds.

To cash in H and E bonds registered in the deceased's name but payable on death to the surviving spouse, they must be sent to the Federal Reserve.

Receiving benefits

The surviving spouse or other beneficiaries may be eligible for any of the following:

Social Security benefits. For the surviving spouse to qualify, the deceased must have been age 60 or older or their children must be under age 16. Disabled spouses can usually collect at an earlier age. Surviving children can also get benefits.

Employee benefits. The deceased may have insurance, back pay, unused vacation pay, and pension funds the surviving spouse or beneficiaries are entitled to. The employer will have the specifics.

Insurance they may not know about. Many organizations provide life insurance as part of their membership fee. They should be able to provide information.

DETERMINING POTENTIAL ESTATE TAXES

The next step is to get an idea of what your estate is worth and whether you need to worry about estate taxes.

How much is your estate worth?

Begin by listing all of your assets and their value, including cash, stocks and bonds, notes and mortgages, annuities, retirement benefits, your personal residence, other real estate, partnership interests, life insurance, automobiles, artwork, jewelry, and collectibles. If you're married, prepare a similar list for your spouse's assets. And be careful to review how you title the assets, to include them correctly in each spouse's list.

If you own an insurance policy at the time of your death, the proceeds on that policy usually will be includible in your estate. Remember: That's *proceeds*. Your $1 million term insurance policy that isn't worth much while you're alive is suddenly worth $1 million on your death. If your estate is large enough, a significant share of those proceeds may go to the government as taxes, not to your chosen beneficiaries.

How the estate tax system works

Here's a simplified way to project your estate tax exposure. Take the value of your estate, net of any debts. Also subtract any assets that will pass to charity on your death — such transfers are deductions for your estate. Then if you're married and your spouse is a U.S. citizen, subtract any assets you'll pass to him or her. Those assets qualify for the marital deduction and avoid estate taxes until the surviving spouse dies. (If you're single or your spouse isn't a U.S. citizen, turn to pages 24 and 25 for more information.) The net number represents your taxable estate.

You can transfer up to your available exemption amount at death free of estate taxes. So if your taxable estate is equal to or less than the estate tax exemption in the year of your death (reduced by any gift tax exemption you used during your life), no federal estate tax will be

Chart 1

Gift and estate tax exemptions and rates for 2009–2013

	2009	2010	2011	2012	2013
Gift tax exemption	$ 1 million	$ 1 million	$ 5 million	$ 5 million[2]	$ 1 million
Estate tax exemption[1]	$3.5 million	$ 5 million[3]	$ 5 million	$ 5 million[2]	$ 1 million
Highest tax rates	45%	35%[3]	35%	35%	55%[4]

[1] *Less any gift tax exemption already used during life.*

[2] *Indexed for inflation.*

[3] *Estates can elect to follow the pre–Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 regime (estate tax repeal + limited step-up in basis).*

[4] *The benefits of the graduated gift and estate tax rates and exemptions are phased out for gifts/estates over $10 million.*

Source: *U.S. Internal Revenue Code*

due when you die. But if your taxable estate exceeds this amount, it will be subject to estate tax. The 2010 Tax Relief act, however, complicates estate tax projections. In addition to bringing back the estate tax retroactively for 2010 with an exemption increase and a rate reduction compared to 2009, the act extends these levels — but only through 2012. So in 2013, without further Congressional action, the exemption and top rate will return to levels prescribed by pre-2001 tax law. (See Chart 1 on page 8.)

Therefore, assuming you expect to live beyond 2012, you'll want to consider at least two scenarios when projecting your potential estate tax liability: 1) the $5 million exemption and 35% top rate, and 2) the $1 million exemption and 55% top rate.

If you had a loved one who died in 2010, you also should be aware that his or her estate has a couple of options in calculating estate taxes. (See Planning Tip 4 at right.)

The impact of state taxes

Many states, prompted by changes to the federal estate tax (such as increases in the federal exemption amount and elimination of the credit for state death tax), now impose estate tax at a lower threshold than the federal government does. It is vital to consider the rules in your state in order to avoid unexpected tax liability or other unintended consequences.

The nuances are many; be sure to consult an estate planning professional with expertise about your particular state.

Planning Tip 4

CONSIDER THE OPTIONS FOR 2010

For anyone who died in 2010, the estate may either follow the new rules under the 2010 Tax Relief act (estate tax but unlimited step-up in basis) or elect to follow the pre-act regime (no estate tax but limited step-up in basis).

First some background on step-up in basis:

- Generally, the income tax basis of most inherited property is "stepped up" to its date-of-death fair market value. This means that recipients of the property can sell it immediately without triggering capital gains tax. Even if they hold on to it, they typically will pay less capital gains tax whenever they do sell it than they would have if the basis hadn't been stepped up.
- Under the estate tax repeal, the automatic step-up in basis is eliminated. Instead, estates can generally allocate only up to $1.3 million to increase the basis of certain assets plus up to $3 million to increase the assets inherited by a surviving spouse.

So, if the estate of someone who died in 2010 doesn't exceed the new $5 million exemption (less any gift tax exemption used during life), then following the new rules will likely be more beneficial: No estate tax will be due anyway, and the deceased's heirs won't have to worry about any limits on the step-up in basis.

If the estate exceeds the deceased's available estate tax exemption, the decision becomes more complicated. Factors such as the extent of the possible estate tax liability, the extent to which assets have appreciated beyond the deceased's basis and the extent to which the assets are going to a surviving spouse vs. other heirs will need to be considered.

Fortunately, the Tax Relief act does give families some time to make this decision. It extends the estate tax filing deadline to Sept. 19, 2011, for estates of those who died after Dec. 31, 2009, and before Dec. 17, 2010.

ESTATE TAX SAVING STRATEGIES

Here's a look at the most important estate planning tools and how you can use them to minimize taxes and maximize what goes to your heirs as tax rules change over the coming years. You'll learn how the marital deduction, lifetime gift and estate tax exemptions, various trusts, life insurance, family business structures, charitable contributions, and other estate planning techniques can help you achieve your goals. You'll also see why it will be helpful to seek professional financial, tax and legal advice about ways to use these techniques effectively. Please contact your estate planning advisor if you have any questions about how they might apply to your situation.

THE MARITAL DEDUCTION

The marital deduction is one of the most powerful estate planning tools. Any assets passing to a surviving spouse pass tax free at the time the first spouse dies, as long as the surviving spouse is a U.S. citizen. Therefore, if you and your spouse are willing to pass all of your assets to the survivor, no federal estate tax will be due on the first spouse's death.

But this doesn't solve your estate tax problem. First, if the surviving spouse doesn't remarry, that spouse won't be able to take advantage of the marital deduction when he or she dies. Thus, the assets transferred from the first spouse could be subject to tax in the survivor's estate, depending on the size of the estate and the estate tax laws in effect at the survivor's death. Second, if your spouse does remarry, you probably don't want your spouse to pass all assets to the second spouse even if it would save estate taxes.

Take advantage of exemption "portability"

Because assets in an estate equal to the exemption amount aren't subject to estate taxes, a married couple can use their exemptions to avoid tax on up to double the exemption amount. (See Chart 1 on page 8.) The 2010 Tax Relief act includes a provision that will (temporarily) make it easier for married couples to take advantage of both their exemptions.

If one spouse dies in 2011 or 2012 and part (or all) of his or her estate tax exemption is unused at his or her death, the estate can elect to permit the surviving spouse to use the deceased spouse's remaining estate tax exemption. Thus, the exemption is "portable" between spouses.

Similar results can be achieved by making asset transfers between spouses during life and/or setting up certain trusts at death (both discussed later in this section). But the portability election will be much simpler and, if proper planning hasn't been done before the first spouse's death, will provide valuable flexibility. Plus, the surviving spouse can use the remaining exemption to make lifetime gifts.

Still, this election is available for only two years unless Congress extends it. And if the election has been made but the surviving spouse doesn't use the exemption to make lifetime gifts (or doesn't die) before portability expires, the portability of the exemption will be lost. So married couples can't depend on portability being available to ensure that they take full advantage of both spouses' exemptions.

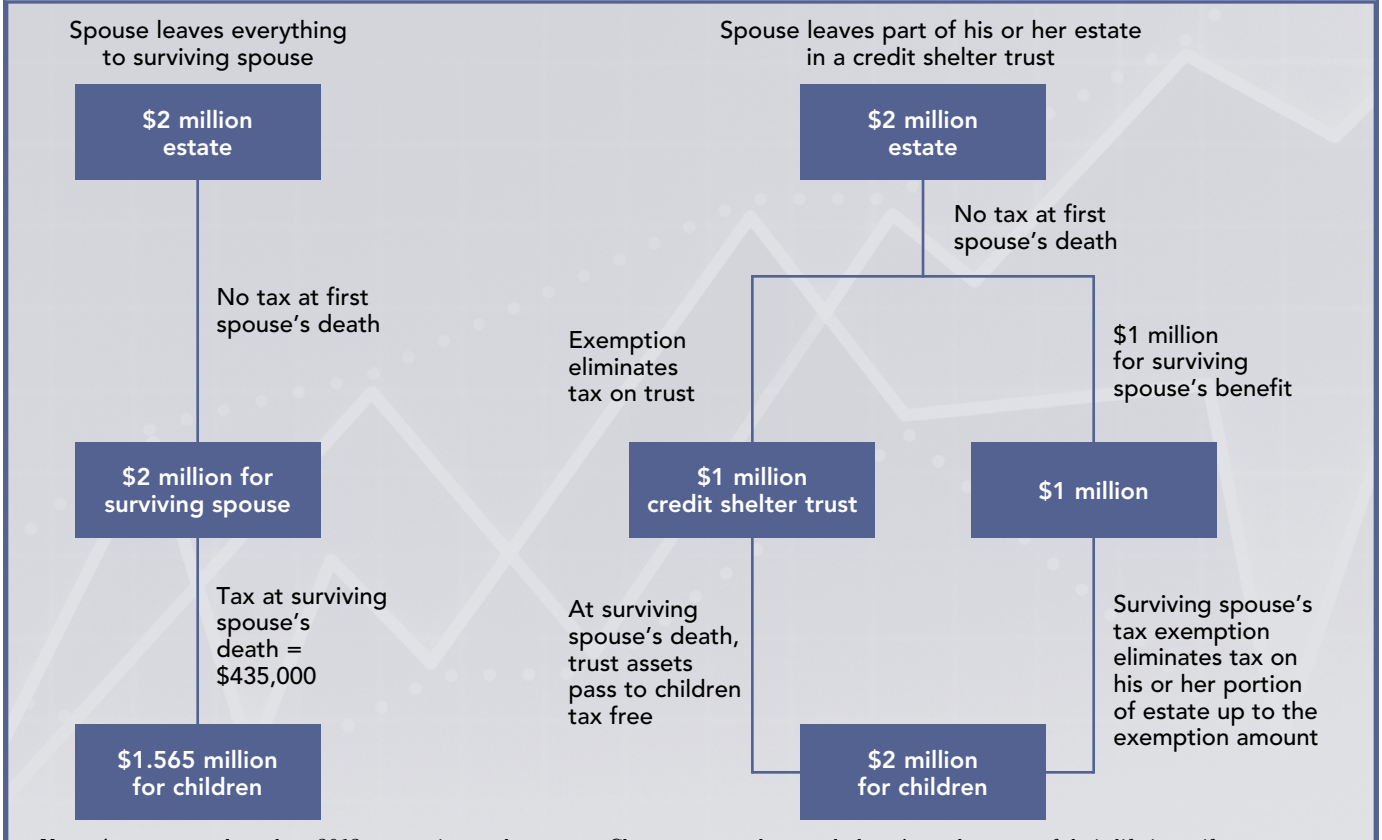
Preserve both exemptions with a credit shelter trust

One effective way to preserve both spouses' exemptions is to use a credit shelter trust.

Let's look at an example: It assumes that in 2013 the law reverts to pre-2001 act law (that is, the 2010 Tax Relief act changes are not extended) and that the couple hasn't used up any of their lifetime gift tax exemptions. As shown in Chart 2, left column, the Joneses have a combined estate of $2 million. At Mr. Jones' death, all of his assets pass to Mrs. Jones — tax free because of the marital deduction. Mr. Jones' taxable estate is zero. Shortly thereafter, Mrs. Jones dies, leaving a $2 million estate. The first $1 million is exempt from estate tax because of the $1 million estate tax exemption but the

Chart 2

How to reduce estate taxes with a credit shelter trust



Note: *Amounts are based on 2013 exemption and tax rates. Chart assumes the couple hasn't used up any of their lifetime gift tax exemptions and doesn't take into account any state estate taxes.*

Source: *U.S. Internal Revenue Code*

Case Study I

SPLITTING ASSETS

Does it matter which spouse dies first? Maybe. Let's go back to our friends, the Joneses. Assume Mr. Jones owns $1.5 million of assets in his name and Mrs. Jones has $500,000 in her name. If Mr. Jones dies first, the credit shelter trust can be funded with $1 million from his assets. But if Mrs. Jones dies first, only the $500,000 in her name would be available to fund the trust. Mrs. Jones' estate can take advantage of only $500,000 of her $1 million exemption amount. At Mr. Jones' death, his estate is subject to a tax of $210,000, all of which could have been avoided had Mrs. Jones been able to fully fund her credit shelter trust.

To take maximum advantage of the credit shelter trust strategy, be sure property in each estate totals at least the exemption amount. Ensuring each spouse has enough assets may require reviewing how your assets are currently titled and shifting ownership of some assets. Even if you can't perfectly divide assets, any assets owned up to the lifetime exemption limit will reduce the total tax.

A warning here is appropriate: Assets can generally be retitled between spouses without any negative tax consequences, so long as both spouses are U.S. citizens. Moreover, there may be state issues in certain limited situations. Seek professional advice before transferring titles.

remaining $1 million is subject to $435,000 in taxes, leaving $1.565 million for the children. (Note that, for illustrative purposes, this and other examples in the guide ignore state estate taxes.)

The problem? Mr. and Mrs. Jones took advantage of the exemption in only one estate.

Let's look at an alternative: As shown in the right column of Chart 2 on page 11, Mr. Jones' will provides that assets equal to the exemption go into a separate trust on his death. This "credit shelter trust" provides income to Mrs. Jones during her lifetime. She also can receive principal payments if she needs them to maintain her lifestyle. Because of the trust language, Mr. Jones may allocate $1 million (his exemption amount) to the trust to protect it from estate taxes. If there were remaining assets (assets over $1 million), they would pass directly to Mrs. Jones.

Because the $1 million trust isn't included in Mrs. Jones' estate, her taxable estate drops from $2 million to $1 million. Thus, the tax at her death is eliminated, as both spouses' exemptions are used. By using the credit shelter trust in Mr. Jones' estate, the Joneses save $435,000 in federal estate taxes.

The Joneses do give up something for this tax advantage. Mrs. Jones doesn't have unlimited access to the funds in the credit shelter trust because, if she did, the trust would be includible in her estate. Still, Mr. Jones can give her all of the trust income and any principal she needs to maintain her lifestyle. And the family comes out ahead by $435,000. But the outcome would be quite different if both spouses didn't hold enough assets in their own names. (See Case Study I.)

Control assets with a QTIP trust

A common estate planning concern is that assets left to a spouse will eventually be distributed in a manner against the original owner's wishes. For instance, you may want stock in your business to pass only to the child active in the business, but your spouse may feel it should be distributed to all the

children. Or you may want to ensure that after your spouse's death the assets will go to your children from a prior marriage.

You can address such concerns by structuring your estate plan so some or all of your assets pass into a qualified terminable interest property (QTIP) trust. The QTIP trust allows you to provide your surviving spouse with income from the trust for the remainder of his or her lifetime. You also can provide your spouse with as little or as much access to the trust's principal as you choose. On your spouse's death, the remaining QTIP trust assets pass as the trust indicates.

Thus, you can provide support for your spouse during his or her lifetime but dictate who will receive the trust assets after your spouse's death. Because of the marital deduction, no estate taxes are due at your death. But the entire value of the QTIP trust will be included in your spouse's estate.

LIFE INSURANCE

Life insurance can play an important role in your estate plan. It's often necessary to support the deceased's family or to provide liquidity. You must determine not only the type and amount of coverage you need, but also who should own insurance on your life to best meet your estate planning goals.

Support your family

Your first goal should be taking care of the people you care about. Carefully analyze how much they'll need to replace your lost earning power. The first question is whether your spouse is employed. If your spouse is, consider whether becoming a single parent will impede career advancement and earning power. If your spouse isn't employed, consider whether he or she will start to work and what his or her earning potential will be.

Next, look at what funds may be available to your family in addition to your spouse's earnings and any savings. Then estimate what your family's living expenses will be. Consider your current expenditures for housing, food, clothing, medical care, and

Planning Tip 5

MAKE SURE YOUR CREDIT SHELTER TRUST WILL ACHIEVE YOUR GOALS

If you already have a credit shelter trust in your estate plan, it's important to review your plan documents to ensure that they'll allow your estate to take full advantage of the 2011 and 2012 changes and be prepared for the possibility of a return to the pre-2001-tax-act law in 2013.

The document language should be flexible enough to allow you to gain all available estate tax benefits. For example, check that the language doesn't provide for a fixed dollar amount to go to the credit shelter trust. Such language could cause you to lose out on the ability to shelter the full $5 million you might be entitled to should you die in 2011 or 2012.

Suppose the document says that $3.5 million is to go into your credit shelter trust. If your total estate is $10 million, then the balance, $6.5 million, will go to your spouse. If your spouse dies after 2012 — when the lifetime exemption is only $1 million — then $5.5 million will be subject to estate tax. Had the full $5 million gone instead to the credit shelter trust, only $4 million would be subject to estate tax. Under the pre-2001 system, this could translate to a savings of $825,000 of tax.

Planning Tip 6

CONSIDER SECOND-TO-DIE LIFE INSURANCE

Second-to-die life insurance can be a useful tool for providing liquidity to pay estate taxes. This type of policy pays off when the surviving spouse dies. Because a properly structured estate plan can defer all estate taxes on the first spouse's death, some families may find they don't need any life insurance proceeds at that time. But significant estate taxes may be due on the second spouse's death, and a second-to-die policy can be the perfect vehicle for providing cash to pay the taxes. It also has other advantages over insurance on a single life. First, premiums are lower. Second, uninsurable parties can be covered. But a second-to-die policy might not fit in your current irrevocable life insurance trust (ILIT), which is probably designed for a single life policy. To ensure that the proceeds aren't taxed in either your estate or your spouse's, set up a new ILIT as policy owner and beneficiary.

other household and family expenses; any significant debts, such as a mortgage and student loans; and your children's education, which can be difficult to estimate.

How do you determine the amount of insurance you need? Start by calculating how much annual cash flow your current investments, retirement plans and any other resources will provide. Use conservative earnings, inflation and tax rates. Compare the amount of cash flow generated with the amount needed to cover the projected expenses. Life insurance can be used to cover any shortfall. When you quantify the numbers to determine what cash flow your family will need, the result may be surprisingly high. Remember that you may be trying to replace 25 or more years of earnings.

Avoid liquidity problems

Insurance can be the best solution for liquidity problems. Estates are often cash poor, and your estate may be composed primarily of illiquid assets such as closely held business interests, real estate or collectibles. If your heirs need cash to pay estate taxes or for their own support, these assets can be hard to sell. For that matter, you may not want these assets sold.

Even if your estate is of substantial value, you may want to purchase insurance simply to avoid the unnecessary sale of assets to pay expenses or taxes. Sometimes second-to-die insurance makes the most sense. (See Planning Tip 6.) Of course, your situation is unique, so get professional advice before purchasing life insurance.

Choose the best owner

If you own life insurance policies at your death, the proceeds will be included in your estate. Ownership is usually determined by several factors, including who has the right to name the beneficiaries of the proceeds.

The way around this problem? Don't own the policies when you die. But don't automatically rule out your ownership either.

Determining who should own insurance on your life is a complex task because there are many possible owners, including you or your spouse, your children, your business, and an irrevocable life insurance trust (ILIT). Generally, to reap maximum tax benefits you must sacrifice some control and flexibility as well as some ease and cost of administration.

To choose the best owner, consider why you want the insurance, such as to replace income, to provide liquidity or to transfer wealth to your heirs. You must also determine the importance to you of tax implications, control, flexibility, and ease and cost of administration. Let's take a closer look at each type of owner:

You or your spouse. Ownership by you or your spouse generally works best when your combined assets, including insurance, don't place either of your estates into a taxable situation. There are several nontax benefits to your ownership, primarily relating to flexibility and control. The biggest drawback to ownership by you or your spouse is that, on the death of the surviving spouse (assuming the proceeds were initially paid to the spouse), the insurance proceeds could be subject to federal estate taxes, depending on the size of the estate and the estate tax laws in effect at the survivor's death.

Your children. Ownership by your children works best when your primary goal is to pass wealth to them. On the plus side, proceeds aren't subject to estate tax on your or your spouse's death, and your children receive all of the proceeds tax free. There also are disadvantages. The policy proceeds are paid to your children outright. This may not be in accordance with your general estate plan objectives and may be especially problematic if a child isn't financially responsible or has creditor problems.

Your business. Company ownership or sponsorship of insurance on your life can work well when you have cash flow concerns related to paying premiums. Company sponsorship can allow premiums to be paid in part or in whole by the company under a split-dollar arrangement. But if you're the controlling shareholder of the company and the proceeds are payable to a beneficiary other than the company, the proceeds could be included in your estate for estate tax purposes.

Case Study II

IN AN ILIT WE TRUST

Walter was the sole income provider for his family. While working on his estate plan, he and his advisor determined he needed to purchase life insurance to provide for his family if something happened to him. After calculating the size of policy his family would need, Walter had to determine who should own it.

Because his children were still relatively young, Walter ruled them out as owners. He also ruled out his wife; he was concerned that, if his wife were the owner and something happened to her, his children would lose too much to estate taxes. So Walter decided to establish an irrevocable life insurance trust (ILIT) to hold the policy. Despite the loss of some control over the policy, Walter felt the ILIT offered the best combination of flexibility and protection for his family.

An ILIT. A properly structured ILIT could save you estate taxes on any insurance proceeds. Thus, a $1 million life insurance policy owned by an ILIT instead of by you, individually, could reduce your estate taxes by as much as $350,000, assuming a 35% estate tax rate, and by even more if estate tax rates do go up after 2012 as scheduled. How does this work? The trust owns the policy and pays the premiums. When you die, the proceeds pass into the trust and aren't included in your estate. The trust can be structured to provide benefits to your surviving spouse and/or other beneficiaries. (See Case Study II on page 15.) ILITs have some inherent disadvantages as well. One is that you lose some control over the insurance policy after the ILIT has been set up.

Case Study III

THE EARLY BIRD CATCHES THE TAX SAVINGS

Mr. and Mrs. Brown began a gift program in 2007, giving their combined annual exclusion amount ($24,000 in 2007 and 2008 and $26,000 in 2009, 2010 and 2011) to each of their two sons, two daughters-in-law and four grandchildren annually. These gifts totaled $1,008,000.

Before the end of 2011, both Mr. and Mrs. Brown died with a combined estate of $12 million. If they hadn't made the annual exclusion gifts, however, their combined estate would have totaled $13.008 million. The annual exclusion gifts provided an estate tax savings of $352,800.

The savings may actually be even greater. If Mr. and Mrs. Brown hadn't made the annual gifts, those assets might have generated income or appreciated in value each year. This additional income and appreciation would have been includible in their estate. By making the gifts to their children and grandchildren, they passed on not only the $1,008,000 of assets free of tax, but also the future income and appreciation of those assets.

ANNUAL GIFTING

Even with exemptions and insurance proceeds out of your estate, you still can have considerable estate tax exposure. One effective way to reduce it is to remove assets from your estate before you die. As long as you can make the gifts without incurring gift tax, you'll be no worse off taxwise.

Taking advantage of the annual gift tax exclusion is a great way to reduce your estate taxes while keeping your assets within your family. Each individual is entitled to give as much as $13,000 per year per recipient without any gift tax consequences or using any of his or her gift, estate or GST tax exemption amount. The exclusion is indexed for inflation, but only in $1,000 increments, so it typically increases only every few years. (The last increase was in 2009.) Case Study III shows the dramatic impact of an annual gifting program.

Make gifts without giving up control

To take advantage of the annual exclusion, the law requires that the donor give a

present interest in the property to the recipient. This usually means the recipient must have complete access to the funds. But a parent or grandparent might find the prospect of giving complete control of a large sum to the average 15-year-old a little unsettling. Here are a few ways around that concern:

Take advantage of Crummey trusts. Years ago, the Crummey family wanted to create trusts for their family members that would provide restrictions on access to the funds but still qualify for the annual gift tax exclusion. Language was included in the trust that allowed the beneficiaries a limited period of time in which to withdraw the funds that had been gifted into the trust. If they didn't withdraw the funds during this period, the funds would remain in the trust. This became known as a "Crummey" withdrawal power.

The court ruled that, because the beneficiaries had a present ability to withdraw the funds, the gifts qualified for the annual gift tax exclusion. Because the funds weren't actually withdrawn, the family accomplished its goal of restricting access to them.

The obvious risk: The beneficiary can withdraw the funds against the donor's wishes. To protect against this, the donor may want to explain to the beneficiaries that they're better off not withdrawing the funds, so the proceeds can pass tax free at his or her death. Your tax or legal advisor can counsel you about other ways of drafting the document to protect against withdrawals.

Establish trusts for minors. An excellent way to provide future benefits (such as college education funding) for a minor is to create a trust which provides that:

- The income and principal of the trust be used for the benefit of the minor until age 21, and
- Any income and principal not used pass to the minor at age 21.

A trust of this type qualifies for the annual gift tax exclusion even though the child has no current access to the funds. Therefore, a parent can make annual gifts to the trust while the child is a minor. The funds accumulate for the future benefit of the child, and the child doesn't even have to be told about the trust. But one disadvantage is that the child must have access to the trust assets once he or she reaches age 21.

Chart 3

The power of giving away appreciating assets

	Municipal bond	Appreciating stock
Value of gift	$ 13,000	$ 13,000
Income and appreciation (5 years)	2,750*	7,000*
Total excluded from estate	$ 15,750	$ 20,000

By giving an appreciating asset, Cathy removes an extra $4,250 from her estate.

* *These amounts are hypothetical and are used for example only.*

Leverage the annual exclusion by giving appreciating assets

Gifts don't have to be in cash. Any asset qualifies. In fact, you'll save the most in estate taxes by giving assets with the highest probability of future appreciation. Take a look at Chart 3. Cathy gave her daughter a municipal bond worth $13,000. During the next five years, the bond generated $550* of income annually but didn't appreciate in value. After five years, Cathy had passed $15,750 of assets that would otherwise have been includible in her estate.

But suppose Cathy gave her daughter $13,000 in stock instead of the bond. If the stock generated no dividends during the next five years but appreciated in value by $7,000, Cathy would have given her daughter $20,000 of assets — and taken an additional $4,250 out of her estate.

Remember that a recipient usually takes over the donor's basis in the property gifted. If an asset worth $13,000 cost the donor $8,000, the recipient takes over an $8,000 basis for income tax purposes. Therefore, if the asset is then sold by the recipient for $13,000, he or she has a $5,000 gain for capital gains tax purposes.

* *This amount is hypothetical and is used for example only.*

Consider whether you should max out your gift tax exemption

Taxable gifts equal to or less than the gift tax exemption amount (see Chart 1 on page 8) create no gift tax, just as assets in an estate equal to or less than the estate tax exemption amount create no estate tax. But note that this is on a combined basis. In other words, if you make $200,000 of taxable gifts during your life, the amount of assets in your estate that will avoid estate taxes will be reduced by $200,000. You can use the exemption during life or at death, but not both.

Because many assets appreciate in value and as of this writing the gift and estate tax exemptions are scheduled to go down to only $1 million in 2013, it may make sense to gift up to the current $5 million by the end of 2012 — if you can afford to do so without compromising your own financial security. If you can't afford to give the full $5 million but can give in excess of the $1 million exemption scheduled for 2013, you could lock in an opportunity for your family to save taxes. (See Case Study IV on page 19.)

Also remember that each spouse is entitled to his or her own exemption. If a couple uses up their gift tax exemptions by making $10 million in taxable gifts and after five years the assets have increased in value by 50%, they'll have removed an additional

$5 million from their combined taxable estate without incurring any gift or estate tax liability.

Leverage your tax-free gifts with an FLP

Family limited partnerships (FLPs) can be excellent tools for long-term estate planning, because they can allow you to increase the amount of gifts you make without increasing the gift tax cost. But the IRS frequently challenges FLPs, so caution is needed when implementing them. FLPs are special because they may allow you to give assets to your children (and grandchildren) at discounted values for gift tax purposes.

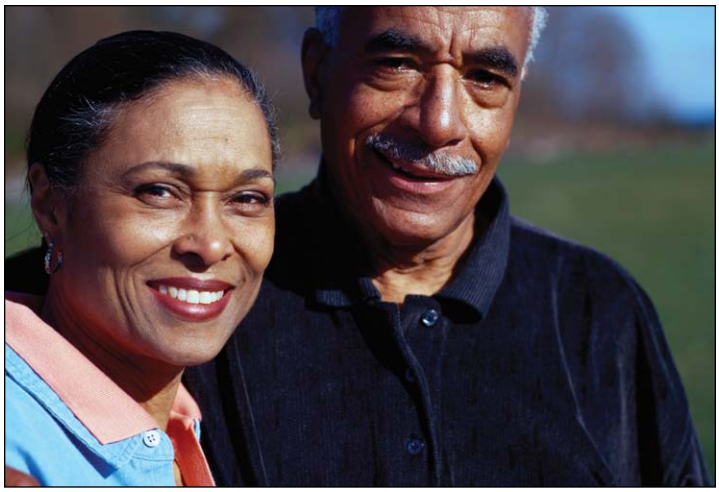
Here's how it works: First you select the type of assets (such as real estate or an interest in a business) and the amount (based on the gift tax rules discussed earlier) and place them into the FLP. Next you give some or all of the limited partnership interests to your children and grandchildren.

The limited partnership interests give your family members ownership interests in the partnership, but no right to control its activities. Control remains with the small percentage (typically at least 1%) of partnership interests known as general partnership interests, of which you (and possibly others) retain ownership. The result is that you can reduce your taxable estate by giving away assets (the

Case Study IV

WHEN "TAXABLE" GIFTS SAVE TAXES

Let's say John has an estate of $7 million (and thus has substantial estate tax exposure). In 2011 he has already given $13,000 for the year to each of his chosen beneficiaries. He doesn't feel comfortable giving away another $5 million of assets to use up his entire lifetime gift tax exemption. But he would like to take *some* advantage of the high exemption currently available in case it's not extended beyond 2012. So he gives away an additional $2 million of assets. John uses $2 million of his gift tax exemption by making the taxable gift. Therefore, his estate can't use that amount as an exemption. But when he dies, the exemption may be less than that amount anyway. Plus, by making the taxable gift, he also removes the future appreciation from his estate. If the assets, say, double in value before John's death, the gift will essentially have removed $4 million from his estate. This amount escapes the estate tax.



partnership interests), without giving up total control of the underlying assets and the income they produce.

Because the limited partners lack any control, these interests can often be valued at a discount. Recent court cases have given the IRS more ammunition to attack FLPs and to reduce or eliminate the gift and estate tax benefits, but they also have provided insights into how to structure and administer an FLP that will survive IRS scrutiny. Please seek professional advice before creating an FLP or making a gift of FLP interests. In addition, when making a gift of an FLP interest, obtaining a formal valuation by a professional business appraiser is essential to establish the value of the underlying assets and of the partnership interests.

CHARITABLE CONTRIBUTIONS

Sharing your estate with charity will allow you to cut your estate tax bill. Direct bequests to charity are fully deductible for estate tax purposes. Leave your entire estate to charity, and you'll owe no estate taxes at all. In addition to tax advantages, contributing to charity is a good way to leave a legacy in your community or to instill in your heirs a sense of social responsibility.

But what if you want to make a partial bequest to charity and a partial gift or bequest to your natural beneficiaries? A trust can be the answer.

Provide for family today and charity tomorrow with a CRT

Your will can create a trust that will pay income for a period of time to beneficiaries you name. At the end of the stated period, the remaining trust assets pass to your charitable organization(s) of choice. This is a charitable remainder trust (CRT).

For example, let's say you want to make sure your elderly father is provided for after your death. From a CRT created upon your death, your father can receive annual distributions until he dies. At that time, the remainder passes to charity. You get what you wanted — you provide for both your father and charity. And, because you're making a partial charitable donation at the time of your death, your estate receives a deduction for a portion of the trust's value.

The size of the estate tax deduction is determined based on the value of the trust assets, the trust term and the amount to be paid to the beneficiary. The value of the interest given to the noncharitable beneficiary is included in your estate.

Take the reverse approach with a CLT

Now let's reverse the situation. You wish to provide an income stream to a charity for a set period after your death, with the remainder passing to your beneficiaries. The charitable lead trust (CLT) provides a way to do this — and obtain a partial charitable deduction for your estate.

Gain an income tax deduction with lifetime charitable gifts

You can use the above techniques during your lifetime as well. And if you create a charitable trust during your life, you may be entitled to an income tax deduction for the portion that government tables calculate to be the charitable gift. This way, you can reduce both your income and estate taxes.

The benefits are even greater if you fund the trust with appreciated assets. Let's say you transfer appreciated securities to a CRT. After receiving the stock, the trustee sells it and reinvests the proceeds. Because a CRT is tax exempt, no capital gains tax is owed. The trustee is able to reinvest the full proceeds, thus increasing the annual distributions to you or your chosen beneficiaries. (Note that some or all of the amount distributed to the beneficiary may be taxable.) See Planning Tip 7 for more ideas on incorporating charitable giving into your estate plan.

STRATEGIES FOR FAMILY-OWNED BUSINESSES

Few people have more estate planning issues to deal with than the family business owner. The business may be the most valuable asset in the owner's estate. Yet,

many family-owned businesses don't survive the first generation. If you're a business owner, you should address the following concerns as you plan your estate:

Who will take over the business when you die? Owners often fail to develop a management succession plan. It's vital to the survival of the business that successor management, in the family or otherwise, be ready to take over the reins.

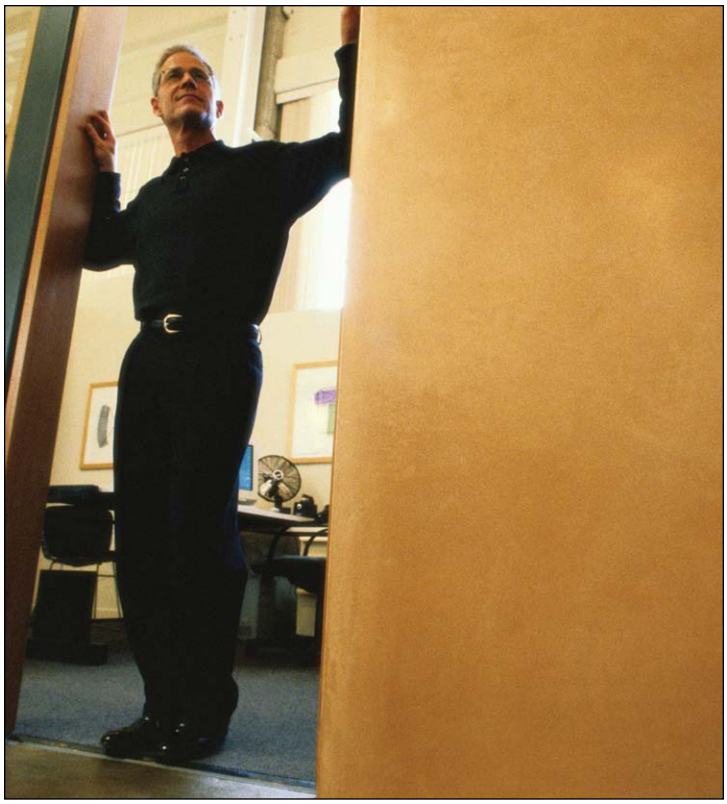
Planning Tip 7

LEAVE A LEGACY WITH A PRIVATE FOUNDATION OR DONOR-ADVISED FUND

You can form a private foundation to support your charitable activities or to make charitable grants according to your wishes. If the foundation qualifies for tax-exempt status, your charitable contributions to it will be deductible, subject to certain limitations.

An alternative to consider is a donor-advised fund (DAF). Generally, such funds are sponsored by a large public charity that allows you to make contributions that are used to create a pool of funds you control. Thus, a DAF is essentially a small-scale private foundation that requires much less administration.

Whether a private foundation or a DAF is right for you depends on various factors.



Who should inherit your business? Splitting this asset equally among your children may not be a good idea. For those active in the business, inheriting the stock may be critical to their future motivation. To those not involved in the business, the stock may not seem as valuable. Or perhaps your entire family feels entitled to equal shares in the business. Resolve this issue now to avoid discord and possible disaster later.

How will the IRS value your company? Because family-owned businesses aren't publicly traded, knowing the exact value of the business is difficult without a professional valuation. The value placed on the business for estate tax purposes is often determined only after a long battle with the IRS. Plan ahead and ensure your estate has enough liquidity to pay estate taxes and support your heirs.

Take advantage of special estate tax breaks

Current tax law has provided two types of tax relief specifically for business owners:

Section 303 redemptions. Your company can buy back stock from your estate without the risk of the distribution being treated as a dividend for income tax purposes. Such a distribution must, in general, not exceed the estate taxes and funeral and administration expenses of the estate. One caveat: The value of your family-owned business must exceed 35% of the value of your adjusted gross estate. If the redemption qualifies under Sec. 303, this is an excellent way to pay estate taxes.

Estate tax deferral. Normally, estate taxes are due within nine months of your death. But if closely held business interests exceed 35% of your adjusted gross estate, the estate may qualify for a deferral of tax payments. No payment other than interest is due until five years after the normal due date for taxes owed on the value of the business. The tax related to the closely held business interest then can be paid over as many as 10 equal annual installments. Thus, a portion of your tax can be deferred for as long as 14 years from the original due date. Interest will be charged on the deferred payments. (See Case Study V on page 23.)

Ensure a smooth transition with a buy-sell agreement

A powerful tool to help you control your — and your business's — destiny is the buy-sell agreement. This is a contractual agreement between shareholders and their corporation or between a shareholder and the other shareholders of the corporation. (Partners and limited liability company members also can enter into buy-sell agreements.)

The agreement controls what happens to the company stock after a triggering event, such as the death of a shareholder. For example, the agreement might provide that, at the death of a shareholder, the stock is bought back by the corporation or that the other shareholders buy the decedent's stock.

A well-drafted buy-sell agreement can solve several estate planning problems for the owner of a closely held business and can help ensure the survival of the business. (See Planning Tip 8.) It's also critical to be sure that funding for the agreement is in place, or you risk making all the planning ineffective.

Planning Tip 8

PROTECT YOUR INTERESTS WITH A BUY-SELL AGREEMENT

A buy-sell agreement offers three key benefits:

1. It provides a ready market for the shares in the event the owner's estate wants to sell the stock after the owner's death.
2. It sets a price for the shares. In the right circumstances, it also fixes the value for estate tax purposes.
3. It provides for stable business continuity by avoiding unnecessary disagreements caused by unwanted new shareholders.

Remove future appreciation by giving stock

One way to reduce estate taxes is to limit the amount of appreciation in your estate. We talked earlier about giving away assets today so that the future appreciation on those assets will be outside of your taxable estate. There may be no better gift than your company stock — this could be the most rapidly appreciating asset you own.

For example, assume your business is worth $500,000 today but is likely to be worth $1 million in three years. By giving away the stock today, you'll keep the future appreciation of $500,000 out of your taxable estate.

Case Study V

SOMETIMES PUTTING OFF UNTIL TOMORROW MAKES SENSE

Lee owned a small manufacturing company that accounted for 50% of his estate. When he died in October 2009, his estate's total estate tax liability was $1 million. Half of the liability was due at the normal due date of his estate's tax return in July 2010 (nine months after Lee's death). The other $500,000 of liability could be paid in 10 installments, starting in July 2015 (five years and nine months after Lee's death) and ending in July 2024. Lee's estate would also have to pay interest on the unpaid liability each year, but at special low rates.

Gifting family business stock can be a very effective estate tax saving strategy. But beware of some of the problems involved. The gift's value determines both the gift and estate tax ramifications. The IRS may challenge the value you place on the gift and try to increase it substantially. Seek professional assistance before attempting to transfer portions of your business to family members.

Finally, the IRS is required to make any challenges to a gift tax return within the normal three-year statute of limitations, even though no tax is payable with the return. But the statute of limitations applies only if certain disclosures are made on the gift tax return.

SPECIAL STRATEGIES FOR SPECIAL SITUATIONS

Standard estate planning strategies don't fit every situation. Single people, unmarried couples, noncitizen spouses, individuals planning a subsequent marriage and grandparents are among those who might benefit from less common techniques. In this section, we look at several special situations and estate planning ideas that may apply to them.

Singles

Single people with large estates may be at a disadvantage because they don't have the unlimited marital deduction, which allows a spouse to leave assets to a surviving spouse's estate tax free. But a will or a living trust can ensure that your loved ones receive your legacy in the manner you desire. In addition, with the use of trusts, you can provide financial management assistance to any heirs who aren't prepared for this responsibility.

Subsequent marriages

Estate planning for subsequent marriages can be complicated, especially when children from a prior marriage are involved. Finding the right planning technique for your situation not only can ease family tensions but also can help you pass more assets to the children at a lower tax cost.

A QTIP marital trust can maximize estate tax deferral while benefiting the surviving spouse for his or her lifetime and the children after the spouse's death. Combining a QTIP trust with life insurance benefiting the children or creatively using joint gifts can further leverage your gifting ability. (Turn back to page 12 for more on QTIP trusts.)

A prenuptial agreement can also help you achieve your estate planning goals. But any of these strategies must be tailored to your particular situation, and the help of qualified financial, tax and legal advisors is essential.

Unmarried couples

Because unmarried couples aren't granted rights automatically by law, they need to create a legal relationship with a domestic partnership agreement. Such a contract can solidify the couple's handling of estate planning issues. (Note that same-sex couples that are legally married under state law are not considered to be married under federal law. So they need to consider whether a domestic partnership agreement is necessary in order to maintain certain rights under federal law.)

In addition, unmarried couples don't have the benefit of the marital deduction. There are

Chart 4

Generation-skipping transfer tax exemptions and rates for 2009–2013

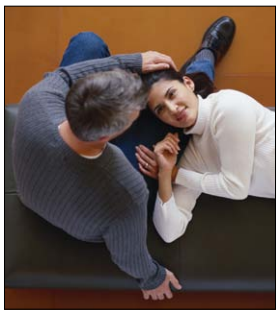
	2009	2010	2011	2012	2013
Exemption	$3.5 million	$ 5 million	$ 5 million	$ 5 million[1]	$ 1 million[1]
Tax rate	45%	0%	35%	35%	55%

[1] *Indexed for inflation.*

solutions, however. One partner can reduce his or her estate and ultimate tax burden through a traditional annual gifting program or by creating an irrevocable life insurance trust or a charitable remainder trust benefiting the other partner. Again, these strategies are complex and require the advice of financial, tax and legal professionals.

Noncitizen spouses

The marital deduction differs for a non-U.S. citizen surviving spouse. The government is concerned that, on your death, your spouse could take the marital bequest tax free and then leave U.S. jurisdiction without the property ever being taxed.



Thus, the marital deduction is allowed only if the assets are transferred to a qualified domestic trust (QDOT) that meets special requirements. The impact of the marital deduction is dramatically different because any principal distributions from a QDOT to the noncitizen spouse and assets remaining in the QDOT at his or her death will be taxed as if they were in the citizen spouse's estate. Also note that the gift tax marital deduction (for noncitizen spouses) is limited to a set amount annually.

Grandparents

You may be one of the lucky ones who aren't only personally financially well off, but whose children are also financially set for life. The downside of this is that they also face the prospect of high taxes on their estates. You may also want to ensure that future generations of your heirs benefit from your prosperity. To reduce taxes and maximize your gifting abilities, consider skipping a generation with some of your bequests and gifts.

But your use of this strategy is limited. The law assesses a GST tax on transfers to a "skip person" — anyone more than one generation below you, such as a grandchild or an unrelated person more than 37½ years younger than you.

The GST tax was repealed for 2010 along with the estate tax, and the 2010 Tax Relief act brought the GST tax back for 2010 as well, but at a rate of 0%. After 2010, the GST tax rate returns to being the same as the top estate tax rate. (See Chart 4 above.)

Fortunately, there's a GST tax exemption. As with the gift and estate tax exemptions, the GST tax exemption has been increased to $5 million — but only through 2012. (Also see Chart 4 on page 25.) Each spouse has this exemption, so a married couple can use double the exemption. (Note that the Tax Relief act doesn't make the GST tax exemption portable, however.) Once you've used up your exemption, additional transfers (whether gifts or bequests) that aren't otherwise exempt will be subject to the GST tax — in addition to any applicable gift or estate tax.

Outright gifts to skip persons that qualify for the annual exclusion are generally exempt from the GST tax. A gift or bequest to a grandchild whose parent has died before the transfer isn't treated as a GST.

Taking advantage of the GST tax exemption can keep more of your assets in the family. By skipping your children, the family may save substantial estate taxes on assets up to double the exemption amount (if you're married), plus the future income and appreciation on the assets transferred.

Even greater savings can accumulate if you use the exemption during your life in the form of gifts. If you can afford to do so without compromising your own financial security, you may want to use up some or all of your $5 million GST tax exemption by the end of 2012. After all, the exemption is scheduled to drop back down to $1 million (indexed for inflation) in 2013. But keep in mind that, if you want to avoid all taxes on the transfers, you'll also have to use up an equal amount of your gift tax exemption.

If maximizing tax savings is your goal, you may also want to consider a "dynasty trust." The trust is an extension of the GST concept. Rather than the assets being included in the grandchildren's taxable estates, the dynasty trust allows assets to skip several generations of taxation. This is available only in jurisdictions that have abolished the "rule against perpetuities." Talk with your estate planning advisor for more information on how this may affect your estate plan.

Simply put, you create the trust either during your lifetime by making gifts or at death in the form of bequests. The trust remains in existence from generation to generation. Because the heirs have restrictions on their access to the trust funds, the trust is sheltered from estate taxes. If any of the heirs have a need for funds, the trust can make distributions to them. (See Case Study VI at left.)

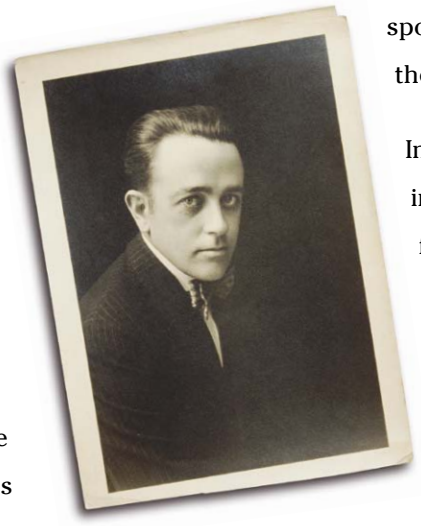
Case Study VI

DYNASTY TRUST PROVIDES MANY BENEFITS

Saul and Eleanor have accumulated a sizable estate, as has each of their children. Because their children are financially secure and Saul and Eleanor want to take advantage of the $5 million generation-skipping transfer (GST) tax exemption while it's available, they've decided to make some significant gifts to their grandchildren. But they don't feel comfortable giving such large sums to minors and young adults outright. So they decide to set up a dynasty trust for their grandchildren's benefit. With so much uncertainty about future estate tax rates and exemptions, Saul and Eleanor also like the idea that the trust will protect the assets from estate taxes for generations to come. Further, they'll remove the future appreciation on those assets from their estates without an estate tax cost.

COMMUNITY PROPERTY ISSUES

Ten states have community property systems: Alaska (elective), Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin. Under a community property system, your total estate consists of your 50% share of community property and 100% of your separate property. What's the difference?



Community property usually includes assets you and your spouse acquire under two conditions: 1) during your marriage, and 2) while domiciled in a community property state. (See Planning Tip 9.) Each spouse is deemed to own a one-half interest in the community property, regardless of who acquired it. For example, wages and other forms of earned income are treated as community property, even if earned by only one spouse.

Separate property usually includes property you and your spouse owned separately before marriage and property you each acquire during marriage as a gift or inheritance that you keep separate. In some states, income from separate property may be considered community property.

In most community property states, spouses may enter into agreements between themselves to convert separate property into community property or vice versa. This can be an important part of your estate plan.

Remember, marital rights are expanded

Community property states start out with greater protection for the surviving spouse because he or she is deemed to own 50% of any community property interest. But some states go much further, and the laws can be complex. For example, rules may vary depending on how many children you have and how much the surviving spouse owns in relation to the decedent.

In some cases, the surviving spouse is entitled to full ownership of property. In other situations, he or she is entitled to the income or enjoyment from the property for a set period of time. Seek professional advice in your state, especially if your goal is to limit your surviving spouse's access to your assets.

Planning Tip 9

DETERMINE YOUR DOMICILE

There's no one definition or single set of rules establishing domicile. Because you can have a residence in, and thereby be a resident of, more than one state, domicile is more than just where you live. Domicile is a principal, true and permanent home to which you always intend to return, even if you're temporarily located elsewhere.

Plan carefully when using a living trust

If a living trust isn't carefully drafted, the property may lose its community property character, resulting in adverse income, gift and estate tax consequences. For example, improper language can create an unintended gift from one spouse to the other. To avoid any problems, the living trust should provide that:

- Property in the trust and withdrawn from it retains its character as community property,
- You and your spouse each retain a right to amend, alter or revoke the trust, and
- After the death of one spouse, the surviving spouse retains control of his or her community interest.

(For more on living trusts, turn to page 4.)

Reap the basis benefit

Assets are usually valued in your estate at their date-of-death fair market values. (By election on an estate tax return, you may choose instead to use the value of the assets six months after death. Typically, this would make sense only if the estate has dropped in value since the date of death.) For example, stock you purchased for $50,000 that is worth $200,000 at the time of your death would be valued in your estate at $200,000.

The good news is that your assets generally receive a new federal income tax basis equal to the value used for estate tax purposes. In our example, your heirs could sell the stock for $200,000 and have no gain for income tax purposes. Their income tax basis would be $200,000 instead of your $50,000.

Community property owners receive a double step-up in basis benefit. If the $200,000 of stock in the previous example were community property, only one-half of the stock ($100,000) would be included in the estate of the first spouse to die. But, the income tax basis of all of the stock rises. Therefore, the surviving spouse could sell his or her 50% share of the stock at no gain, as well as the decedent's 50% share.

Sometimes the basis rule works against you. If property is valued in your estate at

less than the cost to you, the heirs still receive an income tax basis equal to the date-of-death value. If you had purchased stock for $75,000 that was valued in your estate at $50,000, your heirs would receive a basis of $50,000. If the heirs later sold the stock for $100,000, they would have to realize a gain of $50,000 ($100,000 – $50,000) rather than a gain of $25,000 ($100,000 – $75,000).

Watch out for unwanted tax consequences with ILITs

Several community property state issues must be taken into account to avoid unwanted tax consequences when an ILIT owns a life insurance policy. These typically relate to who owns the policy before it's transferred to the trust and whether the future premiums are gifted out of community property or separate property.

For example, if you give an existing policy that was community property to an ILIT and the uninsured spouse is a beneficiary of the trust, the estate of the surviving uninsured spouse could be taxed on 50% or more of the trust. However, proper titling of the policy, effective gift agreements between spouses and proper payment of premiums can avoid this problem. Be sure to get professional advice on these arrangements.

(For more on ILITs, see page 16.)

Distinguish between separate and community property for FLPs

For community property state residents, it's important to state in the FLP agreement whether the FLP interest is separate or community property. In addition, you should consult your attorney to determine if a partner's income from an FLP is community or separate property.

(For more on FLPs, see page 19.)

Get spousal consent before making charitable gifts

Under the community property laws in many states, a valid contribution of community property can't be made to a charity by one spouse without the consent of the other spouse. Consent should be obtained before the close of the tax year for which the tax deduction will be claimed.

(For more on charitable contributions, see page 20.)

Enjoy easier generation-skipping transfers

Community property can be the perfect vehicle for generation-skipping transfers because a married couple with community property equal to their combined GST exemption amount could qualify for effective use of this strategy without needing to transfer any assets to each other.

(For more on generation-skipping transfers, see page 25.)

Weigh your property treatment options

You don't always have to follow the property system of your state of domicile or the state in which you buy real estate. For example, if you live in a community property state and want to avoid having to obtain your spouse's consent to sell or make gifts of community property, you may elect out of community property treatment. But you also can retain community property treatment if you move from a community property state to a separate property state.

To do this, consider establishing a joint trust to hold the community property when you move to the new state or simply prepare an agreement outlining the status of the assets as community property. But you must ensure the community property assets remain segregated. If they become intermingled with separate property assets, you could lose the community property status.

Another option is to leave assets in a custody account governed by the laws of the community property state. It may be possible to retain the community property nature of the assets by simply segregating them from other assets on arriving in the new state. But make sure the estate planning documents that dispose of the segregated assets provide for the disposition of only one-half of the assets at the death of each spouse.

Be sure to execute similar strategies if you have separate property that you wish to remain separate when you move to a community property state. Again, to retain its separate property status, it can't become intermingled with community property. Make a well-thought-out decision about how you'd like your property to be treated.

If you aren't concerned about the limits on community property and are interested in obtaining its tax advantages but don't reside in a community property state, consider taking advantage of the Alaskan system, which allows nonresidents to convert separate property to community property. Note that implementing such a decision is complex, involves placing property in trust, and requires careful planning and coordination with your advisor.

IMPLEMENTING AND UPDATING YOUR PLAN

estate planning is an ongoing process. You must not only develop and implement a plan that reflects your current financial and family situation, but also constantly review your current plan to ensure it fits any changes in your circumstances.

Of course, with the estate tax law changes that went into effect under the 2010 Tax Relief act plus uncertainty about what will happen after 2012, reviewing your estate plan regularly is more important than ever. You'll also want to update your plan after any of the events in Planning Tip 10.

WHERE DO YOU GO FROM HERE?

Remember, estate planning is about much more than reducing your estate taxes; it's about ensuring your family is provided for, your business can continue and your charitable goals are achieved. So make sure you have an up-to-date plan in place.

Planning Tip 10

4 MORE REASONS TO UPDATE YOUR ESTATE PLAN

1. ***Family changes.*** Marriages, divorces, births, adoptions and deaths can all lead to the need for estate plan modifications.
2. ***Increases in income and net worth.*** What may have been an appropriate estate plan when your income and net worth were much lower may no longer be effective today.
3. ***Geographic moves.*** Different states have different estate planning regulations. Any time you move from one state to another, you should review your estate plan.
4. ***New health-related conditions.*** A child may develop special needs due to physical or mental limitations, or a surviving spouse's ability to earn a living may change because of a disability. Such circumstances often require an estate plan update.

To this end, use the estate planning checklist on the next page to identify areas where you need more information or assistance. Or jot down a few notes about things you want to look at more closely and discuss with a professional advisor. It may be easy for you to put off developing a detailed estate plan — or updating it in light of changes in tax law or your situation. But if you do, much of your estate could go to Uncle Sam — and this could be very hard on your family.

So please call your estate planning advisor with any questions you have about the strategies presented here or how they can help you minimize your estate tax liability. He or she can discuss your situation and help you develop and implement an estate plan that preserves for your heirs what it took you a lifetime to build.

ESTATE PLANNING WORKSHEET

If you have any questions about the topics covered in this guide, or if you want more information on how they relate to you, please fill out this worksheet and mail, e-mail or fax it to your estate planning advisor, or call to discuss your estate planning needs.

ESTATE PLANNING NEEDS EVALUATION

Please check all boxes that apply to your situation.

Do you have an estate plan in place?

- ❑ Yes (date last reviewed:_____)
- ❑ No, but I would like to develop one

I need help with:

- ❑ Writing my will
- ❑ Selecting an executor, personal representative and trustees
- ❑ Establishing a living trust
- ❑ Valuing my estate
- ❑ Reducing estate taxes
- ❑ Creating a family limited partnership
- ❑ Transferring property
- ❑ Creating a buy-sell agreement
- ❑ Planning for a subsequent marriage
- ❑ Planning for a noncitizen spouse
- ❑ Determining the role of life insurance
- ❑ Planning for community property
- ❑ Updating my estate plan
- ❑ Other _____

I would like to learn more about the following estate planning strategies:

- ❑ Gifting as a technique for transferring wealth
- ❑ Setting up a trust for my heirs
- ❑ Creating a succession plan and transferring ownership of my business
- ❑ Making taxable gifts
- ❑ Giving to charity
- ❑ Implementing generation-skipping transfers
- ❑ Other _____

❑ My greatest estate planning concern/need is:

_____

_____

_____

_____

_____

_____

_____

_____

_____

NAME

TITLE

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