CLARK & TREVITHICK

Client Guide to Estate Planning

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A Complimentary Publication of

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Why We Prepared The Client Guide to Estate Planning

Far too often people concentrate all of their hard work and creativity on building an estate, but fail to take the time to carefully plan how their estate can be preserved, protected and passed on to the maximum benefit of their heirs.

Estate planning is easy to put off. People generally do not like to think about their own mortality. Also, the jargon of estate planning can be intimidating. Since the origins of estate planning law are ancient, lawyers tend to overwhelm their clients with obscure Latin phrases like "inter vivos" (during life) and "post mortem" (after death). In addition, the Federal estate tax law has become increasingly complex with the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Reconciliation Relief Act of 2003. In order to make decisions that have estate tax implications, clients must acquire a basic understanding of concepts like the marital deduction, the unified credit against estate and gift taxes, the generation skipping transfer tax, and the phase out of estate and generation skipping transfer taxes.

In order to make it easy for our clients to acquire a working knowledge of estate planning concepts and techniques, we have prepared this Client Guide to Estate Planning. The Guide is divided into three parts. Part I contains an *introduction to estate planning terms and concepts*; Part II surveys *the basics of estate planning*; and Part III discusses a number of *sophisticated techniques for minimizing or deferring the federal estate tax*. The Guide contains plain English answers to the most commonly asked estate planning questions. We hope your particular inquiries will be explained.

Behind the tab labeled *Estate Planning Information Organizer* is a form on which you may record all of the family and asset information that we need to make estate planning recommendations to you. Please complete the Information Organizer as thoroughly as possible (the information you send us will remain confidential) and return it to any one of the following attorneys of our Trust and Estate Group:

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PART I

Introduction To Estate Planning Terms And Concepts

WHAT IS ESTATE PLANNING?

An estate plan is an arrangement for the use, conservation and transfer of one's wealth. The "*estate planning*" process usually involves more than preparing a will, although a will is normally a part of any estate plan even where a funded living trust is the principal means of wealth transfer.

A well-designed estate plan should achieve many important goals:

- ✓ Meet *testamentary objectives* and *avoid probate*.
- ✓ *Protect* loved ones.
- ✓ *Administer* and *distribute* assets and properties.
- ✓ *Pay debts* and *settle claims*.
- ✓ Minimize *federal estate* taxes.
- ✓ Provide defined *investment strategy* and *asset protection*.
- ✓ Secure *disability* and *retirement planning*.

Proper estate planning is not something that is just implemented at death. The best estate planning techniques are conceived *during lifetime* and provide for the optimum utilization of assets during the owner's lifetime. The thoughtful estate plan should anticipate and provide for such lifetime needs as funds for children's education, income for retirement, replacement income in the event of disability, and management of the estate in the event of incapacity. Satisfying these needs may be accomplished by a variety of techniques such as a living trust, gifts, life insurance, irrevocable trusts, and durable powers of attorney. These planning techniques will be discussed in detail later in this Guide.

WHO NEEDS AN ESTATE PLAN?

Even if one has not actually signed a "*formal will*" (or even a simple dated, handwritten statement known as a "*holograph*") or formally created a living trust, he or she has an estate plan imposed by California law. Unfortunately, many clients do not know how this state mandated estate plan will affect their property and heirs. Accordingly, we recommend that everyone have some form of well thought out estate plan. Either you plan your "estate plan" or State law of

your residence at the time of your death will dictate succession to ownership to your property at your death. The State, in effect, writes the Will or Trust that you failed to prepare.

Without a will or trust, one's properties and holdings pass at death under several methods:

- **By Operation of Law**

  Some assets pass to a successor automatically "*by operation of law*." There is no requirement of a formal probate administration or other court proceeding to vest ownership in the name of the successor. Examples include real estate, such as the principal residence, if held in *joint tenancy* between spouses or a parent and child, a joint checking or savings account or so-called "pay on death" *(POD)* account, or a joint tenancy securities brokerage account. Recently, the California Legislature approved a new designation "community property with right of survivorship." Assets with this designation pass to the surviving spouse by operation of law.

- **In Accordance With Designated Beneficiary Instruments**

  Other assets provide for a "*designated beneficiary*" to receive the property or its proceeds upon the death of the owner. Examples include employer-sponsored qualified retirement plans such as *401(k)* arrangements, individual retirement accounts *(IRAs)*, deferred compensation death benefit plans, simplified employee pension plans (SEPs), Roth IRAs, SIMPLE plans (savings incentive match plan for employees), other ERISA plans, and term and permanent *life insurance* policies and *annuities*. Here, too, there is no requirement of formal probate administration or other court proceeding to vest ownership in the name of the designated beneficiary.

- **In Conformity With Statutory Rules of Intestate Succession**

  In the absence of a will or trust, assets and properties which are not described by the first two categories are distributable at death by State statute to one's *heirs*. The California Probate Code includes comprehensive rules which provide the manner by which heirs take from relatives. These are the "*intestate succession*" laws and they may apply without regard to the worth of the estate involved (there is no maximum dollar figure), or the kinds of properties included (both real and personal properties, tangible and intangible). The character of an asset as *separate property* or *community property* determines the result in part as does the fact of whether one is survived by a spouse or children. Here, however, there is a requirement of a formal probate administration or other court proceeding to vest ownership in the names of the decedent's heirs.

During your lifetime, your estate may need management in the event of your incapacity. The procedure for appointing a temporary or permanent conservator for you can be time consuming, expensive and humiliating. A well designed estate plan normally includes a durable power of attorney for assets which appoints an agent to handle your financial affairs during your incapacity, and a health care directive which includes appointment of an agent to make health care decisions.

WHAT IS A DURABLE POWER OF ATTORNEY FOR ASSETS?

When a medical emergency arises, a person is often unable to carry on with his or her business and financial affairs. In order to make sure that someone is available to handle these

matters if you are incapacitated, it is often advisable to execute a *Durable Power of Attorney.* A Durable Power of Attorney is a legal document that grants a spouse or some other trusted person you select the ability to act on your behalf. In the absence of a Durable Power of Attorney, it may be necessary to have a Conservator appointed by the Court. This Court process can be time consuming and expensive.

A Durable Power of Attorney must contain the words "this power of attorney shall not be affected by subsequent incapacity of the principal" or "this power shall become effective upon the incapacity of the principal" or similar language showing the intent of the principal that the authority conferred on the agent will be exercisable notwithstanding the principal's subsequent incapacity. A power of attorney that does not contain such language is not "durable" and will terminate with the incapacity of the principal.

A Durable Power of Attorney may be general or limited. The *General Durable Power of Attorney* is a sweeping grant of authority to the agent to do whatever is necessary to manage the principal's property. A *Limited Durable Power of Attorney* is one which restricts the agent's authority to act to a specific period of time, to certain specific assets covered by the power, or to certain specific actions.

A Durable Power of Attorney can also be *immediately effective* or can be *springing*, coming into being only after the principal has been determined to be incapacitated. It is important that the instrument establishing a Springing Durable Power of Attorney define "incapacity" and create a procedure for determining incapacity. Moreover, if the Durable Power of Attorney is to terminate upon the restoration of capacity, a definition of and procedure for determining restoration of capacity is imperative.

We normally recommend that our clients use the Springing Durable Power of Attorney. Since a Springing Durable Power of Attorney only becomes effective when you are determined to be incapacitated, there is less opportunity for the Power of Attorney to be misused during your lifetime.

WHAT IS AN ADVANCE HEALTH CARE DIRECTIVE?

In recent years, the California Legislature has recognized that many people are deeply concerned about the potential expense and emotional trauma for their families of being subject to extraordinary life sustaining procedures where there is no hope of recovery. Previously, there were two statutory procedures in California to deal with this situation. The *Natural Death Act* allowed a person to declare in writing his or her wish that the treating physician withhold or withdraw "life-sustaining procedures" when certain conditions are met. An alternative to the written directive to the treating physician or living will was the *Durable Power of Attorney for Health Care.*

In 2000, the California Legislature revised and consolidated the law in the area by creating the *Advance Health Care Directive.* Under the new *Advance Health Care Directive* you can do either or both of two things:

First, you may appoint another person to be your health care "*agent.*" This person (who may also be known as your "*attorney-in-fact*") will have legal authority to make decisions about your medical care if you become unable to make these decisions for yourself.

Second, you may write down your health care wishes in the *Advance Health Care Directive*

form – for example, a desire not to receive treatment that only prolongs the dying process if you are terminally ill. Your doctor and your agent must follow your lawful instructions.

The Advance Health Care Directive law *does not* invalidate any existing directives under the *Natural Death Act* or an existing *Durable Power of Attorney for Health Care.* All prior documents which were valid when created remain valid.

In our Advance Health Care Directive, we provide our clients with a series of attachments which were developed by the Harvard Medical School and which allow you to make some very specific decisions in a number of situations in which Advance Health Care Directives are used.

ARE THERE TAX CONSIDERATIONS ABOUT HOW WE HOLD TITLE TO OUR PROPERTY?

The character of a couple's property as *community property* or *joint tenancy* property has substantial income tax significance after the death of one spouse. Under the federal income tax law, community property currently receives a *new basis (usually a "step up") to the fair market value at the date of death.* The full step up in basis was available through December 31, 2009. In 2010, the federal estate tax was repealed for that one year only. For individuals dying during 2010, a series of modified step up in basis rules will apply. Please refer to the Section of the Guide entitled "What Are the Federal Estate and Gift Taxes and How Are They Calculated." Beginning January 1, 2011 the estate tax is reinstated.

A simple example of the step up in basis is a community property apartment building that was purchased for $1,000,000 and which was worth $5,000,000 in 2009, will have a basis of $5,000,000 if either spouse died on or before December 31, 2009 or on or after January 1, 2011. That means that the surviving spouse will have no capital gain and thus no income tax to pay if the surviving spouse sells the property thereafter for $5,000,000.

Property that is held in joint tenancy by spouses may not receive the benefit of this full step up in basis. That is because of a presumption under California law that one half of joint tenancy property is the separate property of each spouse. In the above example, if the apartment building is held in joint tenancy, only one half of the property will receive a step up in basis. The remaining half will keep its original basis of $500,000 (one half of the original $1,000,000 purchase price). Thus, the apartment building will have a basis of $3,000,000 consisting of $500,000 of original basis and $2,500,000 stepped up basis. If the surviving spouse sells the property for $5,000,000, there will be a $2,000,000 capital gain for income tax purposes.

In order to avoid this result, it is usually recommended that spouses hold title to appreciated property as community property. This is best when the current value is higher than the basis. However there might be other considerations, such as the impact of a divorce and the loss over control of the property. If the spouses like the convenience of holding title as joint tenants, they can sign an agreement between themselves that title to their joint tenancy assets is so held for convenience only and the assets are considered by the spouses as community property. This type of agreement overcomes the separate property presumption and assures that both halves of the property will step up in basis. Also, the California Legislature recently approved a new designation "community property with right of survivorship." Property held in this manner has the dual benefit of a full step up in basis while passing to the surviving spouse automatically at death without probate. All community property passes to the surviving spouse automatically at death without probate unless willed to another.

PART II

Basics of Estate Planning

SHOULD YOU HAVE A WILL?

One obvious reason to have a Will is that you may not like the way that the intestate descent and distribution law will cause your estate to be distributed to your heirs. For example, many people believe that a deceased person's spouse automatically inherits all property owned by the deceased spouse. This is not necessarily true. If a married person dies without a Will and that person has any separate property, then that person's children will inherit either one-half (if only one child) or two-thirds (if two or more children) of that property. Moreover, each child shares in the distribution equally. If a child is a minor, a guardian need be appointed. Children over 18 receive their inheritances outright. The descent and distribution law does not take into account the different needs of the children, for example, a disabled child entirely dependent upon his or her parents.

The ability to *control the timing and method of the distribution* of assets to heirs is an additional reason to have a Will. If minor children inherit property, it will be necessary to have a guardian appointed to administer each child's inheritance. Guardianship is time consuming, costly and inconvenient. Guardianships terminate when the ward reaches age 18. Guardians must seek court approval for a variety of actions that they may take. Gifts to heirs age 18 or older under the intestate descent and distribution law pass outright to the beneficiaries. By setting up a trust in a Will (called a "*testamentary trust*"), it is possible to delay and stagger gifts to heirs who are not yet mature enough to handle their financial affairs wisely. Establishing a testamentary trust can assure that those beneficiaries who are inexperienced in financial matters will not get too much too soon.

There are a variety of other reasons to have a Will. First, a Will can designate the person who administers an estate before the probate court. This person is called an "*executor*." Executors have important functions regarding property subject to probate administration, such as preparing an inventory of property, operating a business during the period that the estate is in probate, deciding what assets should be sold, and distributing assets in accordance with the provisions of Will. Also, an executor can be given the authority to administer the estate under the *Independent Administration of Estates Act*. This law allows an executor to avoid some time consuming procedures. An Executor will be able to take certain actions regarding the estate property without the formality of a court hearing.

If no executor is named in the Will or if there is no Will, the probate court decides who will administer the estate. Since the probate court judge will not be very familiar with a particular family situation, the person that should have been selected may not be the person who is appointed.

Tax planning is an important reason to have a Will. A carefully prepared Will can often save heirs thousands of dollars of unnecessary taxes as will be demonstrated in a later section of this outline. If there is no Will, the question of how an estate is affected from a tax standpoint is left to the unpredictability of what the law will be like in the state where you die and who your survivors are.

Another important reason to have a Will is that it allows the designation of who will have *custody of minor children* in the event of the untimely death of both spouses. Often parents desire to protect their children's assets by designating one person to maintain physical custody of the children and a different person to control and invest the children's property.

Couples who hold all of their property in joint tenancy believe that this method of ownership will always avoid probate, at least on the death of the first spouse. Unfortunately, this is not necessarily true. In the case of a simultaneous death, California law presumes that each spouse survived the other. As a result, if there are no Wills nor a Living Trust, the joint property is divided in half and *each half is separately administered* and distributed in accordance with the intestacy laws.

Finally, a Will is a person's last statement to their loved ones. Many people choose to make sentimental gifts of a personal nature in their Wills or use their Wills to express appreciation to family and friends. It is not uncommon these days for people to make a video tape to supplement their written Will. The video tape is an effective way of making a final statement to family and friends.

WHAT IS PROBATE?

Probate is a court supervised process in which a person's estate is administered and distributed. In the typical probate, the judge reviews the Will to determine if it was signed with the proper formalities. If there is no Will, the intestate succession laws are applied. A personal representative (called the "*executor*" if there is a Will, or the "*administrator*" if there is no Will) is appointed. An *inventory and appraisal* of the decedent's assets and properties subject to Probate is completed by the personal representative and filed for review by the court. The decedent's assets and properties are first applied to pay the debts and obligations of the decedent, the settlement of any claims, and the satisfaction of federal and state income and estate taxes. Then the remaining assets and properties are distributed to the heirs upon a *final accounting* of the personal representative and the payment of fees and costs.

For many clients, the *avoidance of probate* is a principal objective of their estate planning. This is because the probate process can be time consuming and costly. For an estate of moderate or high net worth (several million dollars or more), final distribution may not come before one or more years has passed since the decedent's death. Creditors are entitled to a four month notice period to make claims against the estate. Locating all assets and properties and having them appraised by the "*probate referee*" may also take a significant period of time. There may be substantial fees and costs incurred by the personal representative and the attorney engaged by the personal representative. Such fees as they relate to "ordinary services" are determined as a percentage of the "*value of the estate accounted for*."

Probate Fees

Value of Estate Accounted for				
Over	*But not over*	*Statutory Rate*		*Of the amount over*
$1	$100,000		4%	$1
$100,000	$200,000	$4,000	+3%	$100,000
$200,000	$1,000,000	$7,000	+2%	$200,000
$1,000,000	$10,000,000	$23,000	+1%	$1,000,000
$10,000,000	$25,000,000	$113,000	+0.5%	$10,000,000

For values in excess of $25,000,000, a reasonable amount is determined by the court. As an example, the statutory fee payable to the personal representative in administering an estate with a value of $2,000,000 is $33,000; the statutory fee is $43,000 for an estate valued at $3,000,000. A like amount would also be payable to the attorney for the personal representative as explained below. Where there is more than one personal representative, the single statutory fee is apportioned between them by the court.

In addition to the statutory fee payable to the personal representative for ordinary services, compensation for "*extraordinary services*" may also be awarded. As an example, services rendered in preparing the federal and state estate tax returns constitutes an extraordinary service. Other examples include services related to real and personal property sales and mortgages, the carrying on of the decedent' s business, participating in judicial proceedings to determine the decedent's intention concerning undisclosed beneficiaries and the defense of the personal representative's final accounting. The amount of compensation is that amount determined to be "*just and reasonable*" by the court. The personal representative may also retain tax counsel, auditors and accountants when necessary under this provision for extraordinary service compensation.

Similarly, for ordinary services performed by the *attorney for the personal representative*, compensation is payable based upon the same schedule of the value of the estate accounted for. Attorneys' fees for extraordinary services are also awarded as determined to be just and reasonable by the court.

WHEN SHOULD PROBATE BE AVOIDED OR UTILIZED?

Since probate can be time consuming and expensive, many estate planners recommend that, except in unusual circumstances, steps be taken to avoid having assets and properties pass through probate. There are several alternatives for avoiding probate. In simple estate plans where tax planning is not an important factor, couples place all of their holdings in joint tenancy so that the surviving spouse becomes the owner of the entire joint tenancy property by "*operation of law*." Similarly, a couple can designate the "*non-insured spouse*" as the beneficiary of life insurance and the "*non-participant spouse*" as the recipient of qualified retirement plan benefits or IRAs. While such an arrangement does avoid probate at the death of the first spouse to die, the surviving spouse may nevertheless need to prepare an estate plan to deal with the final devolution of the couple's assets and properties after the subsequent passing of the surviving spouse. Here, the living trust is a useful solution. In estates of significant wealth, say more than $1,000,000, such a simple "*no-will plan*" can be costly from an estate tax perspective.

There are some circumstances in which a Will requiring probate is preferable to a living trust. First, although probate fees will be incurred at death, the cost of a Will where there are no significant gifts to minors, is generally less than that of a living trust. Second, the watchful eye of the probate court may be desirable in situations where disputes or divisiveness among heirs is likely, or third party claims can be anticipated, say against the estate of a decedent who engaged in a high risk occupation.

WHAT IS A REVOCABLE LIVING TRUST AND WHY DOES IT AVOID PROBATE?

To understand the "*revocable living trust*" as an estate planning mechanism, one first needs to know how a "*trust*" is defined. A trust is a legal relationship established for the administration of property. The person who creates the trust is alternatively referred to as the "*trustor*;" "*settlor*" or "*grantor*". The trustor transfers property to another person, known as the "*trustee*," who accepts, holds and administers the property for the benefit of another person who is referred to as the "*beneficiary*."

Under the California rules, a trust is created when a *trustor* expresses an intention to create a trust and the trustee agrees to accept the property to be held in trust. A trust is created only if there is trust property. So, the act of merely signing a "*trust declaration or agreement*" is not enough.

A "*revocable*" trust is a trust created under state law over which the trustor retains the power to withdraw the property contributed, and to alter, amend, or terminate the trust at any time. Unless a trust is expressly made irrevocable by the trust instrument, the trust is presumed to be revocable. Because the trustor can revoke or amend the trust at any time, a revocable trust is disregarded for federal income tax purposes. The trustor of the revocable trust is treated as its owner and is taxable on all of the trust's income and gains. Likewise, the trustor is treated as the owner of the property held in the revocable trust at death for federal estate tax purposes, even though the property held in trust will pass to someone else without probate. Many people are under the mistaken belief that because a revocable living trust avoids probate, the assets in the living trust escape the federal estate tax. As will be discussed later, tax planning with a living trust is possible, but the mere fact of setting up a living trust does not guarantee no federal estate tax.

Simply put, the revocable living trust avoids probate because the trustee of the trust, rather than the trustor, holds legal title to the assets and property contributed by the trustor during lifetime. When the trustor dies, his or her individual estate does not include the assets and property held in the living trust if the trustee was vested with ownership of the properties during the trustor's lifetime. The estate planning use of the revocable living trust is predicated upon the trustor conveying all of his or her assets and properties to the trustee during lifetime. Even though a trustor may, and often does, act as the trustee of a revocable living trust during lifetime, a successor trustee is designated to serve after the death of the trustee appointed at death (possibly the decedent's spouse or adult child). The successor trustee continues to hold, administer and distribute the trust property in the manner provided in the trust declaration. Even if no successor trustee is named in the trust declaration, the trust will not fail. Any interested party can request a court to appoint a successor trustee. Accordingly, no probate of the estate of the deceased trustor is required; because there will always be a trustee to administer the property held in the living trust.

WHAT ARE THE FEDERAL ESTATE AND GIFT TAXES AND WHAT IS THE UNCERTAINTY ABOUT THEM?

The "*federal estate tax*" is a duty on the transfer of wealth at death. First enacted in 1916, the federal estate tax has evolved into an intricate body of law included in the Internal Revenue Code. A parallel system of "*wealth transfer taxation*" applies to gratuitous transfers of wealth during lifetime - the "*federal gift tax*." The federal income tax is an entirely separate system of taxation that is very different from the estate and gift taxes; but all three taxes are of concern in estate planning. The federal "*generation-skipping tax*" is a second tax which skips a generation (i.e. a bequest from a grandparent to a grandchild.)

The *Economic Growth and Tax Relief Reconciliation Act of 2001* (the "*Tax Relief Act of 2001*"), as modified by the *Jobs & Growth Tax Relief Act of 2003* (the "*Tax Relief Act of 2003*") has phased out the federal estate tax as shown below for deaths occurring in 2009. In 2010, for one year only, the federal estate tax has been repealed and modified rules for the step up in basis of assets at death have become effective. The federal gift tax, however, was not repealed in 2010. The gift tax will continue in a modified form. The following chart shows the applicable exclusion amount and the tax rates which will apply through 2011. California does not have any estate, gift, inheritance or generation-skipping transfer taxes.

Applicable Exclusion Amounts and Highest Estate and Gift-Tax Rates				
	Estate and GST Tax		Gifting During Lifetime	
Calendar Year	Applicable Exclusion Amount	Highest Estate and GST Tax Rate	Applicable Exclusion amount	Highest Gift-Tax Rate
2009	$3.5 million	45%	$1 million	45%
2010	N/A (taxes repealed)	N/A (taxes repealed)	$1 million	Top individual income tax rate
2011	Tax Reinstated to 2000 Level	Tax Reinstated to 2000 Level	$1 million	Tax Reinstated to 2000 Level

At the time of this publication the Congress has allowed the *federal estate tax* and *generation-skipping taxes* to expire. For more information please see the *Estate Tax Alert* entitled "The Federal Estate Tax Repeal – Sailing in Uncharted Waters," which is attached to this Client Guide to Estate Planning.

The factor which makes estate planning after the Tax Relief Act of 2001 most complicated is the "*sunset*" provision of the Act. Under the *sunset* clause, federal estate taxes will "*bounce back*" to the law as it existed before enactment of the Tax Relief Act of 2001, unless Congress modifies the estate tax law. This uncertainty requires that estate plans prepared after the Tax Relief Act of 2001 need to have a great deal of flexibility. Also, although Congress allowed the Tax Relief Act of 2001 to become effective on January 1, 2010, many in Congress have vowed to enact legislation which restores the estate tax retroactively.

The federal estate tax is calculated by applying marginal rates to the "*gross estate*" of the decedent less applicable "*deductions*." The gross estate includes all of the property owned by the decedent as of the date of death. A common source of confusion for estate planning clients is why the federal estate tax applies to the revocable living trust if the property held in trust is not subject to probate administration. The answer is that the federal estate tax law is not determined by local probate statutes; and what a decedent owns or is "*deemed to own*" at death for federal estate tax purposes may extend far beyond the person's probate estate as such. Property held in a revocable trust is treated for federal estate tax purposes as owned by the person having the power to withdraw the contributed property, or amend, alter or terminate the trust.

The federal gift tax is currently imposed on "*completed gifts*" made by one person (the "*donor*") to another person (the "*recipient*" or donee) during the donor's life. For 2010, each donor has an annual $13,000 per recipient gift tax exclusion. Married couples currently can join and give $26,000 annually per recipient. Certain payments made directly to providers of medical and educational services are not treated as taxable gifts to the recipients of those services. There is also an unlimited exclusion for gifts between spouses who are not aliens.

If a gift exceeds the amount of the annual exclusion or the gift does not qualify for the annual exclusion (certain gifts to irrevocable trusts do not qualify) the gift is a "*taxable gift*." Each person currently has a $1,000,000 lifetime applicable exclusion amount for gift taxes. A single unified transfer tax rate applies to both estate and gift taxes. Thus, even though a donor makes a taxable gift in any year, a gift tax will be payable only if the gift exceeds the donor's remaining applicable exclusion amount.

Example 1

Assume a couple makes a gift in 2010 of $100,000 outright to their adult daughter. If they join in making the gift, $26,000 of the gift is covered by the annual exclusion, leaving a $74,000 taxable gift. If neither spouse has used his or her applicable exclusion amount, then each spouse's $1,000,000 applicable exclusion amount will be reduced by $37,000; and each spouse will have $963,000 of applicable exclusion amount remaining to offset future taxable gifts or the federal estate tax when they die.

The federal estate and gift tax rates are applied to the *fair market value* of the property at the date of the gift (for the gift tax) or on the date of a person's death (for the estate tax). The Internal Revenue Code also provides for an elective alternate valuation date six months following the date of the decedent's death. If it is chosen, all properties included in the decedent's gross estate must be valued by reference to the alternate valuation date unless distributed, sold, exchanged or otherwise disposed of within the six month period in which event the valuation date is the sale or disposition date. In order to make the alternate valuation date election, the gross estate must decrease and so must the federal estate tax owing.

WHAT IS THE MARITAL DEDUCTION AND HOW IS IT CLAIMED?

When calculating the federal estate tax certain deductions are taken into account. These include items such as debts, liabilities, claims and administration expenses, and gifts to qualified charities. Perhaps the most important federal estate tax deduction is for property passing from the decedent to his or her surviving spouse (the "*marital deduction*"). No matter how large a couple's estate is there will be no federal estate tax on the death of the first spouse to die as long as the deceased spouse's property passes to or for the benefit of the surviving spouse in a way that qualifies for the marital deduction. Any property subject to the marital deduction that is left at the death of the surviving spouse must be included in the estate of the surviving spouse for federal estate tax purposes. If the surviving spouse dies in 2010, the year of the repeal of the federal estate tax, marital assets will escape estate taxes.

The marital deduction is available for property passing "*directly*" from the decedent to his or her surviving spouse; and it may also be claimed for certain "*gifts made in trust*." The most common marital deduction trust used in the context of the revocable living trust is the qualified terminal interest property trust known by the acronym "*QTIP Trust*." To qualify as a QTIP Trust an election must be made by the executor on the decedent's federal estate tax return. The arrangement by its terms must provide that:

- The surviving spouse is entitled to all income at least annually.
- The QTIP Trust may not be used for the benefit of any person other than the surviving spouse.

The QTIP Trust can have the practical effect of insuring that the decedent's property will pass to his or her heirs following the death of the surviving spouse. By comparison, a direct gift of the deceased spouse's property to the surviving spouse cannot guarantee that result. This feature usually is desirable for estate planning couples, particularly where the spouses have children of prior marriages or it is foreseeable that a surviving spouse may remarry after the death of the deceased spouse. Added flexibility can be gained by providing the surviving spouse with a limited power to appoint the QTIP Trust at death to the deceased spouse's descendants, or by directing that the QTIP Trust pass to the deceased spouse's descendants following the surviving spouse's passing.

WHAT IS A CREDIT-SHELTER OR BYPASS TRUST?

A "*credit-shelter or bypass trust*" is created as part of a living trust to take maximum advantage of the federal estate tax applicable exclusion amount that each person may use to shelter bequests at death from tax . Under the Tax Relief Act of 2001, the applicable exclusion amount increased in 2009 from $2,000,000 to $3,500,000.

Example 2

Assume that a husband and wife have a combined community property estate of $7,000,000 in 2009. If one spouse died in 2009 and left his or her $3,500,000 half of the community estate to the surviving spouse, there would be no federal estate tax. The unlimited marital deduction in 2009 made certain that there would be no federal estate tax at the death of the

first spouse to die. On the other hand, if the surviving spouse preserves principal, he or she will have a taxable estate worth $7,000,000 at death. The surviving spouse's available applicable exclusion amount would cover only $3,500,000 of his or her estate in 2009 leaving the remaining $3,500,000 subject to an estate tax of $1,575,000 in 2009 at the 45% top estate tax bracket.

However, by creating a credit-shelter trust at the death of the deceased spouse, no federal estate tax will result on the death of either spouse. *The federal estate tax benefit of each spouse's applicable exclusion amount is preserved.* The trust estate is available to support the surviving spouse during his or her lifetime and then may pass without federal estate tax to the couple's descendants.

WHAT IS THE GENERATION-SKIPPING TRANSFER TAX AND EXEMPTION?

A "*generation-skipping transfer ('GST') tax*" is imposed on transfers outright or in trust to a beneficiary more than one generation below that of the "*transferor's*" generation at a flat rate equal to the maximum federal gift and estate tax rate which was *forty-five percent in* 2009. In 2010, for one year only, the generation skipping transfer tax is scheduled to be repealed. However, the repeal is subject to the "sunset provision" of the Tax Relief Act of 2001. If the Congress and the President do not take action in the future to make the repeal permanent, or otherwise change the exclusion amount or tax rate, the law will revert after December 31, 2010 to the way the law was in 2001. Again, many in Congress have promoted the idea of a retroactive reinstatement of the GST tax.

The GST tax is separate, and in addition to, the federal estate tax duty. As an example, if a grandparent bequeaths property directly to his or her grandchild under a Will and the grandchild's parent (the child of the grandparent) is then living, both the federal estate tax and the GST tax will be due subject to certain exceptions discussed below. The total transfer tax cost of such a gift can be quite high.

Fortunately, every individual was allowed a **$3,500,000 GST tax exemption** in 2009 which could be allocated to any property so transferred. Married couples could treat transfers as if made one-half by each spouse, in effect giving them a combined GST tax exemption of $7,000,000 in 2009. Once a generation-skipping exemption is allocated to a gift, any subsequent appreciation in the value of the transferred property similarly remains exempt from the GST tax even though the beneficiary is a person more than a generation below that of the transferor.

PART III

Sophisticated Techniques for Minimizing or Deferring the Federal Estate Tax

HOW CAN AN IRREVOCABLE LIFE INSURANCE TRUST BENEFIT MY ESTATE?

The "*irrevocable*" life insurance trust is primarily a federal estate tax savings device. The trust can be designed in such a way that the trust assets, including life insurance policy proceeds, will be "*excluded*" from the trustor's gross estate at death, as well as upon the death of the trustor's spouse. This can be accomplished even though the spouse of the insured benefits from the life insurance proceeds while alive. This advantage is not available for the insured if the spouse owned the policy directly. Where support for the noninsured spouse is available from assets other than life insurance, the life insurance trust is often structured to provide liquidity for payment of estate taxes at the death of the surviving spouse. In this case, the life insurance trust is normally funded with a second-to-die life insurance policy that only pays off at the death of the surviving spouse.

While the life insurance trust has many advantages, those benefits do not come without drawbacks. One disadvantage is administrative complexity. In order for the trustee to pay premiums as they become due, the trustor or some other person must make annual gifts to the trust. An insurance trust is complicated by the fact that in order to qualify the gifts for the annual gift tax exclusion ($13,000 per donee and $26,000 per donee if the spouses join in the gifts), the recipient of the gift must have a present right of enjoyment over the gift. In order to satisfy the present right of enjoyment, the beneficiary of the trust is given a limited withdrawal right over the gift. This withdrawal right is commonly referred to as a "*Crummey Power*" after the family who conceived this technique. Typically, when a gift is made to the insurance trust, the trustee writes a letter to each beneficiary informing the beneficiary of the gift and the beneficiary's right to withdraw the gift for a period of time (often thirty days).

Another disadvantage is that the insurance trust is irrevocable. Once the trust is established, the donor loses the ability to make changes. Some flexibility may be drafted into the trust document to give the Trustee discretionary power, but the trust must be irrevocable in order to exclude the insurance from the grantor's estate.

A very sophisticated insurance trust that avoids both the estate tax and the generation skipping transfer tax is often referred to as a "*dynasty trust*." In this type of insurance trust, the insurance proceeds can be received in the trust completely free of estate and income taxes.

Several generations of children, grandchildren, great-grandchildren (and perhaps beyond) can benefit from the insurance trust without the imposition of an estate tax or generation-skipping transfer tax.

WHAT ARE THE ADVANTAGES OF A QUALIFIED PERSONAL RESIDENCE TRUST?

For most estate planning clients, one of the most valuable assets is their personal residence. The relatively high residential real estate values in Southern California often result in a federal estate tax at the death of the surviving spouse.

In 1990, Congress enacted legislation which allows a client to give his or her home to another, such as a child, while continuing to live in the property. This is accomplished by a special type of irrevocable trust known as the "*Qualified Personal Residence Trust*" or "*QPRT*" for short. The QPRT allows a client to:

- Make a current gift of the personal residence to children or other beneficiaries applying a substantial valuation discount.
- Eliminate the value of the property from the gross estate for federal estate tax purposes.
- Retain the right to reside in the home for a term of years.

The QPRT works best where the residence is expected to appreciate substantially after it is transferred to the trust. By using a QPRT, the client can remove a major asset from his or her gross estate while having the transfer valued for gift tax purposes at only a fraction of the underlying asset value. The result is a substantial leveraging of the unified estate and gift tax credit.

To create a QPRT, one establishes an irrevocable trust. When the residence is transferred to the QPRT, the transferor reserves the right to live in the residence for a term of years. At the end of the term of years, the residence passes to the transferor's designated beneficiaries, usually the children. Alternatively, the residence can remain in the QPRT for the benefit of the beneficiaries. The transferor can reserve the right to rent the residence after the end of the term of years, but rent must be paid at fair market levels. If the transferor dies before the end of the term of years, the current full fair market value of the residence is included in the transferor's gross estate for federal estate tax purposes. Thus, in event of a premature death, the estate planning purpose of the QPRT will not be realized.

The "*transfer tax leverage*" advantage of the QPRT stems from the valuation discount which is applied to the otherwise taxable gift to the trust. The value of the gift is less than the current fair market value of the personal residence because the beneficiaries (children) will not enjoy the gifted property until the end of the term of years of the QPRT.

EXPLAIN HOW AN "INTENTIONALLY DEFECTIVE GRANTOR TRUST" WORKS AND DESCRIBE ITS USEFULNESS IN SOPHISTICATED ESTATE PLANNING

An "*intentionally defective grantor trust*" is one of the most powerful wealth transfer tools available in the estate planner's arsenal. Its usefulness deserves special attention and careful consideration in almost every client's case. This section of our Client Estate Planning Guide will explain the most important elements of this approach to transferring property and develop the income and transfer tax (meaning, the estate, gift and generation-skipping transfer tax) theories that apply. One note in beginning, though, and that is that an intentionally defective grantor trust is purely a creature the Internal Revenue Code rather than the trust laws. At its core, it is simply a trust, but the terms and provisions of the trust instrument are carefully drafted to achieve unique tax consequences.

What Determines Grantor Status?

A trust is considered a *grantor* trust when its income and gains are taxable to the "grantor" (meaning the person who establishes the trust by transferring property to the trustee) rather than the trust, even if no distributions are made during the year from the trust to the grantor. Internal Revenue Code sections 671 through 679 provide a series of rules which determine when taxes on trust earnings are imposed upon the grantor. Broadly viewed, a grantor is taxed on trust income and gains (reported on Form 1040) when the grantor retains certain powers over, or interests in, the income and/or principal (called "corpus") of the trust equivalent to ownership for income tax purposes. Similarly, the deductions of the trust are attributed to the grantor under these tax rules.

Here are those powers and interests:

- A reversionary interest in the trust corpus or income exceeding five percent (5%) of the value of that portion of the trust.
- A power of the grantor or a "non-adverse" party (someone who does not have a substantial beneficial interest in the trust that would be adversely affected by the grantor's exercise or non-exercise of such power) to control the beneficial enjoyment of the trust.
- Reservation of important administrative powers to the grantor or a non-adverse party other than in a fiduciary capacity.
- Reservation of the power to revoke by those persons.
- Reservation of the power to distribute income to, or for the benefit of, the grantor.

Some examples: The power to shift the distribution of trust income between beneficiaries causes the grantor to be taxed on that income. Other powers that similarly cause the grantor to be taxed include the power to control investments in entities in which the trust and grantor have significant voting control, the power to accumulate income in favor of the remaindermen, the power to determine whether income will be distributed or accumulated and added to principal, the power to amend or modify the trust instrument, and the power to repurchase trust assets by substituting property of equivalent value. The grantor is taxed on trust income if the grantor or the grantor's spouse retains administrative powers enabling the grantor to obtain, by dealings with the trust, financial benefits that would not be available in an arm's-length transaction, i.e., the

borrowing of trust income or corpus at any time during the year, even if the grantor repays the loan with interest during the same year. Also, a grantor is taxable on trust income that is used to pay life insurance policy premiums on the grantor's life, or on the life of the grantor's spouse.

Gift, Estate and Generation-Skipping Transfer Tax Consequences

Sometimes the type of grantor trust described here is referred to as being "intentionally defective" because, despite the trust being *irrevocable*, the grantor, rather than the trust, is currently taxed on income and gains. You will see below why that can be beneficial for estate planning purposes. If drafted properly, the grantor trust corpus will be excluded from the gross estate of the grantor for estate tax purposes notwithstanding that trust income and gains are deemed to belong to the grantor for income tax purposes. That means that only certain of the powers and interests listed above can be employed in structuring the grantor trust for estate planning purposes. Effective structuring is described below.

The transfer of property to a grantor trust without the receipt of full and adequate consideration is treated as a completed gift for gift tax purposes. But the payment of income taxes otherwise owing on trust income and gains by the grantor is not a gift to the trust beneficiaries (as determined by *IRS Revenue Ruling 2004-64).* And if the grantor trust is established for the benefit of the grantor's grandchildren, the generation-skipping transfer tax can apply unless generation-skipping transfer tax exemption of the grantor is allocated along with the gift. However, an installment sale can be used in lieu of a gift and the gift tax consequences of establishing the grantor trust ameliorated. The installment note receivable will be included in the grantor's estate (or the interest and principal repayments received before death), but appreciation on the value of the property subject to the installment sale accrued subsequent to that transfer will be excluded from the grantor's gross estate.

Unlike a *grantor retained annuity trust*, there is no estate tax inclusion period (ETIP) for a grantor trust. Consequently, all or a part of the grantor's GST tax exemption can be allocated for the benefit of grandchildren at the time of establishing the trust if a gift approach is used. This may minimize the amount of GST exemption actually allocated.

Tax-Free Nature

The usefulness of this approach lies in the ability of the trust corpus to grow undiminished by the cost of ordinary income, dividend and capital gains taxes. The power of an intentionally defective grantor trust is coupling its use with the transfer of wealth to children and other beneficiaries through the means of the trust. Neither the trust nor the beneficiaries are taxed on the earnings of the trust during the grantor's lifetime, or until grantor trust status terminates, whichever first occurs.

In some ways, this kind of trust is similar to an individual retirement account ("IRA"), or a section 401(k) qualified retirement plan account, because these enjoy tax-deferred growth as well. But the beneficiaries of the grantor trust, unlike the designated beneficiaries of IRAs and qualified retirement plans, never pay income taxes; the accumulated earnings and principal of IRAs (other than Roth IRAs to which only limited contributions can be made during the grantor's lifetime) and qualified retirement plan accounts are tax deferred only until distributions are actually made to their owners or designated beneficiaries. In addition, IRAs and qualified retirement plan accounts may not be transferred to another person during the owner's or participant's lifetime. They are inalienable and to that extent offer some asset protection.

However, grantor trusts, notwithstanding being deemed owned by the grantor for income tax purposes, may also be protected from the reach of creditors of the grantor and beneficiaries, depending upon the nature of the powers and interests retained by the grantor and the interests of the beneficiary.

Structure

There is no maximum or minimum size for an intentionally defective grantor trust used for estate planning. The benefits to be realized are derived without regard to the total value of the trust estate. One factor to consider, though, is the grantor's financial ability to satisfy the income taxes due on the taxable income and gains of the trust likely to be accrued from year to year and the income taxes due from other sources, including assets not transferred to the trust and readily converted into monies to satisfy those necessary tax payments. Certain strategies can be employed in drafting the grantor trust which affords an appropriate safety net for the grantor. For example, the trustee and grantor may retain the right to release their powers that cause the trust to be treated as a grantor trust for income tax purposes.

Since gross estate exclusion for federal estate tax purposes is a principal objective of the grantor trust, the powers and interests retained by the grantor cannot run afoul of certain Internal Revenue Code rules, such as those of Section 2036. It says that transfers of property with retained rights to income, or the power to control the enjoyment of income or principal, are included in the transferor's gross estate. So, in a typical grantor trust, no such powers or authorities are retained. Rather, the grantor may simply hold an administrative power such as the right to remove and replace the trustee, or to substitute property of the trust estate with assets of equivalent value. As mentioned, the trust could also provide that income may be used to pay premiums on insurance on the life of the grantor with the same result. Similarly, the grantor would not retain the power to amend the trust because doing so would cause its inclusion in the grantor's gross estate under the rules of Internal Revenue Code section 2038, or retain a reversionary interest which could be included in the gross estate under Internal Revenue Code section 2037.

If the gift approach is used in establishing the grantor trust, gift taxes paid within three years of the date of death of the grantor would be included in the gross estate under section 2035 of the Internal Revenue Code. Under the gift approach, the grantor may allocate GST exemption. In that case, the trust should not terminate at the grantor's death, or at the death of a child. Its administration should continue for the benefit of grandchildren. In fact, the trust can be designed to continue as long as permitted under the applicable *Rule Against Perpetuities* (under California law, the later of ninety (90) years or the death of selected persons living when the trust is established, plus twenty-one (21) years). Alternatively, the grantor trust could be created in a jurisdiction which has suspended the rule; Delaware is an example.

Example 3

Assume that a parent transfers securities worth $1 million to an irrevocable trust under which she retains the power to replace those securities with assets of similar value so that the trust is a grantor trust. The growth rate in this example is ten percent (10%) and the marginal income tax is twenty percent (20%) of the annual earnings. No gift tax would be paid at creation because the grantor may apply her $1 million gift tax exemption in filing her gift tax return and allocate $1 million of her GST exemption. At the end of ten (10) years, the trust estate would equal approximately $2.6 million. The appreciation of $1.6

million is excluded from the grantor's gross estate for federal estate tax purposes. No transfer taxes will be paid, even if the principal is not distributed to grandchildren and the trust continues as long as permitted under the applicable Rule Against Perpetuities. The trustee would not have paid any income taxes. Income taxes on the trust's income were paid by the parent grantor.

Assume the same facts as in this example except that the grantor does not retain any administrative power over the trust such that earnings of the trust are taxed to the trust and paid by the fiduciary from income and/or principal of the trust estate. At the end of ten (10) years, the trust estate would equal approximately $2.2 million. The trustee would have paid almost $290,000 in income taxes.

HOW CAN OUR FAMILY BENEFIT FROM A FAMILY LIMITED PARTNERSHIP OR FAMILY LIMITED LIABILITY COMPANY?

While the historic *business planning* use of family limited partnerships (commonly known as "*FLPs*") is well documented, their use for transfer tax minimization planning purposes is a more recent, popular trend. This is generally accomplished through transfer tax valuation discounts and the exclusion of appreciating FLP properties from senior family members' gross estates. In appropriate circumstances of material (non-tax) business purposes, the benefits can be significant, so consideration of FLPs in the right situation makes eminent sense. However, this is an approach the success of which is guided by case law. Its consideration requires apprehension of how the U. S. Tax Court and federal courts in different appellate circuits view effective and ineffective applications. Accordingly, the formation and organization of FLPs (and their more current iteration, the *family limited liability company* commonly known as "*FLLCs*") is a topic of continuing discussion among tax professionals. Like the radio commercial says, ". . . consult with your tax advisor."

FLP Benefits

As has been the case, the use of FLPs can foster continued ownership, management and operation of a family business enterprise devolving over several generations and allow for a pooling of business interests and investment risks.

Second, taking advantage of the same transfer tax-saving principles as the QPRT, property transfers to FLPs (as opposed to transfers directly to children or grandchildren) can result in enhanced valuation discounts of federal estate and gift tax liabilities.

Third, FLPs may offer some level of asset protection against enforcement of judgments against family members.

Fourth, the FLP can "shift" taxable income generated on FLP properties from parents to children whose lesser "other" earnings may put them in lower marginal income tax brackets, resulting in income tax savings for the "family" as a whole. This benefit may also move the after-tax accumulation of income away from the parents' gross estates for federal estate tax purposes.

Structure

In the usual FLP set-up, parents transfer business or investment assets (such as rental real properties, sometimes together with other holdings such as traded securities) to the FLP, taking

back general and limited partnership interests (membership interests in the case of FLLCs) and then subsequently selling or "gifting" some of those partnership interests to their children. In order to take advantage of the gift tax and GST tax annual exclusion, special care must be given to drafting the organizational documents and the operations of the FLP or FLLC. Also, children and other family members may contribute business and investment property to the FLP in exchange for general and limited partnership interests.

A certificate of limited partnership is registered with the California Secretary of State under the California Revised Limited Partnership Act. The parents then capitalize the FLP by contributing to capital of the FLP selected individually owned trade or business properties. The general partners (or managers in the case of the FLLC) are usually the senior family members (parents) who initially retain "control" of the FLP by virtue of this general partner position. Note that since the general partner has full liability it preferably should be an entity. Where the general partner is a corporation, the senior family members usually control the corporation through majority capital stock ownership. The senior family members also may initially acquire all of the limited partnership interests (or children can contribute property in exchange for the initial issuance of limited partnership interests). If California real estate is to be contributed to the FLP, care must be taken to avoid a change in ownership causing a reassessment and an increase in property tax. Capital accounts are established on the books and records of the FLP and maintained in accordance with Treasury Regulations. Initial capital accounts are determined with regard to the respective values of the trade or business properties being contributed to capital and by whom. The FLP continues to operate the trade or business properties conveyed and makes distributions to the general and limited partners as determined under the written limited partnership agreement (subject to special federal income tax rules requiring that "*capital be a material income producing factor*").

The FLLC is essentially a family limited partnership utilizing a limited liability company as the operative vehicle rather than a limited partnership having a general partner. With the FLLC there is no requirement that any person or entity serve as the general partner. The majority of membership interests control the FLLC, or the entity may be structured with designated managers as a manager managed FLLC. The FLLC is treated as a partnership for federal income tax purposes. California has a special gross receipts tax on FLLCs. Sometimes the limited liability company statutes better support valuation discounts on the sale or transfer of membership interests from senior family members to junior family members because their statutory provisions for such sales and transfers are more restrictive when compared with FLPs. That is one reason for the popularity of the FLLC in this type of business planning.

Estate and Gift Taxation

Generally, the transferred trade or business properties are excluded from the parents' gross estates for federal estate tax purposes and only the retained general and limited partnership interests are subject to estate taxation. This result has been challenged, though, in some cases where the gross estate tax "pull back" rule of section 2036 of the Internal Revenue Code has been successfully applied by the IRS, such as in the seminal *Strangi* cases.

Clearly, most of the litigation the IRS has pursued involves estates whose decedent-taxpayer established an FLP in a manner manifesting "bad facts," poor planning and under circumstances unlikely to achieve success even with the best reading. Still, the most recent decisions of the U.S. Tax Court portend that even "good fact" cases may be caught under section 2036 if case law guidelines are not carefully reflected.

If proper capital accounts are established upon creation of the FLP, no gift generally results on the parents' contribution of assets to capital of the FLP for gift tax purposes.

Asset Protection and Other Benefits

As to other benefits of the FLP, the statutory restrictions on so-called "*charging orders*" of creditors (assignees) of family members traditionally afford some level of asset protection. However, new rules applicable to FLLCs give judgment creditors special foreclosure remedies, but alternative redemption procedures are available to the FLLC and family members that allow for effective planning nonetheless.

In some cases, the FLP may also serve as the owner of insurance policies on the lives of senior family members whereby policy proceeds payable are excluded from the gross estates of the insured, senior family members. Those proceeds will be reflected in the federal estate tax value of the retained general and limited partnership interests.

HOW CAN A CHARITABLE REMAINDER TRUST FIT INTO MY ESTATE PLAN?

A "*charitable remainder trust*" or a "*CRT*" is an irrevocable tax exempt trust created by a donor. The CRT is normally funded with property that has substantially appreciated in value. When the trustee of the CRT receives the appreciated property transferred by the donor, the trustee usually sells the property soon after the contribution. Because the CRT is a tax exempt trust, the CRT does not pay any current taxes on the sale of the property.

When a CRT is established, the CRT generally pays the donor (and often the donor's spouse) an income interest for life or for a term of years (not exceeding 20 years). After the income interest is paid, the balance of the property in the CRT is normally paid to one or more charities.

Because charitable beneficiaries receive the "*remainder*" interest in the trust after the income interest is paid, the donor is entitled to an *income tax charitable deduction* equal to the present value of the remainder gift to charity. The donor is allowed an income tax charitable deduction at the time of creation of the CRT, even though property may actually pass to the charitable beneficiaries of the CRT many years after the creation.

There are two basic types of CRT, the "*charitable remainder annuity trust*" or "*CRAT*" and the "*charitable remainder unitrust*" or "*CRUT*." A CRAT pays out an annuity interest in a specified amount on a periodic basis (at least annually). The required distribution is a sum not less than *five percent of the initial fair market value* of the property contributed to the CRAT. The CRAT is used primarily in situations where a fixed payment to the beneficiary is desired. The other type of trust is the CRUT which differs from the CRAT in the manner by which the income pay out is determined. In a CRUT, the minimum payout must be at least five percent of the fair market value of the assets of the trust determined annually (rather than determined initially). Accordingly, the annual income amount paid from the CRUT will vary as the fair market value of the trust estate appreciates or depreciates, or is reduced by reason of the making of distributions. There are two hybrid forms of CRUT, the "*NIMCRUT*" and the "*FLIPCRUT*" that are very useful planning devices in special circumstances.

Under the **NIMCRUT** (an acronym standing for "net income make-up charitable remainder unitrust"), the trust declaration provides that if net income in any year is less than the unitrust payout amount, the shortfall is accrued and paid in later years when the earnings of the trust assets exceed the specified percentage. The NIMCRUT is often used to supplement the donor's retirement income. Prior to the donor's retirement, the Trustee implements an investment strategy which focuses on long term growth and low current income. This allows the NIMCRUT to grow with minimal pre-retirement taxes. After the donor's retirement, the investment strategy is switched to maximize income and take advantage of the income distribution make up feature of the NIMCRUT.

The second variation of the CRUT is the **FLIPCRUT**. It is so called because it pays the donor the net income from the CRUT during an initial period selected by the donor. The initial period is normally a term of years or the period before the assets which are contributed to the FLIPCRUT are sold. After the initial period, the distributions flip up to the unitrust payment percentage. FLIPCRUTS are particularly useful where the assets which are contributed to the trust may not be sold for a significant time after the FLIPCRUT is established. This type of trust usually provides that net income from the assets will be paid to the donor until the assets are sold. After the sale, the unitrust payout percentage payments begin.

Exampl e 4

Assume that a CRUT trust pays to the income beneficiary a fixed percentage (unitrust amount) of the trust assets revalued each year. Assume further that the trust is funded with property with an initial value of $1,000,000 and that the agreed payout rate is 6%. In the first year, the payout will be $60,000. However, in the second year the property appreciates to a value of $1,100,000. Accordingly, the non-charitable beneficiary will receive a payout of $66,000.

Example 5

Assume that a NIMCRUT is established with property having an initial value of $1,000,000 with a unitrust payout rate of 6%. The income beneficiary is to receive the lesser of the specified unitrust amount or the trust's net accounting income. Any deficiency between the amount of the net income paid and the unitrust amount in any year is paid in a future year when the trust income exceeds the unitrust amount. Accordingly, if the NIMCRUT has $50,000 of net accounting income in the first year, the non-charitable beneficiary will receive the $50,000 which is the lesser of the net accounting income or the unitrust amount. Assume that in the second year the value of the trust's assets is still $1,000,000 and realizes net accounting income of $80,000. The non-charitable beneficiary will receive a payout of $60,000 (the lesser of the unitrust amount or net accounting income) plus an additional $10,000 to make up for the shortfall in the first year. The remaining $10,000 of net accounting income is added to principal of the trust estate.

WHAT ARE THE BENEFITS OF A FAMILY FOUNDATION?

A "*family foundation*" is a tax exempt entity formed to engage charitable activities where the original donor and/or one or more family members are actively involved in the foundation.

Most private foundations are nonoperating foundations (the foundation does not directly operate any charitable activity). Normally, the bulk of the nonoperating foundation's budget each

year is applied to grants to other charitable organizations which in turn provide charitable services and activities to the public.

In most cases, the motivation for establishing a family foundation is one or more of the following reasons:

- ✓ To return to society some of the family wealth accumulated through the efforts of the donor
- ✓ To reduce income tax liability for contributions to the family foundation while at the same time removing assets from the donor's estate and thus reducing estate taxes
- ✓ To promote family unity and to pass on to future generations the donor's ideas about philanthropy
- ✓ To establish an organized, systematic method of charitable giving
- ✓ To establish a lasting memorial to a family member or members

There are several different types of family foundations. Since the legal and practical advantages of each type of foundation are not the same, a brief overview of the various forms of family foundations is a good starting point for understanding these entities.

The "*Private Non-Operating Foundation*" is the most prevalent form of family foundation. It may be organized either as a nonprofit corporation or a trust; and it may have specific charitable objectives, such as funding for the arts or education, or it may have broad charitable objectives, such as funding religious, scientific, cultural, public safety or other charitable activities.

Contributions to Private Non-Operating Foundations are deductible for income tax and estate and gift tax purposes as follows:

- ❏ *Cash and Non-Appreciated Assets:* Income tax deductible at full value, up to 30 percent of the donor's contribution base (approximately adjusted gross income). Fully deductible for estate and gift tax purposes.
- ❏ *Appreciated Assets:* The owner of appreciated stock in publicly traded corporations may take a charitable deduction equal to the fair market value of a gift to a Private Non-Operating Foundation, up to 20 percent of the donor's contribution base. The owners of other types of appreciated assets (e.g., real estate, closely held stock, etc.) receive a deduction only for the donor's tax basis in the property, up to 20 percent of the donor's contribution base. Gifts of appreciated property are fully deductible for gift and estate tax purposes.

The "*Supporting Organization*" type of family foundation is designed to support one or specifically designated public charities. There are limitations on the control and supervision that may be exercised by the donor of the activities of the supporting organization.

Contributions to Supporting Organizations are deductible for income tax and estate and gift tax purposes as follows:

- ❏ *Cash or Non-Appreciated Assets:* Income tax deductible at full value, up to 50% of the donor's contribution base. Such gifts are fully deductible for gift and estate tax purposes.

- ❏ *Appreciated Assets:* Income tax deductible at fair market value, up to 30% of the donor's contribution base. Such gifts are fully deductible for estate and gift tax purposes.

A "*Private Operating Foundation*" conducts actual charitable activities, like operating an art gallery or a children's athletic center, rather than making grants to other charities. As long as the foundation conducts charitable operations, the income tax and estate and gift deductions for gifts to a Private Operating Foundation are the same as gifts to a Supporting Organization.

The "*Community Foundation Donor Advised Fund*" is a special fund established within a Community Foundation (a public charity) through which the family may advise the Community Foundation how to distribute the earnings and assets of the fund for charitable purposes. This has the advantages of using the Community Foundation's public charity status, while shifting the administration and investment responsibility to the Community Foundation. It is important to note, however, while the family may advise the Community Foundation about the use of the Donor Advised Fund, it is the board of directors of the Community Foundation that has ultimate approval authority for grants. Because the Donor Advised Fund relies upon the Community Foundation's public charity status, gifts to the Donor Advised Fund enjoy the same tax benefits of those to a Supporting Organization.

PART IV

Planning for Qualified Retirement Benefits at Death

WHAT TAXES APPLY TO POST-DEATH RETIREMENT BENEFITS?

Retirement benefits payable to the beneficiaries of a deceased person's qualified retirement plan (such as an employee pension or profit sharing plan) or individual retirement account (such as a Roth IRA, Individual Retirement Annuity, Keogh Plan or Self-Employed Retirement Plan) is an asset of the decedent's estate for federal estate tax purposes. Consequently, the value of those benefits is subject to the federal estate tax with very few exceptions.

In addition to the federal estate tax, the recipients of death benefits from a qualified retirement plan or individual retirement account (except a Roth IRA) are subject to a special income tax called the "*income in respect of a decedent,*" sometimes referred to simply as "*IRD.*" Income in respect of a decedent is income generated by an individual that is not realized until after his or her death. When the death benefit is received, it is generally treated as ordinary income and subjected to federal and state income taxes. However, the decedent's after-tax contributions to the qualified retirement plan or individual retirement account and the pure death benefit portion of any life insurance in the qualified retirement plan (there can be no life insurance in an individual retirement account) are not subject to income tax. Thus, retirement plan and individual retirement account death benefits are subject to both federal estate taxes and federal and state income taxes. The decedent's estate pays the estate tax and the beneficiary pays the income taxes. The estate tax attributable to IRD is deductible for income tax purposes. The estate tax attributable to the IRD is determined as the difference between the actual federal estate tax due from the decedent's estate and the federal estate tax that would have been due had all of the IRD been excluded from the decedent's estate.

WHAT ARE THE MINIMUM DISTRIBUTION RULES FOR RETIREMENT PLANS AND IRAs?

The Internal Revenue Code imposes a severe *50% penalty* on distributions from qualified retirement plans and IRAs which do not meet the requirement of the *minimum distribution rules*. For the owner of a retirement plan or IRA, minimum distributions are generally required at age *70 - 1/2*. For those who inherit a retirement benefit or IRA account the rules are more complicated. Prior to 2001, the rules were very complex, but in 2001, the IRS issued proposed regulations *substantially simplifying* the calculation of minimum required distributions from qualified plans, IRAs, and other related retirement savings vehicles.

The 2001 rules simplify how to determine a distribution period, ease restrictions on when beneficiaries must be designated, and clarify the rules for a surviving spouse who inherits an IRA.

The 2001 regulations have a *uniform table* for calculating minimum distributions, so taxpayers don't have to recalculate benefits annually. The table is easy to use; a taxpayer plugs in his or her birth date and most *recent annual account balance*, and in most cases the amount of the minimum distribution will be lower than under the old method and the *payout periods will be longer*. These changes mean that individuals can leave more money in their accounts and postpone taxation.

Under the old regulations, an account owner had to name a beneficiary by the required beginning distribution date or date of death, in order to retain all distribution options. The new regulations fix the time for designating a beneficiary at the end of the year following the account owner's death. This allows a taxpayer to change beneficiaries without affecting his or her minimum required distribution and permits post-death changes due to disclaimers issued by the beneficiaries. This is a significant change. Under the old rules, once an individual starting receiving distributions, the beneficiary was locked in and could not be changed.

The prior regulations stated that in the event an account owner died before reaching the required distribution beginning date, all benefits had to be paid to a nonspouse beneficiary within five years. The proposed regulations provide for a distribution over the *life expectancy of the beneficiary* (in all cases where there is a designated beneficiary).

The regulations also clarify how a surviving spouse and an inherited IRA is treated. The rules state that a spouse will be considered as having elected to be treated as the owner of the inherited IRA, only if he or she is the sole beneficiary, and has the right to unrestricted withdrawal from the account. In addition, the election will be deemed to have been made only after the distribution of any minimum required amount for the year of the account owner's death.

Under the regulations, the distribution period for annuity payments are determined using the life of the beneficiary, calculated by the starting date of the annuity, regardless of whether that date is after the account owner's required beginning date.

The regulations also permit a beneficiary to disclaim the right to collect benefits at any time before September 30 of the year after the participant's death. This will allow a contingent beneficiary to collect the benefit. This ability to disclaim will give *greater flexibility* when doing estate planning. For example, an account owner can name a spouse as the primary beneficiary and his or her children or grandchildren as contingent beneficiaries. The spouse may later find that he or she does not need the account proceeds for support. In that case the spouse can disclaim and pass the proceeds on to the children or grandchildren.

CONCLUSION

In preparing our *Client Guide to Estate Planning*, we have attempted to provide a simple introduction to many important issues and planning techniques involved in estate planning. Naturally, your estate plan must reflect your unique requirements.

The key starting point for making estate planning decisions is to complete and return to us the enclosed Estate Planning Information Organizer. Upon receipt our experienced estate planning team will review your family and asset information and will prepare recommendations to best implement your objectives.

We look forward to the opportunity to work with you to preserve, protect and pass on to your heirs the assets that you have worked so hard to accumulate.