

Estate Planning -- Are You Prepared?

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Current Status of the Estate Tax Law

2001

In 2001, Congress passed and President Bush signed legislation that called for the repeal of the Federal estate tax. Because of the vagaries of our legislative process, the repeal was to be formally instituted in 2010 and then the law would "sunset" in 2011 and we would go back to the pre-2001 rules. Since 2001, there have been numerous attempts to pass legislation to avoid the 2010 repeal and the ultimate sunset provision

2003

In 2003, the House passed legislation to abolish the estate tax beyond 2010. President Bush, a very vocal opponent of the estate tax, noted that the very legislation he signed into law does not provide families with "certainty so they can plan for the future." However, when the legislation reached the doors of the Senate, the vote on repeal was 54-44, short of the 60 needed.

2005

The Bush administration and opponents seemed to be gaining momentum on abolishing the tax permanently early in 2005. And in summer of 2005, the House again passed legislation to abolish the tax, once and for all. The Senate was expected to take up the measure when Congress returned from its summer recess. Then, Hurricane Katrina hit. When senators returned from their summer break, they were confronted with emergency aid for the states of Louisiana, Mississippi, and Alabama. An emergency aid package of \$10 billion was immediately passed and signed into law, with another \$52 billion aid package signed on September 9, 2005. Estate tax reform was off the table.

2009

With the year of "Throw Momma from the Lear Jet" quickly approaching, on December 3, 2009, by a vote of 225 to 200, a permanent extension of 2009 law was passed – by the House. H.R. 4154, the Permanent Estate Tax Relief for Families, Farmers, and Small

Businesses Act of 2009 would:

- make *permanent* the \$3.5 million estate tax exemption
- make *permanent* the 45 percent top rate.

H.R. 4154 went no further than the House and never made it into law.

2010

And now we find ourselves in 2010. Taxpayers who die in 2010 will not be subject to estate tax on their estates and the basis of their assets will be subject to a limited step-up. In anticipation of the reinstatement of the pre-2001 rules which would result in an estate tax exemption of \$1,000,000 and a top federal estate tax rate of 55%, legislators have been busy trying to work out a deal before 2010 comes to an end.

On June 2, reports came out of Washington that Senator Grassley was encouraging Majority Leader Reid to move forward on the estate tax. The reports were that Senator Grassley, who is the ranking Republican member on the Senate Finance Committee, was calling for Senator Reid to "show his cards". He indicated that he believed the Finance Committee had a deal on the estate tax worked out but that Reid would not let such bill go to a vote. Senator Grassley is concerned that if no action taken, under present law, the estate tax will come back in 2011 with only a \$1,000,000 exemption: "Reid will not really give us a clear direction," Grassley said, adding, "I think that there's going to be a tremendous upheaval at the grassroots of America – and more rural America than big city America – if it looks like we're going to revert to the million-dollar level."

On June 10, Senate Finance Committee member Jon Kyl, R-Ariz., said that he is "pretty close" to gathering the 60 votes needed to pass a bill that would establish the estate tax at a 35 percent top rate with a \$5 million exemption level. Although many Republicans have long wanted to abolish the estate tax, and many Democrats favor continuing the tax at its 2009 levels, Kyl has been among a few senators pushing for what they see as a compromise between those two approaches.

So, what is the current status of the estate tax law? It is anybody's guess. That doesn't mean, however, that you should do no planning while we wait for Washington to sort things out.

How can you protect your family?

A living trust is the typical vehicle most people use to pass their assets at death. Why? A living trust will not go through probate (which is time consuming and costly) and is not a public document (which means that no one other than your family will be able to see your wishes or know the type of assets you had at your death and their values). That being said, living trusts can be drafted in a variety of ways that may or may not protect your family after your death.

Some clients have very basic living trusts which leave everything to the surviving spouse and then to the kids. The problem with this type of trust is that it does not allow the family to maximize the estate tax credit (that \$1,000,000 number we talked about above), nor does it ensure that the survivor doesn't run off with the pool boy, leaving your children with nothing. In most cases, clients should be looking at an A-B trust or an A-B-C trust as part of their living trusts.

A-B Trust

An A-B Trust provides that at the first death, assets equal to the decedent's exemption amount (\$1,000,000) will be held in an irrevocable trust (the B Trust) for the surviving spouse's benefit. Traditionally, this trust will allow income to be distributed to the surviving spouse as well as principal, if the survivor needs it for his or her health, support or maintenance. The balance of the assets are held in the A Trust with no restrictions. By structuring the living trust as an A-B Trust, you can ensure that the exemption amount, and all future appreciation on that amount escapes estate tax at the second death. In addition, that exemption amount will not be able to be gifted to a new spouse, nor will creditors of the survivor be able to access those assets.

A-B-C Trust

The benefit of the A-B-C Trust is much the same as the A-B Trust. It allows the protection of the deceased spouse's exemption amount from future estate taxes. Going beyond the A-B Trust, however, an A-B-C Trust ensures that the deceased spouse's beneficiaries (and not the survivor's new spouse) will be the ultimate beneficiary of not just the exemption amount, but all of the deceased spouse's assets. Additionally, all of the deceased spouse's assets will be exempt from claims of the survivor's creditors.

GST Trust

GST (or generation-skipping transfer) Trusts are designed to come into place in a living trust following the death of both grantors. The name, however, sometimes fools clients into thinking that somehow we are skipping their children as beneficiaries of the trust. This is far from the truth. A GST trust is designed to allow children to live off the assets of the trust for their lifetime, often having broad powers to access the assets of the trust for their health, education, support and maintenance. There are three real benefits of this type of trust: (1) allows whatever is left in the child's share of the trust to pass to the grandchildren estate tax free (that's the generation-skip); (2) protects the child from a potential divorcing spouse; and (3) protect's the child from claims of creditors.

What can be done to minimize taxation?

There are several strategies that are excellent strategies for reducing estate

taxation at your deaths. Because of the nature of this group, I am going to focus on minimizing estate taxes on business assets.

GRAT

A GRAT (grantor retained annuity trust) is a technique that is designed to allow you to give away an income producing asset today while retaining the cash flow from that asset for a period of years. This technique works extremely well with real property that has a high cash flow, S corporations, limited partnerships and limited liability companies. The idea is that you transfer the asset to the GRAT (which is an irrevocable trust) and retain an annual distribution right based on a percentage of the value of the asset transferred into the GRAT. By way of example, assume you have a 25% limited partnership interest in a limited partnership. Assume the partnership holds assets equal to \$4,000,000. You and I may agree that the value of your interest is worth \$1,000,000, but for IRS purposes, because the interest is only a limited partnership interest, you are entitled to a discount -- for these purposes, let's assume a 30% discount (which is well within what the IRS is allowing today). So, now your interest is only worth \$700,000. If that partnership pays you \$70,000 per year (7% of the original \$1,000,000, but 10% of the discounted value) and you transfer the interest to a GRAT and retain the right to receive that \$70,000 for the next 10 years, then the value of the gift for estate and gift tax purposes is: \$108,954. If you retain the right for the next 15 years, the value of the gift is: \$0. If you live the term of the GRAT (which is a requirement for the GRAT to work, and the underlying assets appreciate from \$4,000,000 to \$8,000,000, again, you and I could agree that the value of your original interest is now worth \$2,000,000 (and if subject to estate taxes at 55%, your family would have to pay \$1,100,000 in estate taxes). If you did a 10 year GRAT, your family would pay \$59,925 (over a \$1,000,000 savings). AND, you would have had the benefit of the income for the 10 years.

You may have seen some articles calling 2010 the year of the GRAT. That's because the IRS and Congress is talking about limiting the benefits of this amazing technique. If that happens, the limitations will likely only apply to GRATs executed after the passage of a new law and any GRATs already in place will be grandfathered.

SCIN

A GRAT is an excellent tool when you have a relatively long life expectancy. But, what happens if you don't think that you have 10 or 15 or 20 years left? One option is a SCIN (self-cancelling installment note). A SCIN enables you to sell your assets to your beneficiaries or to a trust for the benefit of your beneficiaries for a note that will extinguish automatically at your death. It is a spin on another transaction -- the installment sale. With an installment sale, you sell an asset today at hopefully a low value with a high discount in exchange for a promissory note. The promissory note allows you to continue to receive cash flow from the sold asset (but maybe not at the high rate that a GRAT requires). At your death (regardless of the

appreciation of the asset), only the promissory note is included in your estate. With a SCIN, nothing is included in your estate. The catch, however, is that with a SCIN you have to add a premium for the self-cancelling feature, which means that the family needs to pay either a higher interest rate or more principal. If you live the term of the note (which cannot be longer than your actuarial life expectancy) then it is likely that the entire asset will be pulled back into your hands to satisfy the note. But, if you die during the term of the note, then nothing will be included in your estate.

INSURANCE

Ok, life insurance does not minimize taxation, but where family businesses or real estate holdings make up a large portion of the estate, it can go a long way to ensure that there is liquidity with which to pay the estate taxes. Life insurance, typically, is a "pennies on the dollar" way to ensure that your family has the money to pay Uncle Sam when the time comes. And, what is that time? Nine months after death. So, in an economy like we have today, where it will be difficult to sell something and impossible to finance an asset, life insurance may be the only tool available to pay Uncle Sam in such a short period of time.

Even if you don't like insurance as an estate tax planning tool, there is another reason to talk about life insurance in an estate plan -- estate equalization. If your son has been working in the business for the past 15 years, been taking out the paltry salary you've been giving him, all thinking that he was really working for the end result -- to own the family business, how is he going to feel when your daughter walks in after your death with an equal 50% ownership interest? Here is a great place to use life insurance to leave to your daughter to make up for what you are leaving your son. So, again, it doesn't have to be just about the taxes, there are other uses for including life insurance in your plan. If you do so, however, make sure you have talked to your lawyer first. Because, while life insurance is not subject to income tax, it is subject to estate tax, unless you structure it properly!

What are the best tools to communicate your wishes?

I don't really think there is a best "tool" to communicate your wishes, but I do think it is important to think about what you wish to communicate within that tool. A perfect example is the idea of equalizing the estate. In the example above, I mentioned that you could equalize giving the business to your son by leaving life insurance to your daughter. Is that really equal? So your son gets to continue slaving away working at the family business, while your daughter walks away with unearned, cold, hard, cash? Things are not as easy as they seem, are they?

There are several things you need to consider when drafting your estate plan. Remember, this is your last opportunity to talk to your family -- these are the last words they are going to hear from you, make sure you say what you mean. Too many times clients get dragged

into a document that reflects their lawyer's boilerplate estate plan instead of really reflecting their own family. I promise you that your children don't look like my children and don't look like the children of the guy next to you...so why would our estate plans all say the same thing: equal to the kids with distributions at 25, 30 and 35? The estate plan is a way where you can still incentivize or disincentivize your children or grandchildren well after the time you are here to do it yourself. Take advantage of that opportunity. And when someone says "that's controlling from the grave," let them know that you are not controlling from the grave, you are simply "continuing to parent."

Have you really thought through what the role is of a trustee and whether you have chosen the right person to hold that responsibility. After your death, the trustee is responsible for gathering your assets, continuing to run your business or vote the stock of your company, divide your assets, invest your assets and make distributions to your beneficiaries. How many people simply put their oldest child in this position, because "he's the oldest." If you really stopped and thought about it, is he really the right person for this position? How will this affect his relationship with his siblings? Did you pick your brother, who is great with money, but never had kids of his own? Would he really make the same decisions as you when determining whether or not to make a distribution to one of your children? Would his wife be telling him what to do? This is not just a throw away position, if you have young beneficiaries, this person may be managing their money and making distributions for decades -- is he or she going to be around that long, and if so, will they hate you for giving them this job?

There are no right or wrong answers to estate planning questions -- UNLESS your answer is "I did whatever the lawyer told me." This is your family, your business, your assets, and your estate plan -- it should be a reflection of you, not your lawyer. So, go back, look at what you have in place and figure out whether it is something you would be satisfied with if you died tomorrow.