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ESTATE PLANNING BASICS

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March 24, 2009
At LaTerrazza Restaurant
New City, New York

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I. INTRODUCTION

This outline is written to give practitioners an overview of the federal transfer tax system and the more common estate planning techniques utilized for clients with estates which are large enough to need transfer tax planning. For family law practitioners: divorcing spouses should be reminded they might wish to change their Wills once divorced, or even sooner!

II. ESTATE AND GIFT TAXATION

The federal transfer tax system imposes an excise tax on the right to transfer assets, whether by lifetime gift or at death. I.R.C. §§ 2001(a); 2501(a)(1). Estate and gift taxes are unified under one rate schedule. I.R.C. § 2502(a)(1). Although gifts are reported on an annual basis, all taxable transfers, whether by gift or at death, are added together at death to determine the ultimate transfer tax liability. I.R.C. § 2001(b).

A. Basics.

Though the federal transfer tax system technically operates through the use of a tax credit, most estate planning practitioners explain the operation of the tax to their clients by referring to the "exemption equivalent," which represents the amount of property sheltered by the credit which can be transferred free from tax. Prior to 2002, each person had a single "unified credit" which could be applied to offset both estate and gift taxes having a value equal to the "exemption equivalent." I.R.C. §§ 2010; 2505. On June 7, 2001, President Bush signed The Economic Growth and Taxpayer Relief Reconciliation Act of 2001 ("EGTRRA"), which had the effect of "de-unifying" the estate and gift tax. Under EGTRRA, the Internal Revenue Code now describes the unified credit as the "Applicable Credit Amount," which is the tentative tax imposed on an exemption equivalent, now called the "Applicable Exclusion Amount." For calculating the federal estate tax, the Applicable Exclusion Amount is subject to a phased-in adjustment based on the following table, but the federal gift tax is calculated as if the Applicable Exclusion Amount is $1,000,000 (thus the de-unification):

SCHEDULE A
Annual Federal Exemption Amounts

Calendar Year	Estate Tax Exemption	GST Tax Exemption	Gift Tax Exemption
2002	$1 Million	$1.06 Million*	$1 Million
2003	$1 Million	$1.06 Million*	$1 Million
2004	$1.5 Million	$1.5 Million	$1 Million
2005	$1.5 Million	$1.5 Million	$1 Million
2006	$2 Million	$2 Million	$1 Million
2007	$2 Million	$2 Million	$1 Million
2008	$2 Million	$2 Million	$1 Million
2009	$3.5 Million	$3.5 Million	$1 Million
2010	(tax repealed)	(tax repealed)	$1 Million
2011 and thereafter	$1 Million	$1.06 Million**	$1 Million

* Adjusted for inflation.
** Adjusted for inflation from 2001.

SCHEDULE B
ESTATE AND GIFT TAX RATES

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
$ 1,000,000 - $ 1,250,000	41%	41%	41%	41%	41%	41%	41%	41%	41%	*	41%
$ 1,250,001 - $ 1,500,000	43%	43%	43%	43%	43%	43%	43%	43%	43%	*	43%
$ 1,500,001 - $ 2,000,000	45%	45%	45%	45%	45%	45%	45%	45%	45%	*	45%
$ 2,000,001 - $ 2,500,000	49%	49%	49%	48%	47%	46%	45%	45%	45%	*	55%
$ 2,500,001 - $ 3,000,000	53%	50%	49%	48%	47%	46%	45%	45%	45%	*	53%
$ 3,000,001 - $10,000,000	55%	50%	49%	48%	47%	46%	45%	45%	45%	*	55%
$10,000,001-$17,184,000	60%**	50%	49%	48%	47%	46%	45%	45%	45%	*	60%
$17,184,0001 and higher	55%	50%	49%	48%	47%	46%	45%	45%	45%	*	55%

* Although the current law provides for no federal estate tax rate in 2010, gifts shall continue to be taxed. The rate shall be the top individual income tax rate.

** Shows the applicable 55% highest rate plus the 5% surcharge to offset the advantages of lower rates for smaller estates.

As the table illustrates, there will be no estate tax imposed on estates of decedents dying in 2010. However, the gift tax, with its $1 million exemption, continues to apply, and the so called "repeal" of the estate tax, along with the phased in increase in the Applicable Exclusion Amount is itself repealed for deaths after December 31, 2010 when the provisions of EGTRRA "sunset". Accordingly (unless the law is changed again), in 2011 the federal estate and gift tax system will return to the old unified system with a $1 million exemption applying to both lifetime gifts and transfers at death. This outline will assume all deaths occur in 2008, and therefore will utilize a $2 million Applicable Exclusion Amount.

B. Rates.

Once the $1,500,000 tax-exempt amount has been exceeded, the minimum effective tax bracket is 43%. I.R.C. § 2001(c)(1). The top effective bracket was 47% in 2005, and, in 2007, the top rate became 45%. Again, however, these rate reductions will sunset in 2011, and the top bracket will return to 55%.

C. Annual Exclusions.

The Code provides that annual gifts of up to $13,000 per donee can be made without using any of the Applicable Exclusion Amount, so that a married couple can give $26,000 per year to any number of donees without tax impact. This $13,000 per donee amount is referred to as the "annual exclusion." I.R.C. § 2503(b). The Taxpayer Relief Act of 1997 ("TRA '97") provides for an inflation adjustment of this amount beginning in 1999, but the adjustment is rounded to the next lowest $1,000. The annual exclusion is now $13,000. Also excluded from gifts are the costs of tuition paid directly to a college, and costs of medical care paid directly to a care provider. I.R.C. § 2503(e).

D. Unlimited Marital Deduction.

A 100% deduction (commonly referred to as the "unlimited marital deduction") is allowed for the value of property transferred between spouses whether during lifetime or at death. I.R.C. § 2056; 2523. In addition, certain types of transfers in trust to a spouse will also qualify for the unlimited marital deduction if certain conditions are met. The transferee spouse must be a U.S. citizen, and the assets transferred to a spouse that qualify for the marital deduction are included in the estate of the transferee spouse upon his or her death.

E. Adjusted Basis At Death.

Interests includible in a decedent's gross estate for federal estate tax purposes are given a new basis equal to their date-of-death value. I.R.C. § 1014. Therefore, valuation of assets for federal estate tax purposes has important consequences for purposes of computing capital gain under the federal income tax. To provide parity in the tax treatment of marital property between community property and common law states, the entire interest in community property is given a new basis on the death of one spouse, even though only the deceased spouse's one-half community interest is includible in his or her gross estate. I.R.C. § 1014(b)(6). Though commonly referred to as the "stepped-up basis rule," it must be noted that assets that have

declined in value will receive a step-down in basis. It is also important to note that a ***carryover basis rule*** applies to ***lifetime gifts****;* accordingly, for purposes of computing capital gain on assets transferred during lifetime, the donee takes the donor's basis.

III. BASIC TESTAMENTARY PLANNING FOR MARRIED COUPLES.

A. Bypass Trust.

A fundamental technique of estate planning for married couples involves the use of a trust in testamentary planning. This trust along with the unlimited marital deduction insures that a married couple takes advantage of each of their $2,000,000 Applicable Exclusion Amounts, so that an aggregate of $4 million can pass to the children without estate taxation. The trust used for this purpose is commonly referred to for convenience as the "Bypass Trust."

1. <u>Estate Tax Savings.</u>

Assume husband ("H") and wife ("W") have a $4.2 million community estate, with each spouse thus having an estate of $2.1 million. Under the unlimited marital deduction, H can leave his entire estate to his W outright without taxation. Assuming no inflation or growth in the assets, upon W's death, this would expose $2.2 million ($4.2 million estate, less W's Applicable Exclusion Amount of $2.0 million) to estate tax, resulting in a federal estate tax of $990,000. This can be avoided by having H leave $2.0 million of his estate to a Bypass Trust and $100,000 outright to W. The $2.0 million is tax-free when H dies (due to his Applicable Exclusion Amount), and the trust assets are again tax-free when W dies (since the trust is not part of her estate). The $100,000 also passes to W tax free due to the marital deduction. At W's death, in 2008 also, again assuming no inflation or growth in the assets, the value of her estate is $2.2 million (her $2.1 million, plus the $100,000 she inherited from H). The $2.0 million placed in the Bypass Trust is not taxed at W's death, regardless of the value of the property at that time, and W's estate of $2.2 million will be able to utilize her Applicable Exclusion Amount of $2.0 million. The estate tax on the remaining $200,000 will be $90,000, resulting in a savings to the children of $900,000 ($990,000 less $90,000). If she dies in 2009, there will be zero tax due to the higher applicable exclusion amount.

2. <u>Typical Bypass Trust Provisions</u>.

Typical Bypass Trust provisions would include:

a. Distributions of trust income and corpus are permitted for the health, support and maintenance of W. This "ascertainable standard" health, support and maintenance for making distributions prevents the trust assets from being part of W's estate, even if she is the trustee of the trust. I.R.C. § 2041; Treas. Reg. § 20.2041-1(c)(2).

b. Distributions to descendants from the Bypass Trust are also permitted. However, since the assets of the Bypass Trust will not be subjected to estate tax in W's estate, it is generally advisable that assets which are included in her estate for

estate tax purposes be distributed to descendants before making distribution of trust assets.

c. W is given a "special" or "non-general" power of appointment to direct disposition of trust assets to descendants by her Will or during her lifetime, which permits W to take a "second look" at family needs/circumstances in deciding how assets should be distributed.

B. Marital Deduction "QTIP" Trusts.

As the example above clearly shows, where the deceased spouse's estate exceeds $2.0 million, the use of the Bypass to shelter the Applicable Exclusion Amount with the excess of the estate passing to the surviving spouse in a form that qualifies for the unlimited marital deduction can save estate taxes for the couple's descendants while leaving the entire estate for the benefit of the surviving spouse. There are two ways to handle disposition of the excess amount that passes to the surviving spouse, and still qualify for the marital deduction.

1. Directly to Spouse.

As in the example, the excess can pass directly to the surviving spouse. This is most often accomplished by using a marital deduction formula clause in the Will.

2. To Marital Trust.

There are many instances, however, where an outright bequest to the surviving spouse may be inappropriate. These include: where the surviving spouse is not a U.S. citizen; where the excess amount is expected to be quite large; where there are children from prior marriages; where the surviving spouse is concerned about protecting inherited assets from attachment by her creditors; where the surviving spouse requires management assistance; or where the deceased spouse wants to insure that his or her portion of the estate will ultimately pass to particular persons (often the deceased spouse's children from a prior marriage) upon the death of the surviving spouse. Under any of those circumstances, it may be best to place the "marital deduction" portion of the estate into a marital trust.

a. Normally, a gift to a trust for the surviving spouse does not qualify for a marital deduction, since the spouse's interest in the trust terminates at his or her death and the value of the spouse's interest in the trust at the second death is therefore zero. I.R.C. § 2056(b)(1). In 1982, Congress addressed this issue by providing for a type of qualifying trust, which would provide a lifetime benefit for the surviving spouse even though it terminates upon his or her death. A marital deduction is allowed for this trust, even though the surviving spouse only receives a "terminable interest" in property, if it is properly drafted. A trust with the qualifying terms is called a "qualified terminable interest property trust," or "QTIP Trust." I.R.C. § 2056(b)(7).

b. In order to qualify for the marital deduction when H dies, the QTIP Trust must include the following provisions:

(1) W must be the only beneficiary of the QTIP Trust during her lifetime.

(2) W must receive all the income annually. I.R.C. § 2056(b)(7)(B)(iii)(I).

(3) W must have the power to require that trust assets be made income-productive. Treas. Reg. §§ 20.2056(b)-7(c); Treas. Reg. § 20.2056(b)-5(f)(5).

(4) Principal distributions are not a requirement. In the typical situation, however, W is given access to the principal (if needed) for her health, support, education and maintenance.

(5) H's Will generally specifies the distribution of after-tax assets upon W's death. W can, however, be given an opportunity to modify the distribution scheme through a testamentary power of appointment.

c. At W's death, the QTIP Trust's assets are taxed as though they were part of W's estate. I.R.C. § 2044(b)(1)(A). H's estate must elect this treatment in writing when H dies. I.R.C. § 2056(b)(7)(B)(v). Unless W's Will provides otherwise, the tax is paid *by the trust* when W dies (not from W's own assets). I.R.C. § 2207A. The tax borne by the trust is based upon the amount by which taxes increase as a result of adding the value of the trust at W's death to the balance of her estate.

d. Another important reason for use of a marital deduction trust is the preservation of the first spouse's "generation-skipping" exemption. This topic is discussed in greater detail in Article V, section 4 below.

e. Finally, as mentioned above, no deduction is allowed for outright transfers to a spouse who is not a citizen of the United States. In those circumstances, a marital deduction may be generated only through the use of the "Qualified Domestic Trust" that complies with the requirements of I.R.C. § 2056A.

IV. "DECOUPLING" OF THE FEDERAL AND STATE ESTATE TAX SYSTEMS AND USE OF "DISCLAIMER TRUSTS".

A very effective tool is still a "Disclaimer Trust" which can be part of a Last Will and Testament or, for example, a Revocable Trust. The surviving spouse may disclaim, into the credit shelter trust, either the total amount of the gap between the Federal Applicable Exclusion Amount (i.e. currently $3.5 million) and New York State's Applicable Exclusion Amount (i.e. currently $1 million) or some lesser amount as determined at the time of the disclaimer. The advantage is flexibility. The requirements for a valid disclaimer are technical and strict adherence is required (Code §2518).

Married couples should consider using a Disclaimer Trust and the following decoupling examples from New York, Connecticut and New Jersey shed light on why estate planning with Disclaimer Trust is effective in reducing estate taxes. Notwithstanding the state estate tax problem, which is significant, a Disclaimer Trust is also useful when dealing with an impractically high

Applicable Exclusion Amount when balancing a surviving spouse's needs for unfettered cash, liquidity and autonomy.

New York: Unless the New York State legislature specifically enacts legislation to incorporate the changes made by the 2001 Act, estates of New York decedents will be subject to the state death credit in effect in 1998. This has effectively resulted in the resurrecting an estate tax, which had been repealed as of February 1, 2000. This occurs as a result of the provisions of Section 951(a) of the New York State Tax Law which provided that for the purposes of Article 26's estate tax provisions "any reference to the Internal Revenue Code means the United States Internal Revenue Code of 1986, with all amendments enacted on or before July twenty-second, nineteen hundred ninety-eight…." Barring action by the New York State legislature, a New York decedent dying after 2001 will still be subject to the 16% top rate.

Before January 1, 2009, for married couples, paying $99,600 was an acceptable trade-off for sheltering an additional $1 million from federal estates taxes. However, in 2009, now that the Federal Applicable Exclusion Amount has increased to $3.5 million, the gap in New York has increased from $1 million to $2.5 million. If the unified credit shelter trust were fully funded with $3.5 million, the New York State estate tax would be $229,200. This is much too significant an amount to ignore.

New York State does not permit a separate state QTIP election. Therefore, the Disclaimer Trust is an especially valuable tool in New York.

Connecticut: Connecticut's transfer tax applies to (a) gifts made after December 31, 2004 above the federal annual gift tax threshold (which currently is $13,000 per year per donee) which in the aggregate exceed $2 million over the donor's lifetime; (b) the estate of a decedent who dies after December 31, 2004 if the taxable estate exceeds $2 million, and (c) the estate of a decedent dying after December 31, 2004 if the combined value of the decedent's Connecticut taxable gifts made after December 31, 2004 and the decedent's taxable estate exceeds $2 million. The tax rates range from 5.08% to 16%. This transfer tax is called a "cliff tax", in that while the first $2 million of aggregate transfers are tax free, if the aggregate transfers exceed $2 million, then all the transfers from $1 on up are taxable! In addition, the estate transfer tax system allows an estate to make an independent QTIP election for Connecticut estate tax purposes whether or not the estate also makes a QTIP election for federal estate tax purposes.

New Jersey: New Jersey enacted an estate tax (P.L. 2002, Chapter 31) on the estate of every resident decedent dying after December 31, 2001, which would have been subject to an estate tax payable to the United States under the provisions of the Internal Revenue Code in effect on December 31, 2001. The amount of the New Jersey tax is the maximum state death tax credit that would have been allowable under the Code as in effect on December 31, 2001. For example, if the unified credit bequest equaled $1 million, there would be a New Jersey estate tax due of $33,200. In Oberhand v. Director, Division of Taxation, 193 N.J. 558, 9420 A.2d 1202 (2008), the Supreme Court of New Jersey found that the amendment was constitutional but that the application retroactive to December 31, 2001 violated the doctrine of "manifest injustice". There is an alternative to this method which is the amount determined using a "simplified tax system" based on the $675,000 unified estate and gift tax applicable exclusion amount provided in the Internal Revenue Code, but the simplified method cannot be used if the taxpayer files or is required to file a Federal return. The legislation was implemented by rule amendments published on April 7, 2003 and were scheduled to expire on March 17, 2008. The

amendments provide that a New Jersey estate tax return must be filed whenever the gross estate as determined in accordance with the provisions of the Code in effect on December 31, 2001 exceeds $675,000. In New Jersey, an estate can make a separate QTIP election only when a federal estate tax return is not required.

V. COMMON TRUST PLANNING FOR DESCENDANTS OF MARRIED OR SINGLE PEOPLE.

The foregoing material deals with testamentary planning when one spouse dies, a person who has become divorced or for a person who never married. Just as important to married couples as it is to single parents is planning for their respective descendants when a parent or both parents have died.

1. Trusts for Minor Children.

Couples with minor children often utilize trusts in their Wills to hold assets after both of their deaths. Such trusts enable a trustee to administer this property without the cost and inconvenience associated with a court-supervised guardianship proceeding. The trusts can continue until the children have reached a sufficient age to manage the property prudently. At the designated time (selected by the parents), the trust assets are often distributed outright to the children. However, in many instances parents will choose a lifetime trust for children.

2. Distribution Provisions.

A child's trust can have distribution provisions, which accomplish the desires of the parents.

a. Like the Bypass Trust, distributions are typically permitted for health, support, maintenance and education of the child and the child's descendants. Again, if the child is or may be the trustee (or is given the power to replace the independent trustee) the same "ascertainable standard" is utilized as was used in the Bypass Trust. I.R.C. § 2041(b)(1)(A).

b. The child is usually given a "power of appointment" to direct disposition of the trust assets at death.

(1) Generally, the trust is not intended to eliminate a child's use or control of the trust assets.

(2) If the parents want to control the ultimate distribution of trust assets, the power of appointment can be restricted or eliminated.

3. Advantages of Lifetime Trusts.

There are many advantages of a lifetime trust arrangement, as opposed to outright distribution.

a. Although the child can benefit from the income and invasions of principal at certain set stages, the trust property cannot be reached by claims of creditors if the trust so provides.

b. Assets in the trust can be protected in the event of a divorce.

c. Management assistance can be provided for a child until a designated age, or for lifetime if needed.

d. At the child's death, a portion of the trust assets escapes taxation upon passage to the third generation.

4. <u>The Generation-Skipping Transfer Tax</u>.

a. The Tax Reform Act of 1986 instituted a third transfer tax, which is imposed on transfers from grandparents to grandchildren, either directly or through a trust which passes to a second generation. The tax rate on generation-skipping transfers is equal to the top estate tax rate. I.R.C. §§ 2621, 2622.

b. Each person has an exemption from the generation-skipping transfer ("GST") tax of $1 million. I.R.C. § 2631(a). TRA '97 increased this exemption for inflation beginning in 1999, rounded down to the nearest $10,000; and for years after 2003, the GST exemption equals the estate tax exemption. Accordingly, a married couple can now place $4 million in trust for their descendants. If properly structured, the trust property is available to the children as needed, but to the extent that the children do not consume the trust property, the entire $4 million *(plus growth)* escapes taxation when the trust assets ultimately pass to the grandchildren.

c. If the initial value of the property placed into trust exceeds $4 million, the excess may potentially be subject to the GST tax. Typically, amounts in excess of $4 million are placed into separate trusts for the children. The children are then given a general testamentary power of appointment over this excess trust, so that any property in this trust will be taxed at the child's death at estate tax rates (ranging from 0% to 45%), instead of being subject to an automatic GST tax at the highest estate tax rate. *See* I.R.C. § 2612(a)(1)(A). The trustee is often directed to distribute assets from the non-exempt trust to the children prior to distributing any funds from the exempt trust, so that the value of the former trust is minimized at the time of the child's death.

VI. COMMON LIFETIME PLANNING TECHNIQUES WITH MARRIED OR SINGLE CLIENTS

A. Irrevocable Life Insurance Trust ("ILIT")

An ILIT is a trust, which is created during the lifetime of the insured individual under a life insurance policy. Generally, the trust's only asset is the policy. The purpose of an ILIT is to remove the death benefit paid under the policy from estate taxation.

B. Grantor Retained Annuity Trust ("GRAT")

A GRAT is a trust to which a Grantor contributes assets, and retain a right to receive payments from the Trust during a fixed term. If the Grantor outlives the term of the trust, the assets remaining in the trust at termination belong to the remainder beneficiary, and are removed from the Grantor's estate. This technique can allow a person to transfer an asset's appreciation to the next generation with no gift taxation.

C. Charitable Remainder Trust ("CRT")/Charitable Lead Trust ("CLT")

A CRT is a trust to which a Grantor contributes assets, and retains a right to receive payments from the trust during a fixed term. At the end of the term, the assets remaining in the trust pass to a charitable remainder beneficiary. This technique is often utilized when a person with charitable motives owns an asset with a low income tax basis. By transferring the low basis asset to a CRT, it can be sold without triggering an immediate capital gains tax. Accordingly, if structured properly, the Grantor can increase his or her cash flow, receive an immediate income tax deduction and ultimately benefit his or her favorite charity. A CLT is a trust to which a Grantor contributes assets and provides that a charity is to receive payments for a fixed term. At the end of the term, the assets remaining in the trust pass to a non-charitable reminder beneficiary (usually Grantor's children). This technique allows a person with charitable motives to potentially transfer assets to his or her children with no transfer taxes.

D. Qualified Personal Residence Trust ("QPRT")

A QPRT is a trust to which a Grantor transfers his or her residence, retaining the right to use the residence for a fixed term. At the end of the term, the residence passes to the remainder beneficiary (again, typically the Grantor's children). At the end of the term, the Grantor can reserve the right to lease the residence from the remainder beneficiaries. This technique allows a person to transfer a residence to his or her children at a reduced gift tax cost.

E. Intentionally Defective Grantor Trust ("IDGT")

An IDGT is a trust, which is structured to be a Grantor Trust for income tax purposes. This will cause all income of the trust to be taxed to the Grantor, and will also prevent a sale to the trust by the Grantor from triggering capital gains taxes. Accordingly, it is utilized when a Grantor desires to sell an appreciating low basis asset to his or her children without triggering tax.

F. Family Limited Partnership ("FLP")

A FLP is a limited partnership formed to hold the family business or investments. Gifts of limited partnership interests are made to children. Since the limited partner's interests are generally unmarketable, they should be subject to significant discounts and the parent is reducing his estate by a greater amount than the gift made. Example. If the property in the FLP is really worth $100K, but you've taken a 25% discount, you have used up only $75,000 of your $1 million lifetime gift exemption.

G. Annual Gift Tax Exclusion

Each year, a donor may gift $13,000 per donee. With large families or friends involved, this can significantly reduce a person's taxable estate without triggering a gift tax or using up any of the $1 million lifetime gift exemption.

VII. CONCLUSION

Hopefully, this article sheds light on some of the key federal transfer tax concepts and viable estate planning techniques. This writer's goal is to familiarize practitioners with these concepts and practice techniques.

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