The Five Levels of Estate Planning

By
Julius H. Giarmarco, Esq.

PREFACE

There are essentially three general strategies for reducing estate taxes. A comprehensive estate plan for persons with large estates must incorporate one or more of these strategies. The first strategy is the leveraging of cash gifts through the purchase of **life insurance** in irrevocable trusts. The next strategy is to use techniques which reduce or shift the **value** of assets. The final strategy is to implement programs which take advantage of the income and estate tax deductions for gifts to **charity**.

Estate planning specialists will tell you that there are two estate tax systems - one for the informed taxpayer and one for the uninformed taxpayer. The less you know, potentially the more the IRS takes. This brochure is intended to help put you in the informed camp - to introduce you to the strategies mentioned above so that you can become a tax-avoider instead of a taxpayer.

ABOUT THE AUTHOR

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This brochure is designed to provide accurate (at the time of printing) and authoritative information with regard to the subject matter covered. This brochure is based on the laws applicable to common law states, and not necessarily the laws of community property states. It must not be used as the basis for legal or tax advice. In specific cases, the parties involved must always seek out and rely on the counsel of their own attorneys. Thus, responsibility for modifying and guiding any party's action with respect to legal and tax matters is placed where it belongs - with his or her own legal counsel.

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I.
Level One Planning - The Living Trust

A. Situation

No estate planning in place, or present planning is outdated or inadequate.

B. Objectives

1. Defer all estate taxes until the death of the surviving spouse.
2. For married persons, take advantage of each spouse's unified credit (i.e., the $1 Million exemption commencing in 2011).
3. Avoid the delays, publicity and cost (approximately 7 1/2%) of probate in the event of death or disability.
4. Make certain that what you have goes to who you want, when you want and how you want.
5. Prevent intentional or unintentional disinheritance of children and grandchildren by surviving spouse.
6. Protect heirs from their inability, their disability, their creditors and their predators.
7. Decide who will manage the estate (i.e. personal representatives, trustees, attorneys-in-fact, etc.) and be responsible for the distribution of the assets.
8. Designate a patient advocate and state intent regarding artificial life support.
9. Designate on a separate list who is to receive items of personal property such as jewelry.

C. Tools & Techniques

1. Revocable Living Trust.
2. Pour Over Will.
3. General Power of Attorney for Financial Matters.
4. Durable Power of Attorney for Health Care/Living Wills.

D. Disadvantages

None, since grantor maintains total control over his/her assets and all documents are amendable and revocable.

THE TRANSFER TAX SYSTEM

Every U.S. taxpayer is given a tax credit, known as the unified credit (the "exemption") which protects a portion of his/her assets from estate taxes. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act"), the exemption for estate taxes is $1 Million in 2002 and then gradually increases to $3.5 Million by 2009. The Act repeals the estate tax and generation skipping tax for only one year in 2010.

Gifting during lifetime is treated differently than bequests at death. The gift tax exemption is $1 Million and remains indefinitely at that amount. Beginning in 2010, the top gift tax rate will be the top income tax rate. The exemption available at death is reduced by the exemption used to make lifetime gifts. The phase in of the rates and exemption is detailed in the table below.

In addition, the law provides an unlimited marital deduction which allows married persons to leave any amount of property to their spouse (if a U.S. citizen) free from Federal estate and gift taxes. The unlimited marital deduction was not affected by the new Act.

Beginning in 2010, after the estate tax has been repealed, the present rules, providing for a fair market value basis for property acquired from a decedent, are repealed. Instead, each decedent's estate generally is permitted to increase the basis of assets transferred, up to a total of $1.3 Million. In addition, the basis of property transferred to a surviving spouse can be increased by an additional $3 Million.

	Estate Tax		Gift Tax	
Calendar Year	Exemption	Highest Estate Tax Rate	Exemption	Highest Gift Tax Rate
2002, 2003	$1 Million	50%, 49%	$1 Million	50%, 49%
2004, 2005	$1.5 Million	48%, 47%	$1 Million	48%, 47%
2006, 2007, 2008	$2 Million	46%, 45%, 45%	$1 Million	46%, 45%, 45%
2009	$3.5 Million	45%	$1 Million	45%
2010	- 0 -	- 0 -	$1 Million	35%
2011	$1 Million	55%	$1 Million	55%

Because of the Congressional Budget Act of 1974, all provisions of the Act "sunset" (i.e., expire) on December 31, 2010, and the estate and gift tax rules in effect in 2001 are reinstated, with a $1 Million exemption. In other words, unless Congress acts before 2011 to extend the provisions of the Act, the estate and gift tax structure in effect prior to the Act will return.

For simplicity's sake, the examples and illustrations in this brochure assume that both spouses die after December 31, 2010 and, therefore, the $1,000,000 exemption applies.

It is important to remember that the size of the estate is increased by the death proceeds of all life insurance owned by the decedent on his/her life. However, no estate or gift taxes are due on transfers to a spouse (who is a U.S. citizen) because of the unlimited marital deduction.

With the typical Living Trust for a married person, the trust property is divided into two parts at the first death. The exemption amount (i.e. $1,000,000) is placed in a Family Trust (Trust B in the chart on Page 4). The balance of the trust property is placed in a Marital Trust (Trust A in the chart on Page 4). No taxes are due at the first death because the $1,000,000 exemption applies to the Family Trust, and the unlimited marital deduction applies to the Marital Trust.

Upon the second death, the assets in the Family Trust pass estate tax free to the children under the terms established in the trust. The assets in the Marital Trust are taxable, but only to the extent they exceed the surviving spouse's $1,000,000 exemption. Thus, a married couple can leave $2,000,000 to their children estate tax free!

THE ADVANTAGES OF A LIVING TRUST

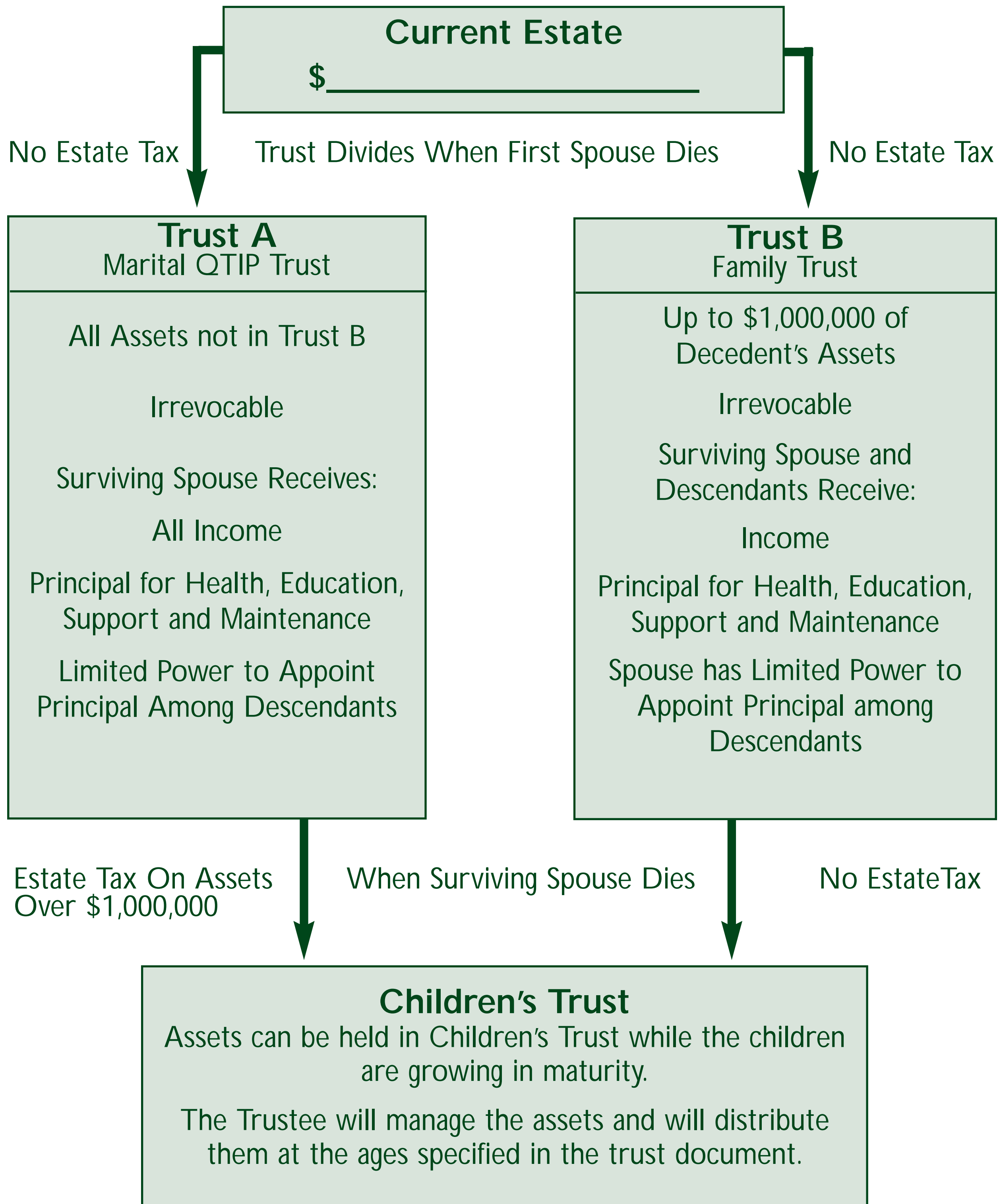
1. A Living Trust is one created during lifetime in which the grantor retains the right to revoke the trust, change its terms, and regain possession of the property in the trust. The grantor is typically the trustee of the trust during his/her lifetime.
2. With proper coordination, a married couple can leave up to $2,000,000 estate tax free to their heirs.
3. A Living Trust will minimize administration and probate costs arising at the grantor's death, since property titled in the name of the trust avoids probate.
4. Placing property in a Living Trust also avoids the necessity of a court supervised conservatorship in the event of the grantor's mental incompetence.
5. Upon death, the trust sets forth the dispositive terms for the grantor's spouse, children and grandchildren. The trust can also protect the grantor's heirs from potential creditors, including divorced spouses.

COMMON MISTAKES IN DESIGNING LIVING TRUSTS

People often execute revocable Living Trusts without really understanding their trust's provisions. For example, is the Marital Trust a so-called QTIP Trust? If not, then the surviving spouse can intentionally or unintentionally disinherit the children. Does the Family Trust allow income to be "sprinkled" to children and grandchildren? If not, the opportunity to shift income to lower tax brackets is lost. Does the trust agreement permit the trustee to postpone distributions to beneficiaries (beyond their required distribution dates) for good cause? If not, it may be impossible to protect trust assets from the beneficiaries' creditors, including divorced spouses. Do the marital and family trusts give the surviving spouse a testamentary limited power to appoint trust property among children and grandchildren? If not, considerable flexibility to reduce the income and estate taxes of the children is lost. For these and many other issues too numerous to cover here, it is advisable to have one's estate planning documents reviewed by an estate planning specialist.

LIVING TRUST DIAGRAM

The Marital - Family type of Trust is designed to make certain that the $1,000,000 exemption of each spouse is used, while allowing the surviving spouse to have use of all of the deceased spouse's assets during the remainder of his or her lifetime. The Family Trust (Trust B) is generally not taxed at either death. The Marital Trust (Trust A) is generally taxed at the surviving spouse's death.



II.
Level Two Planning - The Irrevocable Life Insurance Trust

A. Situation

Estate is projected to be over $1,000,000
($2,000,000 for married couples) at time of death.

B. Objectives

1. Remove life insurance proceeds from the insured's gross estate while still providing benefits to the surviving spouse and descendants.
2. Take advantage of the $11,000 ($22,000 for married couples) annual gift tax exclusion per donee. This exclusion is adjusted for inflation.
3. Leverage the annual gift tax exclusion through the purchase of life insurance, particularly second-to-die life insurance.
4. Use non-taxable dollars to pay estate taxes.

C. Tools & Techniques

1. Irrevocable Life Insurance Trusts.
2. Dynasty Trusts.

D. Disadvantages

1. Grantor-insured cannot act as the trustee of an Irrevocable Trust.
2. Trust is irrevocable and, therefore, cannot be amended or revoked.
3. Grantor cannot directly reach trust property (i.e. cash values) during lifetime. However, the trustee can use cash values for the benefit of the grantor's spouse and descendants during grantor's lifetime. Moreover, grantor can give certain individuals (i.e., spouse, oldest living child, brother, sister, etc.) the power to appoint trust property back to grantor.

THE "CRUMMEY" TRUST

This type of Irrevocable Life Insurance Trust is a popular device used in making gifts that qualify for the $11,000/$22,000 annual exclusion from gift tax. Most other forms of gifts that qualify for the annual exclusion require an immediate or at least a very early (i.e., age 21) distribution of the assets to the beneficiary. After 1998, the gift tax annual exclusion is indexed annually for inflation. The "Crummey" Trust takes its name from a court case upholding this type of trust and supporting its tax benefits.

Each time a contribution is made to a Crummey Trust, a temporary right (i.e., 30 days) to demand withdrawal of that contribution from the trust is available to the beneficiaries. If the demand right is not exercised, the contribution remains in the trust for management by the trustee.

Because the right of withdrawal is not usually exercised, the trustee may use the funds (income and/or principal) for some purpose desired by both the trust grantor and the beneficiaries. Paying premiums on insurance on the life of the grantor is its typical use. When the grantor-insured dies, the insurance proceeds are used to provide benefits to the surviving spouse, children and/or grandchildren. Properly structured, the insurance proceeds are not taxed in the estate of the grantor nor the estate of the grantor's spouse. Moreover, when both spouses have died, the insurance proceeds can then be used to pay the Federal Estate Tax that will be due. This is accomplished by having the Crummey Trust purchase assets from, or loan money to, the estates of the grantor and/or the grantor's spouse.

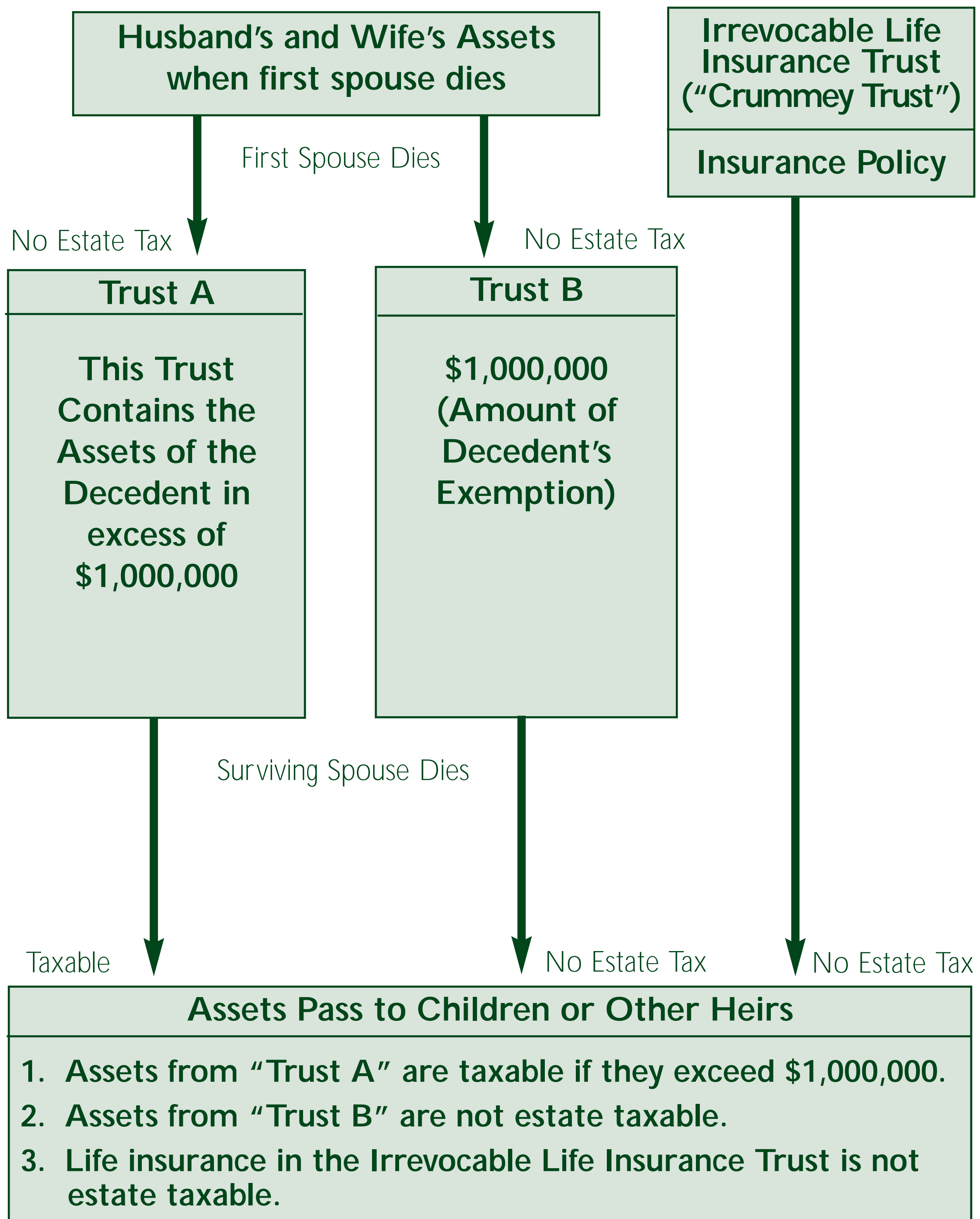
A reduction of the grantor's estate tax liability is the main advantage of the irrevocable trust. As long as the grantor-insured establishes an irrevocable trust and retains no "incidents of ownership" over the policy, and no powers over the trust that could be construed as ownership, the insurance proceeds received by the trust will be excluded from the grantor's gross estate.

For an existing policy transferred to the trust, the grantor-insured must survive at least three (3) years from the transfer of the policy to the trust. Otherwise, the insurance proceeds will be included in the grantor's estate. This three-year-rule can be avoided for a new policy by having the trust apply for the policy as the initial owner.

In funding the Crummey Trust, the vehicle of choice is invariably life insurance because: (i) it increases substantially in size upon the grantor-insured's death – both income and estate tax free; (ii) it can usually be funded with gifts qualifying for the $11,000/$22,000 gift tax annual exclusion per beneficiary; (iii) the cash value of a permanent policy permits funding flexibility since the cash values can be used to pay the premiums after a period of years; and (iv) the insurance proceeds can eventually be used to provide liquidity to pay the grantor's estate taxes.

In essence, the Irrevocable Life Insurance Trust allows death taxes to be paid *for* the estate rather than *from* the estate.

LIVING TRUST WITH IRREVOCABLE LIFE INSURANCE TRUST



GENERATION SKIPPING TRANSFER TAXES

A generation-skipping transfer ("GST") tax applies to lifetime or deathtime transfers to a member of a generation more than one generation younger than the donor (i.e., grandchildren). The GST tax is in addition to the gift or estate tax. However, there is an exemption against the GST tax. The GST exemption is $1,000,000 as indexed for inflation ($1,100,000 in 2002). In 2004 to 2009, the GST exemption is equal to the estate tax exemption, and the GST tax rate is the same as the highest estate tax rate (see table on page 2). In 2010, the GST tax is repealed. However, under the "sunset" provision of the Economic Growth and Tax Relief Act of 2001, on January 1, 2011 the GST tax is reinstated with a $1 Million exemption (as adjusted for inflation) and a flat 55% tax rate.

DYNASTY TRUSTS - LEVERAGING THE GST EXEMPTION

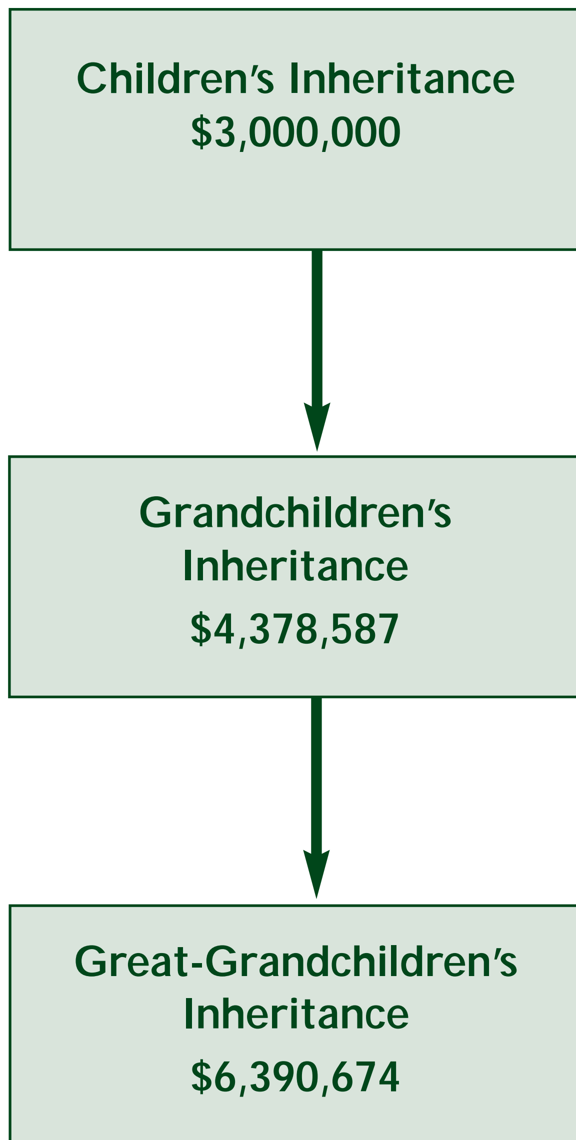
A Crummey Trust funded with life insurance can leverage a grantor's GST exemption. For example, a married couple could gift up to $2,000,000 to a Crummey Trust using the $11,000/$22,000 annual gift tax exclusion per beneficiary and/or the $1,000,000/$2,000,000 estate/gift tax exemption. The trustee could in turn use the $2,000,000 to purchase a second-to-die life insurance policy on the grantors. Let's assume this results in a $10,000,000 policy being purchased. Upon the death of the surviving spouse, the following benefits would be realized:

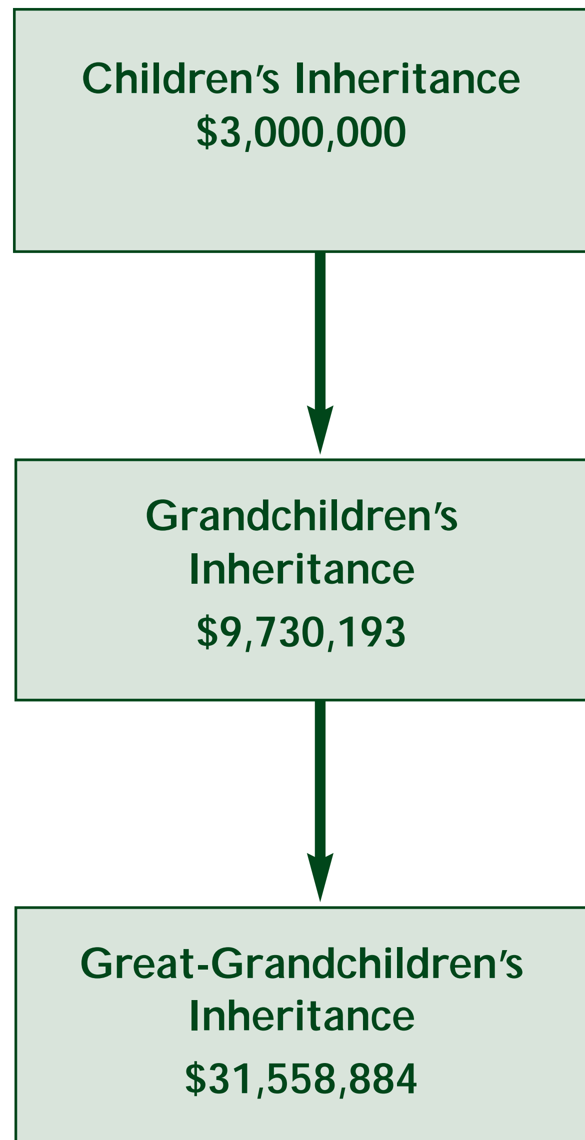
1. The entire death proceeds received by the Crummey Trust would be income tax free under Section 101(a) of the Internal Revenue Code.
2. The entire proceeds would be estate tax free because the grantors did not own the policy.
3. The children and grandchildren would receive the income from the trust and any principal needed for their health, education, maintenance and support.
4. There would be no generation skipping tax because the grantors' GST exemption was used (i.e. allocated) to make the trust "GST exempt".
5. Upon the death of the children, the property (including any appreciation) would pass *estate tax free* to the grandchildren and perhaps even the great-grandchildren.
6. The assets in the Crummey Trust would be outside the reach of the beneficiaries' creditors, including divorced spouses.

DYNASTY TRUST

Assumptions:

1. Amount of Insurance at death of surviving spouse is $3,000,000.
2. Growth rate after taxes and distributions to beneficiaries is 4% annually.
3. One generation = 30 years.
4. Federal Estate Tax = 55%.





The insurance shown above is for illustrative purposes only.
The death benefit and premium are hypothetical and do not represent any particular company or product.
Investment and insurance values are projections only, not guarantees..

SPECIAL SECTION

Keeping the Family Business in the Family

The most valuable asset in a business owner's estate is often the business itself. If the business owner's objective is to pass the family business down to those children who are active in the business, then special planning techniques are required.

Let's assume that a father is the sole owner of a corporation and that his wife is not interested in continuing the business after his death. Let's also assume that there are three children, but that only one of them is active in the business. How can the father pass the family business down to the active child, and still treat his three children equally at the death of the surviving spouse?

The simplest way to accomplish the father's objectives would be for the father and the active child to enter into a buy-sell agreement. Such an agreement would provide that upon the death, disability or retirement of the father, the active child would purchase all of the father's stock at such price and upon such terms as are set forth in the buy-sell agreement. To fund the obligation, the active child will own a life insurance policy on the father's life. The business can help the active child to pay the premiums on this policy with an annual bonus. Upon the father's death, the insurance proceeds can be used to provide income to the surviving spouse, to pay estate taxes upon the death of the surviving spouse, and to provide an inheritance for the non-active children.

To minimize the cost to the active child of purchasing the business, and to freeze the value of the business, the father could begin gifting stock to the child. The stock can be gifted outright or in trust, through the use of a Family Limited Liability Company (see page 12), or through the use of a Grantor Retained Annuity Trust (see page 17). Moreover, these gifts can be made with the father and mother's $11,000/$22,000 annual gift tax exclusion, or with their unused $1,000,000/$2,000,000 exemption. As long as the gifted stock represents a minority interest or lacks marketability, the gift will qualify for a valuation discount (see page 12).

If the value of the business, including the portion of the business gifted to the active child, makes up more than 50% of the father's estate, the estate may qualify for a "family-owned business deduction." In general, the deduction (when used <u>in</u> <u>combination</u> with the estate tax exemption) shelters from estate taxes the first $1.3 Million of value of a business interest from a decedent's estate. However, under the Economic Growth and Tax Relief Reconciliation Act of 2001, the deduction is repealed effective for estates of decedents dying after 2003, but reinstated for decedent's dying after 2010 because of the Act's sunset provision (see page 2). Moreover, overly complicated and restrictive ownership, participation and recapture rules, as well as the impact of inflation, make this deduction of little practical value to most business owners.

Finally, while gifting the business to the active child makes for good tax planning, it does not treat the non-active children equally. In such a case, it is often recommended that an Irrevocable Life Insurance Trust for the benefit of the non-active children be used as an "estate equalization" device.

III.
Level Three Planning - Family Limited Liability Companies and Valuation Discounts

A. Situation

There is a projected estate tax liability that exceeds the life insurance inside irrevocable trusts.

B. Objectives

1. Use the $1,000,000/$2,000,000 exemption to make lifetime gifts. Gifts can be of real estate, closely held stock, or publicly traded stocks and bonds. Thus, the future appreciation on the gifted property is effectively removed from the estate.
2. Take advantage of valuation discounts (for lack of control and marketability) so that (with a 40% discount) $3,333,333 of gifted assets can be "reduced" to $2,000,000 for gift tax purposes.
3. Maintain total control over the gifted property in the hands of the donor.
4. Shift income to children and/or grandchildren who may be in lower income tax brackets.

C. Tools & Techniques

1. Family Limited Liability Companies ("FLLCs").
2. Valuation Discounts.

D. Disadvantages

1. Transfers to FLLCs are irrevocable.
2. Donor loses the income allocated to the donee members.
3. Donor's heirs lose stepped-up basis on appreciated property transferred to the FLLC.

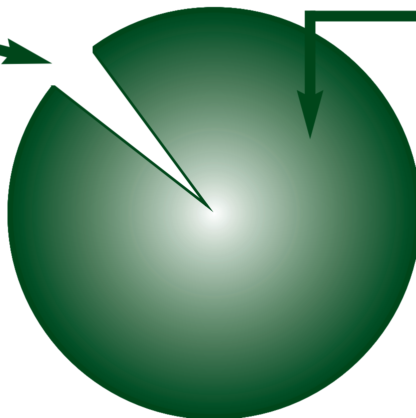
FAMILY LIMITED LIABILITY COMPANIES

A family limited liability company ("FLLC") is established as follows and will provide the following benefits:

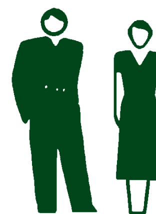
1. A donor transfers marketable securities or assets (e.g., building or equipment) to a FLLC. The donor may use multiple LLCs to further limit liability (i.e., one LLC for real estate, and another for marketable securities).
2. The donor is the "manager" and in that capacity owns a small (1%-5%) membership interest in the FLLC.
3. The donor's spouse, children and/or grandchildren (or trusts for their benefit) are gifted the non-managing membership interest, and in that capacity own the balance (95%- 99%) of the FLLC.
4. The Tax Court recognizes a *minority discount* from the full value of the membership interests gifted to children and grandchildren because such interests do not have any control over the FLLC and lack marketability. Discounts of 25% to 40% are typical, but must be determined by a qualified appraiser.
5. The FLLC can lease equipment or buildings to the donor's corporation, or to any other person or entity.
6. As manager, the donor has exclusive control and management of the FLLC's business and assets. The operating agreement permits the manager to accumulate (as opposed to distribute) profits, and the operating agreement also permits the manager to pay himself/herself a reasonable management fee.
7. The FLLC's profits are allocated to the members in proportion to their ownership interests even if not distributed. If the members are in a lower tax bracket than the donor/manager, an income tax savings will result.
8. Only the value of the donor/manager's membership interest is included in his or her gross estate - despite the fact that he or she "controlled" the FLLC.
9. The initial assets transferred to the FLLC *plus* any after-tax earnings and appreciation thereon, are removed from the donor/manager's gross estate (except to the extent of the donor/manager's membership interest).
10. Assets in the FLLC are difficult for the creditors of a member to reach.
11. The donor/manager's Crummey/Dynasty Trust can be made a member. Thus, the FLLC's income can be used to pay premiums without having to use any of the donor/manager's $11,000 annual gift tax exclusion.
12. In some states a family limited partnership instead of a FLLC may be preferable to accomplish the same results.

CREATE FLLC

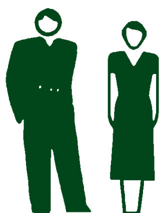
2% Managers
(Mom & Dad)



98% Members
(Mom & Dad)

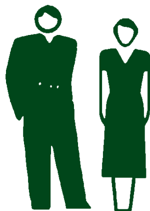


TRANSFER BUILDING TO FLLC



Mom & Dad Contribute Building to FLLC

MAKE GIFTS



2% Managers
(Mom & Dad)

33% Member
Child # 1

33% Member
Child # 2

32%
Member
Crummey/
Dynasty
Trust

SPECIAL SECTION

The Charitable Remainder Trust

A Charitable Remainder Trust ("CRT") enables an individual to make a *deferred* gift to charity, usually of appreciated assets such as marketable securities, real estate and closely held stock, while retaining a right to payments from the CRT. Since the CRT is a tax exempt entity, when it sells the appreciated assets it does *not* pay any capital gains tax. This results in increased cash flow to the donor (and the donor's spouse). Moreover, the donor is entitled to an immediate charitable income tax deduction resulting in reduced taxes. Finally, upon the death of the donor (and the donor's spouse), the assets in the CRT pass to the designated charity estate tax free!

The CRT can be a *unitrust* or an *annuity* trust. A unitrust would provide for the donor to receive a *variable* payout of a set percentage (at least 5% but not more than 50% of the initial fair market value of the trust's assets) of the CRT's *annual* value, whereas the annuity trust would provide for the donor to receive a *fixed* payout of a set percentage (at least 5% but not more than 50% of the initial fair market value of the trust's assets) of the *initial* value of the CRT. Either type of CRT can require that payments be made for the joint lives of the donor and another person, such as the donor's spouse. Moreover, the donor (and the donor's spouse) can act as the trustee(s) of the CRT.

The income tax deduction is the present value of the remainder interest passing to charity (which must be at least 10% of the initial fair market value of the trust's assets), and is based on the age of the donor (and the donor's spouse), the selected payout, the amount contributed to the CRT and the IRS' assumed rate of return (published monthly). For example, an older donor and a smaller payout will result in a larger charitable income tax deduction, and vice-versa.

Upon the death of the surviving spouse, the balance in the CRT passes to the designated charity free of estate tax because of the unlimited charitable estate tax deduction. Thus, at first blush, it would appear that the donor's children are being disinherited. However, simultaneous with the creation of the CRT, the donor will usually establish an Irrevocable Life Insurance Trust for the benefit of his/her children. This is sometimes called a "Wealth Replacement Trust." A married donor will typically use a second-to-die life insurance policy in his/her Wealth Replacement Trust. The donor will use the tax savings from the charitable income tax deduction and the increased cash flow resulting from the use of the CRT to make gifts to the Wealth Replacement Trust, thereby providing for the "replacement" of the property eventually passing to charity.

IV.
Level Four Planning - QPRTS and GRATS

A. Situation

The further need to make gifts when the $1,000,000/$2,000,000 exemption has already been used for other transfers.

B. Objectives

1. Remove property from the grantor's estate.
2. Permit grantor (and grantor's spouse) to continue using the property or the property's income for a fixed term.
3. Make substantial gifts at little or no gift tax cost.
4. Freeze the value of the property transferred.
5. Permit the grantor to maintain control over the property during the fixed term.

C. Tools & Techniques

1. Qualified Personal Residence Trust ("QPRT").
2. Grantor Retained Annuity Trust ("GRAT").

D. Disadvantages

1. Trust is irrevocable.
2. Grantor loses access to property at end of fixed term.
3. Heirs lose stepped-up basis on appreciated property.
4. If grantor dies during the fixed term, the property in trust is included in the grantor's estate.

QUALIFIED PERSONAL RESIDENCE TRUSTS

A Qualified Personal Residence Trust ("QPRT") is established and provides the following benefits:

1. The grantor's residence (or second home) is transferred to a trust, but the grantor retains the right to use the residence for a specified number of years.
2. After the fixed term ends, the property passes to the beneficiaries named in the QPRT, usually the grantor's children and/or grandchildren.
3. If the grantor wants to continue using the residence after the fixed term expires, the grantor can lease it from his or her children at fair market rental rates, which saves more estate tax by removing additional funds from the grantor's estate.
4. The creation of the QPRT involves a gift to the grantor's children and/or grandchildren of only the *remainder* interest. IRS valuation tables are used to compute the value of the grantor's right to remain in the residence for a certain number of years, and the value of that *retained* interest is subtracted from the value of the residence.
5. For example, assume a second home owned by a grantor age 65 is worth $500,000 and the IRS' assumed interest rate is 7.6%. If the grantor establishes a 10 year QPRT, with his or her children as the remaindermen, the total value of the grantor's retained interest is $322,950. Thus, the taxable gift is only $177,050 ($500,000 - $332,950). Of course, this taxable gift can be offset by the grantor's $1,000,000 exemption. Assuming the grantor survives the 10 year term, and the residence appreciates 4% per year, the potential estate tax savings will be $309,690.
6. The longer the term for the grantor's retained interest, the smaller the gift to the grantor's children and/or grandchildren. However, if the grantor does not survive the fixed term, the residence is included in the grantor's gross estate just as if the QPRT had not been created.
7. At the end of the term, the grantor can rent the residence from the children and/or grandchildren. While the rent would be taxable income to the children, the net effect is that the grantor is transferring assets (i.e., rent) to his/her children at income tax rates rather than much higher estate and gift tax rates.
8. A QPRT works best for a residence or second home that the grantor expects to hold for the foreseeable future or replace if sold.
9. A common hedge against death during the term is to insure the grantor's life for an amount equal to the estimated estate tax on the value of the residence. An insurance policy held by an Irrevocable Life Insurance Trust is an ideal hedging strategy.

GRANTOR RETAINED ANNUITY TRUSTS

A Grantor Retained Annuity Trust ("GRAT") is established and provides the following benefits:

1. Typically, Subchapter S stock which pays significant dividends and/or partnership interests with good cash flow are transferred to a GRAT. However, virtually any asset can be used.
2. The GRAT pays the grantor a fixed payment (an annuity), at least annually, for a fixed term of years.
3. After the fixed term ends, the property (plus the appreciation thereon) passes to the beneficiaries named in the GRAT, usually the grantor's children and/or grandchildren.
4. Only the value of the *remainder interest* is subject to gift tax. The value of the remainder interest, and therefore the value of the gift, is reduced by a *longer* term, a *larger* annuity, an *older* grantor, and a *lower* assumed interest rate (published monthly by the IRS).
5. For example, assume Subchapter S stock worth $500,000 (after applicable valuation discounts) is placed in a 10 year GRAT. If the grantor is age 65, and the IRS' assumed interest rate is 7.6%, the following results occur:

Annual Payment	Gift Tax Value of Remainder Interest
$30,000 (6%)	$316,553
$42,500 (8.5%)	$240,117

Note: If the Subchapter S stock is expected to produce a 6% return, that same stock discounted by 30% for lack of marketability and minority interest will, on its discounted value, produce a 8.5% return.

6. If the grantor does not survive the fixed term, the property in the GRAT is included in the grantor's gross estate.
7. A common hedge against death during the term is to insure the grantor's life for an amount equal to the estimated estate tax on the value of the property in the GRAT. An insurance policy held by an Irrevocable Life Insurance Trust is an ideal hedging strategy.

SPECIAL SECTION

"Stretch Out" IRAs

When an IRA account owner dies, the assets in his/her IRA will usually be subject to Federal and State income taxes, and Federal and State estate taxes. Substantial sums (i.e., 70% to 75% of the IRA assets) can be lost to these taxes if the IRA's beneficiary designation has not been carefully planned. The IRA account owner's objective should be to postpone, for as long as possible, the distribution of funds from the IRA (provided such funds are not needed to live on). This allows IRA assets to grow income tax deferred, thereby taking full advantage of the power of income tax free compounding.

Usually, naming the IRA owner's spouse as primary beneficiary affords the greatest flexibility in prolonging the distribution period after the owner's death. This is because upon the IRA owner's death, the spouse can elect to roll the IRA into his/her own existing IRA — both income and estate tax free! The spouse can then select new beneficiaries for the rollover IRA, such as his/her children and/or grandchildren. The surviving spouse can then defer distributions from the rollover IRA until he/she reaches age 70 1/2. Thereafter, required minimum distributions (RMDs) must be taken based on the spouse's life expectancy using the new (and improved) Uniform Table.

Upon the death of the surviving spouse, the children/grandchildren can withdraw the balance in the IRA over their life expectancy. If the spouse dies after age 70 1/2, the children can withdraw the balance in the IRA over their life expectancies. This approach makes it possible for the children/grandchildren to continue enjoying income tax deferred compounding for several years after the surviving spouse's death.

The "stretch out" IRA described above — deceased spouse to surviving spouse, surviving spouse to children/grandchildren — is usually the most effective (and popular) way to defer income taxes and thereby create wealth. However, there must be sufficient liquid assets in the surviving spouse's estate *outside* of the IRA with which to pay the estate tax that will be due on the IRA assets at the surviving spouse's death. Otherwise, the assets in the IRA will have to be distributed to the beneficiaries to pay the estate tax. In such case, the income tax deferral will be lost. Frequently, funds with which to pay the estate tax on IRA assets are provided through gifts to an Irrevocable Life Insurance Trust (see page 6).

V.
Level Five Planning - The Zero Estate Tax Plan

A. Situation

Desire to disinherit the IRS, and to choose children and charity over Congress.

B. Objectives

1. Avoid being an involuntary philanthropist (i.e., paying estate taxes and letting Congress control those funds), and instead become a voluntary philanthropist (i.e., not paying estate taxes and letting the heirs control those funds).
2. Make entire estate available to surviving spouse during his or her lifetime.
3. Provide the children and grandchildren with a desired minimum inheritance.

C. Tools & Techniques

1. Use Crummey/Dynasty Trust funded with a second-to-die life insurance policy to provide children and grandchildren with desired inheritance - income and estate tax free. Sometimes called a Wealth Replacement Trust.
2. Use Living Trust (with QTIP provisions) to provide for surviving spouse.
3. Upon death of surviving spouse, that portion of the estate over the $2,000,000 exemption passes to a private (family) foundation - estate tax free! The grantor's heirs will manage the foundation, and can receive reasonable compensation from the foundation.

D. Disadvantages

1. Grantor-insured cannot act as the trustee of an irrevocable trust.
2. Crummey/Dynasty Trust is irrevocable and, therefore, cannot be amended or revoked.
3. Grantor cannot directly reach trust property (i.e., cash values) during lifetime. However, the trustee can use cash values for the benefit of the grantor's descendants during grantor's lifetime. Moreover, grantor can give certain individuals (i.e., oldest living child, brother, sister, etc.) the power to appoint trust property back to grantor.

THE ZERO ESTATE TAX PLAN

The Zero Estate Tax Plan was first made popular by Boston attorney Gregory J. Englund in his book *Beyond Death and Taxes*. It is an approach to estate planning which results in no Federal or State death taxes being paid. The concept is best understood by way of example. The diagrams that appear on pages 21 through 23 were derived from an article that appeared in the September, 1994 edition of *Life Association News* written by Thomas F. Commito. For simplicity's sake, assume a married couple, both age 60, with a $5 Million estate, a 50% estate tax bracket, and no growth or depletion of their estate.

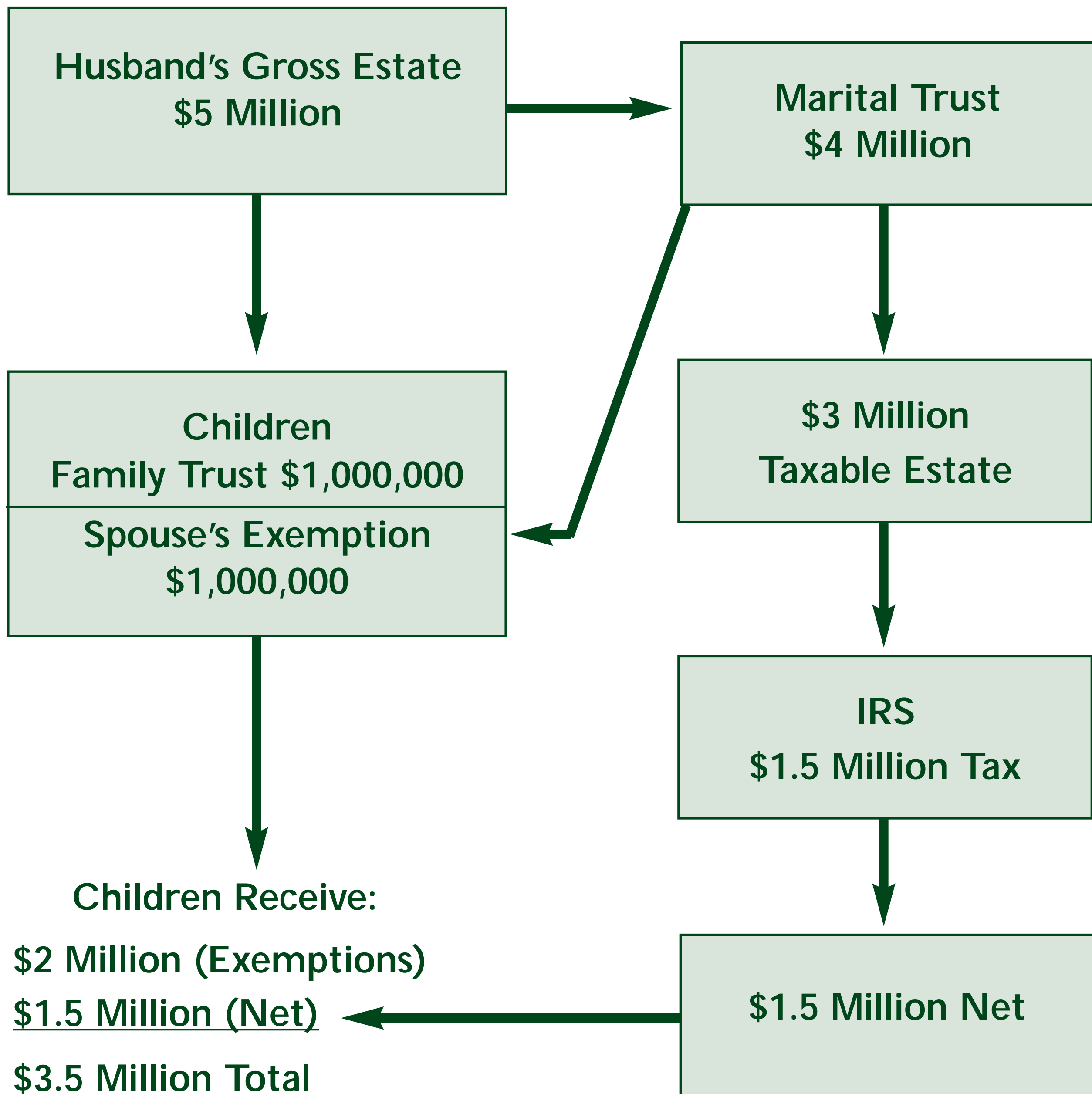
Diagram I illustrates the standard Marital-Family Trust described on pages two, three and four of this brochure. Diagram II illustrates how the children can receive the same $3.5 Million they inherit in Diagram I, but with *no* estate taxes being paid. By gifting $300,000 ($25,000 per year for 12 years) to a Crummey/Dynasty Trust (described on pages six through nine of this brochure) funded with a $1.5 Million second-to-die life insurance policy, it is possible to leave the children $3.5 Million while leaving charity $2.7 Million. The unlimited estate tax deduction for charitable bequests leaves the IRS out of the picture. In Diagram III, by increasing the gift to the Crummey/Dynasty Trust to $600,000 ($50,000 per year for 12 years), the entire $5 Million passes to the children, while $2.4 Million goes to charity and, most importantly, no estate taxes are due.

In summary, by implementing the Zero Estate Tax Plan (Diagram III versus Diagram I), the children receive $5 Million instead of $3.5 Million; charity receives $2.4 Million instead of nothing; and the IRS receives nothing instead of $1.5 Million! Moreover, the $3.5 Million the children receive in Diagram I will be taxed again at their deaths, while the $3 Million in the Crummey/Dynasty Trust illustrated in Diagram III, will not be taxed in the estates of the children and possibly even the grandchildren!

THE CHARITY OF CHOICE: PRIVATE FAMILY FOUNDATIONS

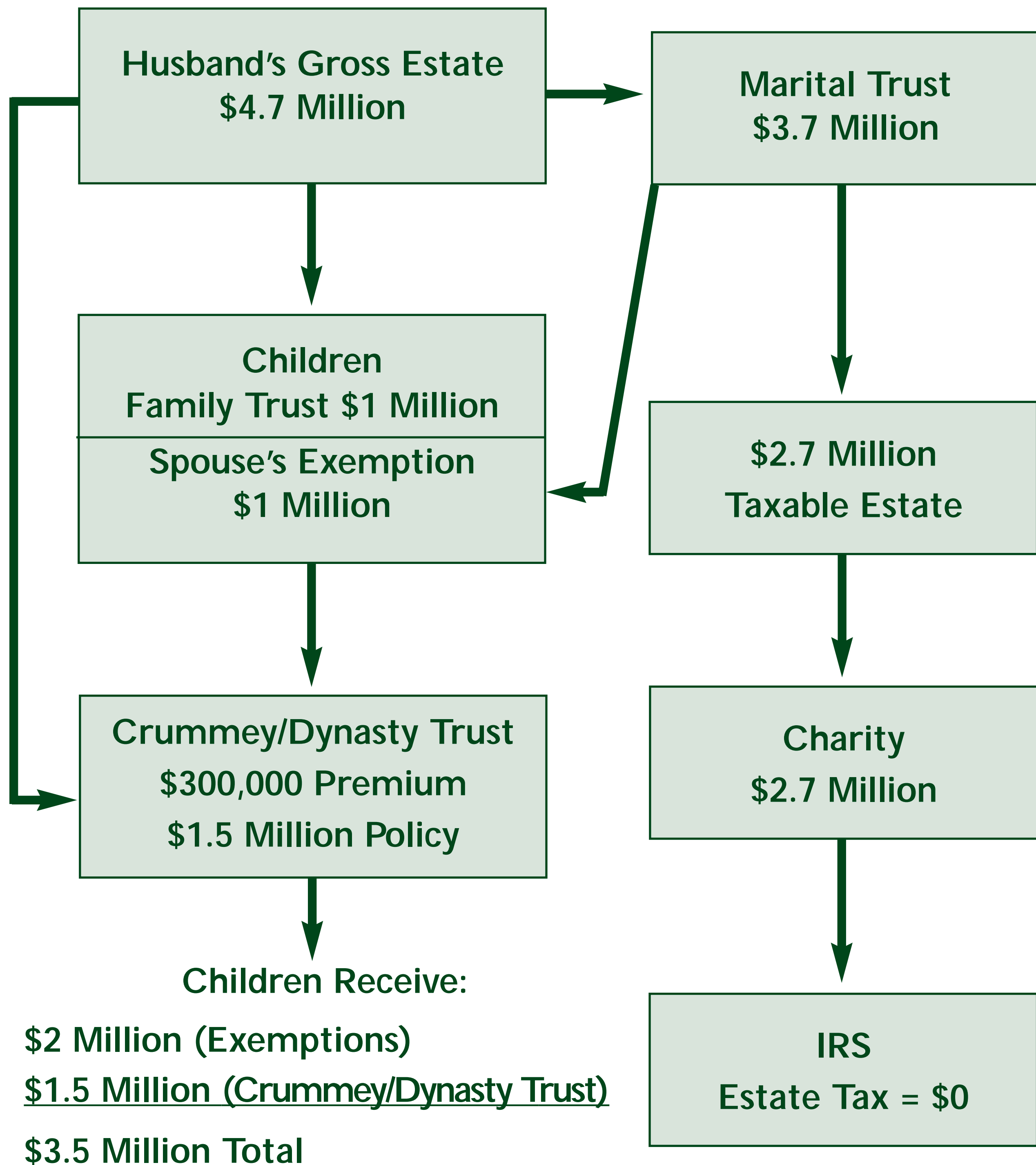
While the Zero Estate Tax Plan works with any qualified charity, the charity of choice is the donor's own private family foundation. In the context of the Zero Estate Tax Plan, upon the death of the surviving spouse, the private family foundation would receive that portion of the estate in excess of the $2 Million exemption. The foundation would carry the name of the donors and would be managed (in perpetuity) by the donor's descendants. The private family foundation is only required to make minimum disbursements (i.e., 5% of its value) each year to qualified charities. As such, the foundation will likely grow in value over the years. As directors of the foundation, the donor's descendants will learn to be altruistic and philanthropic, and will enjoy the self esteem and public notoriety that comes from benefiting charity. Finally, the directors are entitled to reasonable and customary salaries for carrying out the administrative duties of the foundation.

DIAGRAM I
MARITAL-FAMILY TRUST
$5 MILLION GROSS ESTATE



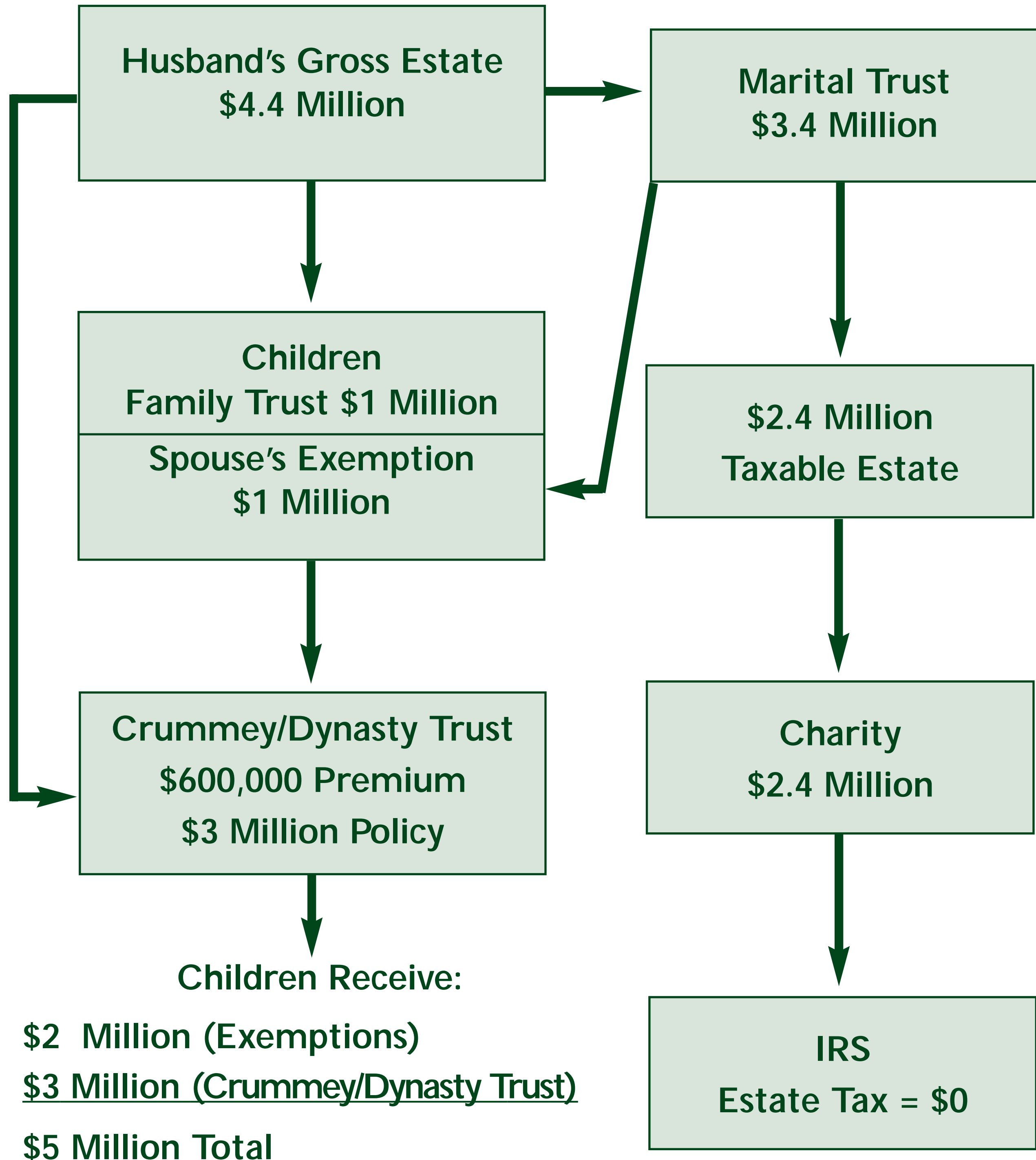
The insurance shown above is for illustrative purposes only.
The death benefit and premium are hypothetical and do not represent any particular company or product.
Investment and insurance values are projections only, not guarantees..

DIAGRAM II
ZERO ESTATE TAX PLAN
$5 MILLION GROSS ESTATE



The insurance shown above is for illustrative purposes only.
The death benefit and premium are hypothetical and do not represent any particular company or product.
Investment and insurance values are projections only, not guarantees..

DIAGRAM III
ZERO ESTATE TAX PLAN
$5 MILLION GROSS ESTATE



The insurance shown above is for illustrative purposes only.
The death benefit and premium are hypothetical and do not represent any particular company or product.
Investment and insurance values are projections only, not guarantees..

SPECIAL SECTION
Charitable Lead Annuity Trusts

A Charitable Lead Annuity Trust ("CLAT") is somewhat the opposite of the Charitable Remainder Trust discussed on page 14. While a CLAT can be established during lifetime, it is more often established upon death through a Will or Living Trust. A CLAT pays a fixed dollar amount to the grantor's private family foundation or to one or more public charities for a set term of years. When the term of the CLAT ends, the remaining assets (i.e., the remainder interest) are then distributed to members of the grantor's family (usually the grantor's children).

Since the charity receives an income stream, only the value of the remainder interest is included in the grantor's gross estate. The value of the remainder interest is based upon the term of the CLAT, the amount payable each year to charity, and the monthly IRS prescribed interest rate. For example, assume a married couple with a $5,000,000 estate leave their children the $2,000,000 exemption, and leave the remaining $3,000,000 to a CLAT. If the CLAT pays the couple's favorite charity (or private family foundation) a 10% annuity (i.e., $300,000 per year) for 20 years, and assuming the IRS' prescribed interest rate is 7.8%, the taxable estate would only be $10,200! This technique gained prominence when used by Jacqueline Onassis in her Last Will and Testament.

Since the grantor's assets receive a stepped-up basis on the grantor's death (except in 2010), there is no capital gain to the CLAT upon the sale of the assets. Moreover, if the CLAT earns more than it pays out to the charitable beneficiary, the future growth in the value of the CLAT passes to the grantor's family without further estate or gift taxes. Therefore, a CLAT works particularly well for assets expected to appreciate significantly.

A testamentary CLAT can be used to achieve a zero estate tax. However, the drawback to using a CLAT to obtain a zero estate tax is that the grantor's children may have to wait over 20 years after their parents' deaths to receive their inheritance. One solution is for the parents to make lifetime gifts of cash to an Irrevocable Life Insurance Trust funded with a second-to-die life insurance policy. Upon the death of the surviving parent, the trust can then provide the children with income and principal to maintain their standard of living until the term of the CLAT ends.

It should be noted that if the grantor's *grandchildren* are the beneficiaries when the term of the CLAT ends, the transfer will be subject to the generation skipping tax discussed on page 8. Nonetheless, a CLAT should always be considered by charitably inclined persons looking to reduce or even eliminate estate taxes.

Estate Planning Techniques That Still Make Sense Even If The Estate Tax Remains Repealed

The Economic Growth and Tax Relief Act of 2001 (the "Act") has a substantial impact on transfer taxes. However, unless re-enacted by a future Congress, these changes are merely temporary. These new laws "sunset" on December 31, 2010, and the transfer tax rules in effect in 2001 will be reinstated in 2011. (see page 2).

Accordingly, persons likely to have estates in excess of $1 Million at the time of their deaths should not postpone conventional estate planning. However, estate planning should proceed with an eye towards the possibility that estate taxes may eventually be repealed or that the exemption may be significantly increased in the future. Following is a discussion of ten techniques that will not result in any adverse tax consequences to the donor (or the donor's spouse) even if transfer taxes are eventually eliminated or substantially reduced.

1. Use The Gift Tax Annual Exclusion. Gifts of $11,000 ($22,000 for married couples) can be made annually to as many donees as the donor desires. These gifts not only reduce the donor's estate by the amount of the gift, but also by the future appreciation on the gifted property.

2. Gift The Exemption Amount. Beyond the $11,000/$22,000 annual exclusion, donors can also give away their $1,000,000 exemption. The advantage to using one's exemption to make lifetime gifts is that the future appreciation and income from the gifted property is shifted out of the donor's estate. If married, this planning opportunity doubles to $2,000,000.

3. Leverage the Generation Skipping Tax Exemption. The $1,100,000 GST exemption (indexed for inflation and doubled for married couples) can be "leveraged" by allocating it to lifetime gifts. In other words, use a "dynasty trust" in conjunction with the gifts referred to in paragraphs 1 and 2 above.

4. Leverage Lifetime Gifts with Life Insurance. Consider using lifetime gifts to purchase a life insurance policy on the donor's life, or a survivorship policy on the life of the donor and the donor's spouse. Typically, an irrevocable life insurance trust ("ILIT") will be used to own the policy. In many instances, an ILIT will provide an excellent way to "leverage" the grantor's gift tax annual exclusion, gift tax exemption and GST exemption.

5. Use CRTs While Income Tax Rates Are Higher. CRTs are widely used to avoid paying capital gains taxes when selling highly appreciated assets. If the grantor and the grantor's spouse are the only non-charitable beneficiaries, a CRT does not create any gift tax. In addition, a current income tax deduction is available equal to the present value of the remainder interest passing to charity. Since the Act also gradually reduces Federal income tax rates through 2006, the value of this charitable income tax deduction will decrease.

6. Use a Private Foundation to Front-End Load Charitable Gifts. With a private foundation, donors can donate now and decide later which charities to benefit. Since the Act also gradually reduces Federal income tax rates through the year 2006, by donating sooner than later, the donor's charitable income tax deduction will be more valuable.

7. Use a CLAT with the Remainder at the Exemption Amount. A charitable lead annuity trust is an excellent way to make a deferred gift to one's heirs at a deep valuation discount. The present value of the remainder interest passing to the donor's heirs is based on the value of the assets contributed to the CLAT, and the amount and term of the payout to the charity. By keeping the remainder valued at or below the exemption amount, no gift tax will be due. Therefore, if transfer taxes are repealed or reduced, the donor will not be disadvantaged.

8. Use a GRAT with the Remainder at the Exemption Amount. A grantor retained annuity trust ("GRAT") is another way to gift income producing assets (e.g., Subchapter S stock and family limited liability company interests) to one's heirs with valuation discounts. It is similar to the CLAT, but with the annuity paid to the donor for the set term, rather than to a charity. Again, as long as the remainder interest is valued at or below the exemption, the grantor will not be disadvantaged if transfer taxes are subsequently repealed or reduced.

9. Make Sales to Intentionally Defective Grantor Trusts ("IDGT"). In lieu of a GRAT, consider selling income producing assets to a "grantor trust" on an installment basis. Since the property is "sold" to the IDGT, there are no gift tax consequences as such. Moreover, under Rev. Rul. 85-13, a sale of property by the grantor to a grantor trust results in no capital gains tax. However, for estate tax purposes, it is recommended that some "seed" money be gifted to the IDGT prior to the sale. Usually, 10% of the value of the property sold is recommended. Therefore, a $1,000,000 gift (using the gift tax exemption) will support a $10,000,000 sale (after valuation discounts).

10. Use a QPRT with the Remainder at the Exemption Amount. A qualified personal residence trust is similar to the GRAT, but the trust is funded with a principal residence or vacation home. By retaining the right to occupy the residence for a term of years, the value of the remainder interest (and the taxable gift) is reduced. By keeping the value of the remainder interest at or below the exemption amount, no gift tax will be due.

CONCLUSION

The Act offers little benefit to taxpayers because of the sunset provision. The noted exception is for those persons who actually die in 2010. Nevertheless, estate planning documents should be drafted with flexibility so that if the estate tax is eventually repealed or substantially reduced, irrevocable transfers can be "undone".

Perhaps the most effective estate planning tool to accomplish flexibility is a "limited power of appointment". For example, the grantor of an irrevocable trust can provide in the trust agreement for a person (i.e., a family member, friend or trusted individual) to have the power to appoint trust property to the grantor, the grantor's spouse and/or the grantor's descendants (i.e., property can go to anyone other than the powerholder himself or herself). As such, if a future Congress re-enacts estate tax repeal, the powerholder could transfer the trust property back to the grantor. If properly structured, there are no tax consequences to either the powerholder or the grantor upon exercise of the power.

In summary, even for those persons who believe that estate taxes will some day be eliminated or significantly reduced, use of any one or more of the aforementioned techniques, as well as limited powers of appointment when applicable, is not only safe, but a prudent course of action.

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