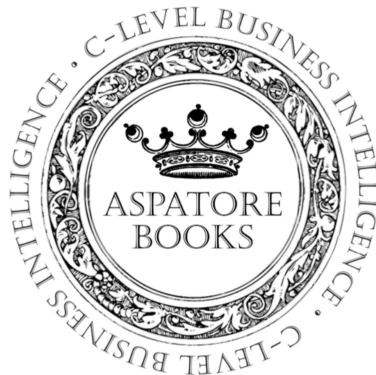
INSIDE THE MINDS

Trusts and Estates Legal Strategies

Leading Lawyers on Drafting an Estate Plan, Implementing Clients' Objectives, and Understanding Tax Complications



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For corrections, updates, comments or any other inquiries please email
TLR.AspatoreEditorial@thomson.com.

First Printing, 2008. Second Printing, 2009
10 9 8 7 6 5 4 3 2 1

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Estate and Transfer Tax Planning

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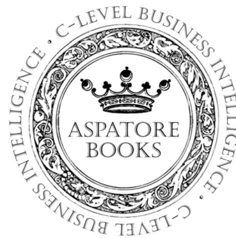

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Components of Trusts and Estates Law

Trusts and estates law provides the framework for planning for people and their assets during their lifetime and after death. The two temporal components are connected and subsumed under the heading of "estate planning," or "trusts and estates." The focus of pre-death and of post-death planning is different, however. (Included as Appendix A is a general outline of estate planning concepts and techniques covering all of these concepts.)

Pre-death estate planning involves planning for people and their assets to achieve personal and tax objectives. The benefits for a client, when these objectives have been achieved, are peace of mind and tax reduction. Peace of mind derives from having in place a plan that makes sense to the individual, putting tax considerations aside. Typically, this includes estate planning that provides for the contingency of incapacity; provides for the disposition of assets on death and perhaps during the donor's lifetime; provides for distributions to charity; provides in a reasonable way for children and others through trusts for children or other management vehicles; and puts in place operational mechanisms to achieve all manner of personal and family objectives. Estate planning allows a person to "survive himself" in the sense that he or she has made provisions to be operative during life and after death.

In addition to obtaining the peace of mind that comes from having in place sensible planning for oneself and one's family, a primary focus of estate planning is to minimize the transfer tax impact otherwise applicable to people with substantial assets. Transfer tax is a collective term for three taxes levied by the federal government, and additionally by some states: a tax on the transfer of assets during a person's lifetime, called the gift tax; a tax on the transfer of assets at a person's death, called the estate tax; and a tax on transfers to grandchildren or more remote descendants, called the generation-skipping transfer (GST) tax. There are threshold amounts before the tax applies. However, above the thresholds, a tax rate of 45 percent applies to the net value of the assets transferred. Planning to reduce or even avoid the impact of such a substantial tax is a primary focus of an estate planning attorney. (See Appendix B for a description of erosion of assets by taxes.)

Post-death trusts and estates planning involves the implementation and administration of the pre-death planning. If the decedent had a will, the process involves a probate administration, which is a court-supervised proceeding by which the decedent's will is executed by the decedent's representative named in the will, called the executor. Because probate administration can be cumbersome and expensive in many states, a popular alternative to planning with a will is the incorporation of the planning in a revocable trust. With a revocable trust, a person changes title to his or her assets during lifetime from his or her individual name to himself or herself as trustee of the trust, and names a successor trustee to step in upon incapacity or death. In that way, the successor trustee can take over for the person upon incapacity or death, and a probate administration is not required.

Notwithstanding this era of legal specialization, trusts and estates attorneys are often the "family lawyer," in the traditional meaning of the term. Estate planning applies to everyone at some level because of the fundamental pre-death and post-death components noted above. Therefore, for many people, their initial contact with an attorney is an affirmative contact for estate planning rather than a forced contact related to a conflict. An estate planning attorney is typically involved in planning for a person's most personal aspirations and objectives. In such a role, the estate planning attorney often becomes a primary trusted adviser for the person. As such, if or when legal matters do arise in the person's life—real estate matters, contract matters, even litigation matters—the trusts and estates attorney will often be the point of first contact. As a concomitant, an experienced trusts and estates attorney often has basic knowledge and experience in many areas of the law and, as a result, may be well suited to serve the role of family attorney.

Planning Preliminaries

Planning to reduce or avoid a 45 percent transfer tax is a primary focus of trusts and estates law. To the extent that the planning is successful, great benefit and financial value is conferred on the client.

A basic example is credit shelter planning. The estate tax applies to estates in excess of a threshold amount, which is $3.5 million in 2009. For a

married couple, the exclusion amount applies to each spouse. However, if the plan of the first spouse who dies leaves everything outright to the surviving spouse, the first spouse's exclusion is not used and is, effectively, forfeited. Assets that pass outright to a spouse qualify for a marital deduction and are not subject to tax on the death of the first spouse. Such outright distribution planning is very common. Indeed, in many states, in the absence of any planning at all, state law would cause the first spouse's assets to pass outright to the surviving spouse. The marital deduction, however, is only a deferral of tax because, in return for the assets not being subject to tax on the death of the first spouse, the assets will be taxed as part of the surviving spouse's estate at their then value.

Basic and standard transfer tax planning involves setting aside the first spouse's exclusion amount ($3.5 million in 2009) in trust for the surviving spouse, or for the surviving spouse and children. The assets so set aside and administered separate from the surviving spouse's assets will not be subject to tax at the death of the surviving spouse. This includes the full future value of the assets, not just the original exclusion funding amount. This planning is the standard "A-B trust" plan. The benefit is that the assets set aside in trust at the death of the first spouse can be excluded from the taxable estate of both spouses, while still providing benefits to the surviving spouse, or to the surviving spouse and children or others.

Parallel planning can be done to plan for the GST tax with an exemption amount provided with respect to that tax. The exemption amount is $3.5 million in 2009. This is the same dollar amount as the estate tax exclusion, but it is a different tax. Planning with the GST exemption involves retaining in trust assets that would otherwise be distributed to children, in the same way A-B trust planning involves retaining assets in trust for the surviving spouse. Leaving aside other benefits of retaining assets in trust, such as management of the assets and protection of them from creditors, assets retained in trust can benefit the children but then pass on to the grandchildren free of estate tax or GST tax at the children's generation level.

For the gift tax, the exclusion amount is limited to a lifetime cumulative amount of $1 million. In addition, each person can make non-cumulative gifts each year of $13,000 to any number of donees. A husband and wife

can make annual gifts of $26,000, even if only one spouse's assets are used to make the gifts. Making regular annual exclusion gifts is a very effective way to reduce the future transfer tax otherwise payable on the assets, especially if the gifted assets appreciate over time. The transfer tax reduction will be enhanced if the assets gifted can properly be valued at a discount. This would be the case if the gifted assets were non-controlling, non-marketable interest in an entity such as a closely held company or partnership, or an undivided interest in real property.

In addition to planning with the gift tax and estate tax exclusions and the GST tax exemption, an estate planning attorney may plan within the tax law and regulations to make value "disappear" for transfer tax purposes. The estate planning techniques described below set forth some of the ways this may be done. The essence of the planning, however, is based on valuing and shifting assets or their value to children or others to avoid transfer taxation on a greater value at a future time. A simple example is a single annual exclusion gift made by parents, when they are both forty and who live to be eighty-five. The $26,000 annual exclusion gift will not be subject to tax at the time of transfer, nor will its future value be subject to tax in the estates of the parents. That $26,000 gift, if invested for the forty-five-year period between the date of the gift and the deaths of the parents at 6 percent, would grow to the amount of $357,880. That amount, taxed at the parents' estate level would generate an estate tax of $161,046, which is completely avoided by the annual exclusion gift. If annual exclusion gifts are made every year to several donees, the amounts that can be transferred over time and sheltered from transfer tax are quite substantial.

Human nature being what it is, many people defer attending to estate planning, which has both tax and non-tax disadvantages. On the tax side, delay is expensive. As demonstrated by the simple example above involving a couple's single annual exclusion gift to a child, substantial tax saving benefits can be achieved. On the non-tax side, although people may not like to consider their own mortality, and some may even believe planning for it will hasten their death, it is foolish not to have a reasonable plan in place, as well as inconsiderate to one's family. Even though death may appear to be remote, the tax and non-tax reasons for planning should make obvious the advisability of having in place a sensible estate plan.

More affirmatively, people invariably derive great peace of mind from the planning. Because estate planning applies to everyone to some degree, the non-tax reasons for planning apply literally to everyone. For example, every adult should have a durable power of attorney and an advance health care directive.

In addition to putting in place a sensible plan, the plan should be reviewed from time to time as circumstances in a person's life change. Events such as marriage, birth of a child, and inheritance are obvious changes that should be taken account of. Also, a person's estate planning objectives, goals, and aspirations for his or her beneficiaries, charitable wishes, and other areas of importance should be reviewed from time to time.

Many people believe estate planning simply to be a matter of filling in forms. Standard approaches in planning and drafting may apply for people with modest assets and straightforward objectives. For many, however, what is important is the experience and judgment a trusts and estates attorney brings to bear in deciding upon the structure and dispositive components of the estate plan. Even if the planning makes use of drafting modules and commonly used *pro formas*, the most valuable parts of the planning are the judgments and decisions of the attorney that are brought to bear throughout the planning and drafting process.

Trusts and estates attorneys tend to be extremely organized, detail-oriented, and thorough. These traits serve a particularly useful purpose in the area of estate planning. An estate planning attorney must thoroughly analyze a client's situation and think through what planning makes the most sense. Effectively, once a trusts and estates attorney understands the client's situation, he or she can make judgments about how best to plan and draft in a very personal and focused way. Effectively, the attorney will do the worrying for the client.

An experienced estate planning attorney is able to navigate the non-tax objectives and the trusts and estates and tax-related issues that permeate the area. On the non-tax side, an experienced attorney is able to assist clients in thinking through how best to plan and draft for their own personal objectives. On the tax side, the attorney is able to help clients reduce transfer taxes otherwise eventually payable.

I define success as conferring on my clients the peace of mind that comes from having in place a comprehensive, sensible plan that contemplates and provides for essentially all contingencies, and that achieves substantial transfer tax savings in the form either of reduced transfer taxes payable or of value shifted to the client's beneficiaries at reduced or no transfer tax cost.

Because trusts and estates attorneys are thorough, detail-oriented and organized, they are motivated to keep up on current developments related to trusts and estates through daily reading. The area of trusts and estates is a substantive and internally consistent universe such that, over time, an attorney can acquire a comprehensive understanding of it. Perhaps because of that, everything related to the area seems useful and important to the attorney, which leads the attorney to a focused effort to stay on top of the area by reading. In addition, because trusts and estates attorneys focus primarily on planning, drafting, and tax matters rather than on adversarial matters, they are typically very collegial with fellow attorneys. As a result, there is a generous sharing of information and ideas among these attorneys that enhances their knowledge for the benefit of their professional development and their ability to assist clients most effectively.

Legal Strategies Not Directly Related to Minimizing Transfer Taxes

Revocable Trust

A revocable or "living" trust is a vehicle established by a "trustor" (or "grantor" or "settlor") for the disposition of the trustor's assets at death, as well as for the management of assets during the trustor's lifetime. The primary advantage of a living trust is that assets transferred to that trust during lifetime avoid probate administration at death, thereby reducing costs upon death and enabling assets to be transferred more quickly to the beneficiaries. In addition, the trust and its administration are private, whereas probate administration is a matter of public record. To avoid probate, a revocable trust requires that title to each asset be formally transferred to the trust (i.e., to the trustee of the trust, who is typically the trustor) during the trustor's lifetime. Although a revocable trust avoids probate administration and statutory fees, administrative work is still required on the death of the trustor. However, it may be done more

expeditiously and less expensively than through a probate administration. There are other considerations relevant to the decision to use a revocable trust that should be discussed in the context of the overall estate planning objectives.

Planning for Incapacity

Durable powers of attorney can be an effective and inexpensive means of providing for incapacity. There are two kinds of durable powers of attorney: for property and for health care. The power for property enables one (the principal) to designate a person or persons, called the attorney-in-fact, to handle property and financial matters in the event of incapacity or other inability to act. Similarly, a power for health care enables the principal to designate a person to make health care decisions in such an event. The power for health care is typically combined with an advance health care directive, which permits one to express his or her wishes regarding the use of life-prolonging treatment and to give special instructions regarding medical decisions. The durable powers of attorney are relatively simple to prepare and may serve to avoid the significant time and expense of conservatorship proceedings in the event of incapacity.

Character and Title Issues

Consideration should always be given to the character of property as between community property and separate property, and as to the form of ownership of assets (e.g., community property, joint tenancy, corporate ownership, etc.). Generally, for assets owned jointly by a married couple, community property character and form of ownership is best. A primary benefit of community property is that, on the death of either spouse, the basis of the entire property, including the surviving spouse's half of the property, is increased to its fair market value for income tax purposes. As a result, the surviving spouse can sell the property without incurring any taxable gain.

Beneficiary Designations

Certain assets, such as retirement plan benefits and insurance, do not pass according to the terms of a will or trust. Such assets pass according to

beneficiary designations. It is important, therefore, that the beneficiary designations of such assets be coordinated with the estate planning objectives and documents.

Legal Strategies Related to Minimizing Transfer Taxes

General Principles

A transfer tax is imposed on lifetime transfers, called the gift tax; on transfers at death, called the estate tax; and on transfers to persons more than one generation below the donor, called the generation-skipping transfer (GST) tax. Subject to exclusion amounts for the gift tax and estate tax, and an exemption amount for the GST tax, the tax rate on transfers is 45 percent. Minimizing transfer taxes is a primary focus of estate planning.

Planning Techniques

The following techniques can reduce transfer taxes while still getting the assets, or the benefit of the assets, to the intended beneficiaries.

Marital Deduction

There is an unlimited marital deduction for property passing to a person's spouse either by gift or at death. As a result, it is possible to avoid all death taxes in the estate of the first spouse to die, regardless of the size of the estate. Many estate plans take advantage of the unlimited marital deduction by passing nearly all of the first spouse's property outright to the surviving spouse. This avoidance is actually a deferral, however, because the assets will then be subject to tax in the estate of the surviving spouse. Although most people choose to defer the tax because of a desire not to pay taxes any sooner than necessary, it may make economic sense to pay some tax at the death of the first spouse because of the graduated estate tax brackets and because the future, appreciated value of the assets can then avoid taxation at the death of the second spouse.

An important point regarding the marital deduction, although not directly related to taxes, is the provision in the law that permits a transfer to a spouse to qualify for the marital deduction for transfer tax purposes, but by

which the donor spouse can control the ultimate disposition of the property. Such an arrangement is a qualified terminable interest property, or Q-TIP, trust. It is of particular use for GST tax planning and for fractionalizing assets that may be taxed in the second spouse's estate, because such fractionalization will reduce their value for tax purposes.

Applicable Exclusion

The applicable exclusion, formerly known as unified credit, is the mechanism by which transfers of up to $3.5 million (in 2009) are sheltered from estate taxes. Typically, the applicable exclusion amount is coordinated with the marital deduction by having the applicable exclusion amount placed in a non-marital deduction trust drafted to avoid inclusion in the surviving spouse's estate. This is known as a bypass or credit shelter trust. (See Appendix C.)

It makes sense to use the applicable exclusion amount to shelter lifetime transfers from gift tax. For lifetime gift purposes, the applicable exclusion amount is $1 million and is not scheduled to increase. Some of the techniques described below are designed to transfer actual value that is greater than the value for gift tax purposes and for calculating the applicable exclusion required to shelter the transfer from gift tax. This leveraging is important because, for estate tax purposes, the gift tax value of any transfer is included as part of the estate for estate taxation. However, any undervaluation for gift tax purposes—from legitimate discounting, from outperforming the IRS valuation tables, from appreciation—is shifted free of transfer tax.

Annual Exclusion Gifts

Generally, gifts made during the lifetime of the donor reduce the applicable exclusion amount available at death. However, annual exclusion gifts of $13,000 per donee can avoid all gift, estate, or GST tax, and do not reduce the applicable exclusion amount. Unlike the applicable exclusion, annual exclusion gifts are not cumulative. Exclusion gift transfers can be made year after year. A regular program of annual exclusion gifts can make possible the transfer of a significant amount of property free of tax over time, because each such transfer saves the future value of $5,850 in tax when

compared with a taxable transfer. Another way of looking at it is that, for a donee to receive $13,000 through an estate at death, estate property of nearly $23,636 would be required before the 45 percent federal estate tax. As with the applicable exclusion, leveraging techniques can increase the effective dollar value of the annual gift tax exclusion.

Payment of Gift Tax

After the applicable exclusion and annual exclusions are used, actually paying gift tax may make sense economically. Compared with paying an estate tax on transfers at death, paying a gift tax for lifetime transfers is more tax-efficient for three reasons. First, the amount paid in gift tax is not itself subject to tax, as is the case with an amount paid as estate tax. For example, if a gift of $1 million is made through an estate, the entire amount is subject to estate tax and a tax of $450,000 is payable (at a 45 percent rate). Assuming the tax is paid from the gifted funds, the donees would receive $550,000. If $1 million is used for gift purposes, however, about $690,000 would be received by the donees because the tax is based only on the amount given. Thus, a gift of $690,000 would generate a tax (at a 45 percent rate) of $310,000. Second, the amount paid in gift tax is not included as part of the donor's estate if the donor lives at least three years beyond the gift. This results in a savings equal to the estate tax rate times the amount of gift tax paid, at the cost of the loss of the use of the funds used to pay the gift tax. Third, if appreciated property is given as a gift, a portion of the gift tax paid is added to the basis of the property, but not above fair market value of the property. This reduces the capital gains tax payable on the sale of the property by the donee.

Grantor Trusts

To maximize the amount transferred to a lower generation, it may make sense to use the transfer techniques described briefly below to make gifts to children and grandchildren in trusts that are drafted to cause all trust income, including capital gains, to be taxed to the grantor rather than the trust or the beneficiary. Such trusts are called "grantor trusts" or "intentionally defective grantor trusts." (See Appendix D. and *Sale to Grantor Trust* below). Retaining the obligation to pay income tax may seem undesirable, but it is excellent estate planning. The theory is the same as noted above with respect to the payment of gift tax, but is even broader. By

the grantor's paying the income tax, the grantor is not only removing the amount paid in tax from the grantor's estate. The grantor is also effectively making a tax-free gift to the trust beneficiary, because the trust or the beneficiary would otherwise have had to pay the income tax. In Revenue Ruling 2004-64, the IRS ruled formally that a grantor's payment of the income tax with a grantor trust is not a taxable gift.

GST Tax

The GST tax is imposed on transfers of property, whether outright or in trust, to persons who are more than one generation below the transferor's generation. The tax is in addition to the estate or gift tax, and is imposed at the maximum rate of those taxes, currently 45 percent. Planning for the GST tax makes sense where property that passes to children may not be consumed during their lifetimes and, therefore, will ultimately pass to grandchildren. (See Appendix E.)

Each person has an exemption from the GST tax of $3.5 million (in 2009). Planning for the GST tax would involve retaining a portion or all of each child's share in trust for the child's lifetime, and perhaps beyond, to reduce taxes at the child's death. By utilizing each spouse's GST exemption, a total of $7 million (in 2009) worth of property, plus all post-transfer appreciation, could be passed to the grandchildren's level, and future levels, undiminished by the GST tax or by estate taxes in the children's estates. The children could be beneficiaries and even trustees of the GST trusts during their lifetimes. Also, an independent (non-beneficiary) trustee could have the power to distribute the property of the trusts to the children if that were ever advisable or necessary.

Assets in the amount of the GST exemption may be placed in a long-term trust, often called a GST-exempt dynasty trust. Many states have abolished the rule against perpetuities, which requires trusts to end after a maximum period of about one hundred years. In those states, trusts can last indefinitely. Moreover, some of those same states (e.g., Delaware, South Dakota, Alaska) have no state income tax. Therefore, a dynasty trust established in such a state could last literally forever and, if or when the trust is not or is no longer a grantor trust, state income taxation could be avoided on accumulated income and capital gains. The

tax savings of this type of planning over the generations would be substantial.

Life Insurance Trust

An irrevocable life insurance trust does not reduce the tax that must be paid, but it generates cash proceeds to pay estate taxes or to achieve other estate planning goals without the insurance proceeds themselves being subject to tax. This is a great benefit because, normally, insurance is an asset like any other, such that the proceeds payable on death are subject to tax. However, if the insurance is not owned by the insured but is owned either by the children or by an irrevocable trust, the proceeds would not be subject to tax. The use of an irrevocable insurance trust can be particularly effective with joint and survivor life insurance, which pays benefits only after the death of the second spouse, which is when the estate taxes would ordinarily be payable. (See Appendix F.)

Life insurance may be combined with a charitable remainder trust because the extra cash flow generated by a charitable remainder trust can defray the cost of the insurance premiums. Also, if a charitable remainder trust is used, the insurance can serve to replace the remainder interest that is distributable to charity and not to the donor's family. In that way, one can obtain the benefits of a charitable remainder trust without losing the value of the principal placed in the trust.

Qualified Personal Residence Trust (QPRT)

A technique for leveraging the transfer of assets to children during the lifetime of the donor is the QPRT. (See Appendix G.) A QPRT is actually a grantor-retained income trust, funded with a personal residence. The technique involves placing a residence in trust for a term of years by a transfer that is a completed gift at inception. The grantor, typically a parent, retains the right to live in the residence for the fixed term. At the end of the term, the property, or other assets then in the trust, passes to the children or (preferably) to a grantor trust for the children. QPRT planning is an excellent way to "leverage" transfers to children, meaning the actual economic value of the transfer is greater than the value for gift tax purposes. The leverage, or discount, results from determining the value of the gift at inception by subtracting the value of

the parents' retained interest for the term of the QPRT. The actuarial valuation that is permitted to be used for a QPRT overvalues the interest retained by the grantor and is locked in as soon as the trust is created. In addition, if the property appreciates over the term of the QPRT, the discount is effectively increased.

The specificity of treasury regulations on QPRTs is helpful, because one can be comfortable that the technique will not be challenged by the IRS. On the other hand, complying with the regulations necessitates a trust agreement that is rather complicated conceptually and in the provisions that must be included. The complexity represented by the trust agreement would not be felt from an operational standpoint, however. The technique does not require the grantor to live or operate differently.

For people with a taxable estate who want to reduce the potential transfer taxes payable but who are reluctant to reduce their own cash flow, QPRT planning offers the following particular advantages:

1. A QPRT gift transfer does not involve giving up liquid assets or cash flow.
2. The existence of the planning is "invisible" during the term of the QPRT.
3. The transfer tax discount (leverage) makes QPRT planning a good use of applicable exclusion.
4. QPRT planning is a no-lose planning technique because, if the QPRT grantor should die during the QPRT term, the applicable exclusion used for the QPRT gift would be restored and the QPRT residence would revert to the grantor's estate for disposition thereunder.

Notwithstanding the estate planning benefits, a parent should not implement a QPRT unless the parent is willing to have the residence pass to the children or to a trust for the children at the end of the QPRT term. At that point, to remain in the house, the parent must pay rent. Although renting one's own house may seem anomalous, it achieves a distinct estate planning benefit by passing money, in the form of rent, to the next generation. Moreover, if the remainder is distributed to an income tax grantor trust, the rental payments should be non-taxable.

A perceived economic negative of QPRT planning is that, when the residence passes to the children or to a trust for them, it retains the parent's income tax basis. As a result, if or when the children sell the residence, a capital gain will be incurred. The current maximum capital gain rate is 15 percent, however, and the effective estate tax being avoided is 45 percent. The applicable exclusion used or gift tax paid on establishing a QPRT plus the capital gains tax on sale should be less than an estate tax on the whole of the residence.

Grantor Retained Annuity Trust (GRAT)

A GRAT involves placing assets in a trust for a term of years during which a fixed amount, known as an annuity, is paid annually to the grantor. (See Appendix H.) As with a QPRT, the value of the completed gift transfer at inception is determined by subtracting the value of the annuity interest retained by the grantor for the term of the GRAT.

The estate planning benefit of GRAT planning is that a grantor can transfer to children or to a trust for children, at no gift tax cost, the total return (income plus appreciation) of the funding assets in excess of an interest rate return set by the IRS for the month of inception (e.g., 2.6 percent for April 2009). No gift is triggered by the transfer of assets to a GRAT, because the annuity paid to the grantor is calibrated to equal the initial value of the assets used to fund the GRAT plus an amount equal to the IRS assumed interest rate return.

Although grantor-retained income trusts are no longer available for transfers to family members, except for personal residence trusts, a GRAT is potentially a useful leveraging vehicle. Indeed, the use of a GRAT is a no-lose proposition because no gift tax need be paid and the potential exists to shift great value to children. For example, assets could be placed in a GRAT structured (by calibration of the annual annuity amount and the term of the trust) to be a gift to children of nominal value. However, the amount by which the actual pre-tax total return (income plus appreciation) from the assets exceeds the IRS's assumed interest rate at inception passes transfer tax-free to the children or to a trust for the children.

- *Funded with an appreciating asset.* The traditional use of a GRAT is to fund the GRAT with assets that are expected to appreciate. No gift tax is incurred on funding because of the retained annuity. The total return of the assets during the GRAT term in excess of the IRS assumed interest rate at inception passes to children free of tax at the end of the term.
- *Funded with an asset that can be discounted.* Funding a GRAT with an asset that can be discounted is economically the same as funding a GRAT with an asset that appreciates to the undiscounted value of the asset. The annuity that must be paid to the grantor is based on the discounted value rather than the real value of the funding assets. This reduces the annuity needed to reduce the GRAT gift to zero, and ensures that more value will pass gift tax-free at the end of the GRAT term.

A large initial funding of one or more GRATs should not necessarily cause the grantor concern. With a traditional GRAT, the entire value of the funding assets (plus the IRS assumed interest rate return) will return to the grantor by the annuity payments. With a GRAT funded with discounted assets, the discounted value of the funding assets, plus the interest rate return, will return to the grantor.

<u>Interests Valued at a Discount</u>

For transfer tax valuation purposes, the value of an undivided interest in real property or a minority interest in a closely held business—including a limited partnership or limited liability company the client might create—may qualify for a substantial discount relative to the underlying value of the real property or assets of the business entity. (See Appendix I.) A discount may be claimed because such an interest represents a fractional, non-controlling interest in the real property or the business entity that confers no rights to the underlying assets or to the management of the business entity. In addition to a discount for lack of control, an interest of this nature would generally be difficult to sell, which supports an additional discount for lack of marketability. The order of magnitude of the combined discounts may yield a reduction from the underlying value of the assets of more than 35 percent. Such a discount means that, in valuing a transfer of such an interest, 35 percent or more of the real value of the assets is made to disappear for transfer tax purposes.

Direct Gifts. Because of the ability to make value disappear for transfer tax valuation purposes by transferring interests in real property or a closely held business, direct gifts of such an interest serve to transfer greater value than the value for gift tax purposes. This is called leverage. Such transfers are a good use of the lifetime gift tax exclusion, which is limited to $2 million combined for a husband and wife. In fact, because of the estate planning benefits of leverage, it can make economic sense to transfer amounts in excess of the applicable exclusion amount and pay gift tax.

Dynasty Trust. The direct gift transfers could be made to a trust established in a state that has no rule against perpetuities and no state income tax, such as Delaware, South Dakota or Alaska. GST exemption would be allocated to the trust. Such a trust would protect the assets in the trust from transfer tax and from state income tax indefinitely. For that reason, such trusts are referred to as GST-exempt or dynasty trusts.

Sale to Grantor Trust. Although a direct gift of an asset that can be discounted is a good method to leverage available gift tax exclusion, a gift tax will be payable for transfers above the exclusion amount. Substantial value can be shifted at no gift tax cost by selling an asset that can be discounted for an installment note to a trust that is ignored for income tax purposes but not ignored for estate and gift tax purposes, called a "grantor trust," or an "intentionally defective grantor trust." Such assets could include an interest in real estate or a closely held business, including a partnership or a limited liability company created by the client. Because a grantor trust is ignored for income tax purposes, one could sell a discountable interest and realize no capital gain on the sale. Moreover, because the interest would be transferred to a trust for children and grandchildren, there would be no gift because the transfer would be pursuant to a sale. The trust would need to pay off the installment note over time, so there would be cash flow issues similar to the issue of paying the annuity with a GRAT. Beneficially, because the trust and sale are ignored for income tax purposes, the interest payments to the grantor on the note would not be taxable income. (See Appendix J.)

From an estate planning standpoint, the interest that is sold would be removed from the grantor's estate. The payments on the promissory note would be included in the grantor's estate, but the total value of those payments will have been frozen at the initial discounted value of the interest sold. A subsidiary estate planning benefit is the fact that the income earned by the trust going forward would be taxable to the grantor rather than to the trust or the beneficiaries because of its grantor trust status. Effectively, the grantor's payment of the trust's income tax would constitute tax-free gifts to the trust and its beneficiaries, and the trust could grow as a tax-free vehicle with respect to both ordinary income and capital gains. In addition to the positive value-shifting effect of this arrangement, the grantor's payment of the income tax would serve to reduce the grantor's estate. Assuming a 45 percent estate tax, the estate tax savings would be substantial. Although paying income tax on the transferred interest might not seem pleasant, a way to look at the cash flow component is that the government is effectively paying 45 percent of the amount paid in income tax, because that amount would otherwise be siphoned off in estate taxes.

For the transaction to have economic substance, the purchasing trust would need to have assets with a value of at least 10 percent of the value of the interest that is to be purchased. Often, a grantor will use all or much of the lifetime gift tax exclusion ($1 million) as "seed money" to fund the trust. If no gift exclusion remains available, then putting such a trust in place would entail gift tax consequences.

When the grantor is deceased and the purchasing trust is no longer a grantor trust, the trust could be moved to a state with no state income tax. In addition, those states also have no rule against perpetuities. This means that, if the trust were established in such a jurisdiction from inception, the benefits of the transaction could be realized for several generations rather than by the next generation only.

A concomitant advantage of planning with assets that can be valued at a discount (e.g., undivided interests in real property or minority interests in a closely held business, including a client-created limited partnership or limited liability company) is that the interest in the real property or entity that is retained by the estate owner may itself be valued at a discount for federal estate tax purposes.

Charitable Trusts

Transfers of property to charity are deductible for estate and gift tax purposes. This reduces the effective cost of making a contribution to charity. (See Appendix K.) One form of charitable giving is a charitable split interest trust. This involves a gift of property to a charitable trust in which a private non-charitable interest is retained. The interest may be either an income-type interest or a remainder interest. The use of charitable trusts may be particularly advantageous, even in the absence of strong charitable motivation, because of the economic and tax benefits such trusts can provide.

Charitable Remainder Trust. A charitable remainder trust is established for a term that can be for the life of the donor or for a term of up to twenty years. The donor retains an economic interest in the form of payments that may be either a percentage of the value of the trust revalued each year, known as a unitrust interest, or a fixed dollar amount payable each year, known as an annuity trust interest. After the term of the donor's retained interest, the remainder interest will be distributed to a charity. A charitable remainder trust is tax-exempt for income tax purposes. Therefore, in addition to a present income tax deduction for the actuarial value of the charitable remainder, a primary benefit of a charitable remainder trust is the ability to sell appreciated assets free of any capital gains tax, thus enabling one to reinvest the entire proceeds of sale, undiminished by tax, in order to increase yield. (See Appendix L.)

Charitable Lead Trust. With a charitable lead trust, a unitrust interest or an annuity trust interest is paid to charity for a period of years, and the remainder interest is distributed to children or to a trust for children. A charitable lead trust can reduce or eliminate the gift tax or estate tax on the non-charitable remainder interest because, as with a GRAT, the present value of that interest (a gift to the children of the remainder) is reduced by the value of the charitable interest; and the charitable interest can be calibrated to equal 100 percent of the value of the assets placed in trust by adjusting the payout amount and the trust term.

Commentary on Planning and Process

When meeting with a new client, the first questions I ask relate to the client's situation and personal objectives. What is the person's family situation and relationships? What are the person's plans and aspirations? If the person were hit by a blimp, how would he or she want his or her assets disposed of, tax considerations aside? Does this person have charitable objectives to be implemented during his or her lifetime or after death? Do the person's children get along? Does a child need the insulation or protection from a spouse or creditors that a trust might provide? The answers to these questions will provide the basis and framework for planning to achieve a person's particular objectives as distinguished from a *pro forma* or abstract approach to estate planning.

Apart from questions relating to a person's objectives and family situation, it is important to know about the person's assets and liabilities to plan properly to reduce or avoid taxes. The amount of assets is relevant for overall tax planning; however, the actual assets are relevant because certain types of assets are more conducive to effective planning. In particular, assets that may be expected to appreciate substantially in value and assets that may be discounted for valuation purposes are especially attractive for planning.

At a general level, the most important goal for my clients is to put in place planning that makes sense and provides adequately for their beneficiaries. As a secondary goal, reducing or avoiding the transfer taxes otherwise payable is important. In fact, because the potential taxes are likely to be 45 percent of the taxable estate, the tax considerations often become primary. The ultimate goal, and what is sought to be achieved through the estate planning process, is the peace of mind a client derives from knowing a sensible plan in terms of both disposition and taxes is in place and that he or she has provided as fully as possible for the beneficiaries. Like Ishmael in *Moby Dick*, a client may feel he or she has "survived himself."

With respect to any of the legal strategies described above, the five main procedural steps are the following:

- *Delineating the client's objectives.* This includes what the client hopes to achieve in terms of disposition of assets and/or tax savings, and

whether the client's objectives are realistic.

- *Analysis and planning.* This is the attorney's area of primary focus. It is essential that the attorney research, analyze and plan the strategy thoroughly and thoughtfully to address the client's objectives and to comply fully with legal requirements and considerations that relate to the contemplated planning.
- *Client understanding.* It is important that the client understand the nature of the planning, any potential property law or tax risks and the ongoing procedural requirements that may be required to implement the strategy.
- *Valuation.* For most strategies, valuation is essential and, for the strategy to be effective, professional substantiation by a qualified appraiser is necessary.
- *Implementation and monitoring.* For a strategy to be effective, one must implement the strategy. Often, less focused attention is given to the need to monitor the strategy after implementation. Most tax saving strategies are designed to operate over time by freezing value for a gift tax purposes at inception, and shifting future value to beneficiaries at reduced or no transfer tax costs. It is essential that such strategies be monitored to ensure they are administered properly, both to achieve the intended objective and to comply with legal requirements and potential IRS scrutiny.

Of the above steps, probably the most essential to a successful outcome is the client's understanding of the planning and the process required for successful implementation, along with the client's willingness to follow through and attend to the proper administration of the strategy. An example would be a client who establishes a family limited partnership but then does not operate the partnership as a business entity separate from his or her own personal assets.

I warn my clients that their goals are unfocused when they believe a strategy can be implemented simply by filling out some forms or putting some papers together. Once the client accepts the procedural and operational requirements that successful implementation of the strategy requires, the planning may proceed.

The strategy we choose may be made subject to the laws of a particular jurisdiction, because state law controls the property law consequences of a strategy and the laws of some jurisdictions are more favorable for particular strategies. For example, several states do not have a rule against perpetuities, which means a trust established in those states can last, literally, forever. Some states do not have a state income tax, which makes those states attractive for long-term trusts. The laws relating to business entities vary among jurisdictions, which makes some jurisdictions such as Delaware more favorable for strategies that involve business entities, including family limited partnerships or limited liability companies. Some jurisdictions, such as Alaska and Delaware, permit a person to establish a trust and remain a discretionary beneficiary without subjecting the trust assets to the person's creditors, so trust assets may not be includable in a trustor-beneficiary's estate in those jurisdictions.

The factors that will have the biggest impact on estate planning strategies are generally the valuation of the assets involved at inception and the investment performance of the assets over time. If the assets can be valued favorably for gift tax purposes, it is tantamount to making value disappear for transfer tax purposes. A favorable valuation may be obtained from a qualified appraiser based on factors relating to the particular asset involved, or an asset may be discounted because it is a fractional interest, a minority or non-controlling interest, and/or a non-marketable interest.

Investment performance is important in conjunction with the valuation at inception because it operates independently from the initial valuation of the assets. That is, although an asset may be properly discounted at inception because it is a minority, non-marketable interest, strong investment performance of the asset will apply to the entire asset without regard to the discount. As a consequence, upon a future liquidation of the entity or asset involved, the value of the interest at full value, with no discount, will be derived.

As part of the planning process for a client, trusts and estates attorneys consider the client's family and beneficiaries, and the IRS. It is important to note, however, that the attorney represents the client—not the client's family and not "a situation." Nevertheless, an estate planning strategy involves client objectives that typically are focused on providing present or

future benefits to beneficiaries of the client rather than to the client. Therefore, it is important to have information and understanding about the beneficiaries to plan most properly and effectively. Most commonly, this will involve crafting specialized trust provisions designed to address a beneficiary's age, abilities, maturity, sense of responsibility and other factors important to the client.

It is also important to consider the IRS and the tax laws, regulations, and rulings the IRS promulgates and administers. By considering and complying with the laws, regulations and rulings, one can have a fair degree of comfort that an estate planning strategy will not be challenged by the IRS and that, if it is examined, it will be accepted. The importance of this latter component cannot be overstated, because a primary objective of all estate planning strategies is to achieve peace of mind for the client. This is accomplished most effectively by establishing a sensible plan that meets the client's personal tax saving goals and avoids scrutiny by, or passes muster with, the IRS.

For any strategy that is planned and implemented, the role of the trusts and estates attorney when working with the client on the strategy is to bring the attorney's knowledge of the law and planning techniques, experience and judgment effectively to bear on the planning and implementation of the strategy at issue. The attorney typically feels as if he or she is "inside" the client's situation and, when drafting documents, inside the documents themselves. The analysis and planning proceeds from that rather unique vantage point. The process is somewhat akin to preparing a blueprint for the construction of a building.

Focusing on clients' most personal objectives often causes the trusts and estates attorney's role to expand as the client develops confidence in the attorney. Being inside the client's situation and having knowledge of and experience with the planning and tax issues involved, the trusts and estates attorney may be in a better position than the client to focus on both issues and details, and to help prioritize the client's objectives. The role is one of process as well as substantive work, and it is important that the trusts and estates attorney have the requisite knowledge, experience and judgment.

Difficult aspects of working out acceptable strategies for clients have to do with their ability to understand how the strategies will work, and the desire that any strategy be simple and inexpensive. Such a mindset increases the risk of mistake, because the complexity of much of the law related to transfer tax planning and the judgments that are required often preclude simple, inexpensive solutions.

The biggest mistakes most often made are lack of attention and follow-through by the client, delay and procrastination by the client, and an inability or reluctance by the client to incur the necessary expenses at the front end to plan and implement a strategy that is projected to yield great benefits but not until a future time, which may not be within the client's lifetime.

In planning and implementing an estate planning strategy of any complexity, it is important to assess at the beginning whether the client is willing to pay for and do what is required to implement and administer the strategy correctly and thoroughly. Because of the complexity of the planning in the transfer tax arena and the prospect of examination and challenge by the IRS, the trusts and estates attorney should ensure that the client is prepared to provide the support, cooperation and follow-through that will be required.

The impact of not doing adequate pre-planning is that time and expense will be wasted, the client will be unhappy and the client will be certain that the fault lies with the attorney. This can be remedied by the trusts and estates attorney being clear and thorough from the beginning, and not pushing clients to engage in estate planning strategies for which the client is not prepared to implement correctly.

The important laws to keep in mind when working on estate planning strategies are state laws relating to property, probate and trust administration, and numerous statutory provisions that relate to estate planning and trust administration matters, such as relations between husband and wife, parent and child, rights of creditors and contract law. State law controls the property law consequences of planning, strategies and documents that are drafted. Most important for the tax planning component of estate planning strategies is federal tax law, primarily transfer tax law related to the gift tax, the estate

tax and the GST tax. Federal law is codified in the Internal Revenue Code. In addition, however, there are regulations promulgated by the Department of Treasury that expand upon the statutory provisions of the Internal Revenue Code; and there are public and private revenue rulings and other pronouncements by the IRS that provide controlling authority and guidance as to the IRS position on various issues. There are also cases, state and federal, that adjudicate matters that proceed to litigation. The case then serves as controlling precedent for the issues the court in the case resolved.

It is essential to comply with the laws and regulations that apply to the estate planning strategies involved. Failure to follow the law may lead to disastrous results in terms of the economics of the strategy and the penalties that may be incurred. For example, a transfer may be effective for property law purposes, meaning the assets have been transferred to a trust such as a charitable remainder trust. However, a charitable deduction for the transfer may not be obtained.

The fact that the area of law is rather complicated offers planning opportunities. An experienced trusts and estates attorney understands how the transfer tax pieces fit together and is able to navigate among the components to achieve optimal results for the client. The attorney can manipulate, in a clinical sense, the estate planning components to offer the best chance that a strategy will succeed; and the attorney may achieve for the client that peace of mind that comes from knowing the client's objectives are being vigorously pursued.

The tax law related to estate planning strategies was last changed in a fundamental way in 2001. (Attached as Appendix M is a description of the 2001 changes in the tax law and some estate planning implications under the 2001 law.) Under the 2001 law, there is the possibility that the estate tax and the GST tax will be repealed; however, such a result is highly remote. In any event, it was never proposed that the gift tax would be repealed. The prospect of a possible repeal of the estate tax has caused substantial inaction over the years since 2001. Clients have been reluctant to take affirmative planning action, which may involve incurring a current gift tax to avoid a more substantial estate tax in the future, because of the possibility that the estate tax may be repealed.

The economic landscape is vastly different today than it was in 2001. As a result, it is extremely unlikely that the estate tax will be repealed, even for the single year of 2010 for which the 2001 law nominally enacted repeal. It is likely that, in 2009, the estate tax and the GST tax will be extended using the $3.5 million exclusion in effect in 2009, with a top tax rate set at the current 45 percent maximum rate.

Because of the uncertainty of the transfer tax law, and as a general planning principle in any event, estate planning drafting and strategies should incorporate substantial flexibility. This principle applies not only for tax planning purposes, but for non-tax estate planning reasons as well, because the ability to adjust the operation of a plan based on future changes and events is always very useful. By infusing the planning with flexibility and back-door options, alternatives and even escapes, helpful flexibility can be built into the plan so it is not carved in stone but can be administered to respond to changes in the client's situation or objectives.

Assuming Congress does act affirmatively before 2010, the clarity, if not certainty, of the transfer tax laws will provide a sound platform on which to plan and implement estate planning strategies. The uncertainty introduced with the 2001 law has fostered inaction. That is unfortunate, because inaction causes opportunities to be missed. Estate planning strategies depend on investment performance over time, so the sooner one implements a strategy, the better. An established transfer tax system will have the salutary effect of making prior ordering, planning and implementation not only possible, but a primary objective for clients. The fact that effective planning will be possible will itself induce clients to engage in more planning.

The average legal fees associated with representation of a client depend on the estate planning strategy involved, primarily based on the time required. The hourly time charges for an experienced trusts and estates attorney in San Francisco range from $400 to $600, although there are many attorneys with hourly rates both higher and lower than that. Although attorneys typically have an hourly rate, once a strategy has been defined, the fees associated with it can be estimated and often made a fixed fee. A few examples may be helpful. For a married couple with a taxable estate ($7 million in 2009) the fees for first-level

documents consisting of a revocable trust, wills, durable powers of attorney, advanced health care directives, and a number of related documents might be within the range of $4,500 to $7,500. For the strategies outlined previously and in the appendices, it is more difficult to estimate fees without giving attention to the facts of a particular matter at hand, because the planning component can range from simple and straightforward to extremely complex and time-consuming. The fees to draft a qualified personal residence trust, grantor-retained annuity trust, charitable remainder trust, or other vehicle may be relatively modest, but the analysis, planning and overseeing of the implementation may be extensive.

In addition to the attorneys' fees, fees will be incurred for the appraisal of assets used in the estate planning strategy. Typically, there will be two levels of appraisal. First, the value of the underlying assets at issue must be appraised if the assets do not have readily ascertainable market value. Examples of such assets are real estate and closely held businesses. Second, it would be typical to use a fractional interest of an asset for an estate planning strategy, and a second appraisal of the fractional interest would be required. Such a second appraisal would ascribe a reduction in value, or discount, for a fractional interest in real estate or a percentage interest of a business asset that reflects reductions for lack of control and lack of marketability. The aggregate of those discounts may be 25 percent to 40 percent of the appraised value of the underlying asset.

The fees for the appraisal of the underlying asset range from a modest fee of perhaps $500 for a personal residence to a substantial fee of $20,000 or more for the valuation of a business. The fees for a discount appraisal may range from $2,000 for the valuation of an undivided interest in real estate to $15,000 or more for the valuation of an interest in a business. The appraisal fees are not paid to the trusts and estates attorney, but to a professional appraiser.

The most important advice for a client engaging a trusts and estates attorney to implement planning strategies is to find the best, smartest and most experienced attorney he or she can find. Because of the complexity of the area and the risks of IRS scrutiny and challenge, there is no substitute for the judgment and creativity an experienced attorney can bring to the matter.

For some matters, experience and creativity are not necessarily required. Therefore, if a client wishes to save money, a less expensive attorney may be sufficient. For matters of great personal importance or large dollar value, however, many clients seek the peace of mind derived from engaging a highly experienced attorney, even though the fees required are greater.

Theodore A. Hellman has specialized in estate planning for more than thirty years and is the head of the estate planning and administration section of Hanson Bridgett LLP in San Francisco, Marin County and Sacramento, California. His practice includes estate planning, trust and probate administration, and planned charitable giving, with a particular focus on the design and implementation of innovative planning and drafting strategies to achieve clients' personal estate planning and tax savings objectives. In addition to estate planning and post-death administration, he assists clients with the full range of issues they encounter in their daily and business lives, including real and personal property, contract, and business issues.

Mr. Hellman received a B.A. from Yale University in 1968; an M.A. in Government from Georgetown University in 1971; and a J.D. in 1974 from the University of Virginia School of Law, where he was on the Virginia Law Review.

Mr. Hellman frequently gives talks on and writes about estate planning topics. Professional and civic affiliations include the State Bar of California (Estate Planning and Trust Law Section); the Marin County Bar Association (Estate Planning and Probate Section, Chair 2000-2005); the Bar Association of San Francisco (Estate Planning, Probate and Trust Law Section, Chair 1991); the Marin Estate Planning Council (Director 2005-2009); the San Francisco Estate Planning Council; Marin Community Foundation (Professional Advisory Committee); California Pacific Medical Center Foundation (Director, 1984-1991; Planned Giving Committee, 1985-present).

Mr. Hellman has been named by attorneys in Northern California as a "Northern California Super Lawyer," listed in San Francisco *magazine, in 2006, 2007, 2008 and 2009 (Top 100).*

Dedication: *To my wife of forty years, Janice, angel of the universe.*

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APPENDIX A

ESTATE PLANNING CONCEPTS AND TECHNIQUES

I. ESTATE PLANNING OVERVIEW

A. People Concerns

1. Planning for incapacity and care

a. Durable Power of Attorney ("DPA") for Property

b. Durable Power of Attorney ("DPA") for Health Care

c. Alternatives: Conservatorship, Living Will, Directive to Physicians, Trusts

2. Special needs and provisions

a. Appointment of guardians

b. Division and allocation issues

c. Trust provisions or custodianship gifts

B. Property Concerns

1. Disposition of property

2. Tax minimization

II. BASIC CONCEPTS

A. Form of Ownership

1. Separate property
2. Community property
3. Joint tenancy
4. Trusts/Trustee(s)
5. Retirement plans/IRAs/insurance

B. Transfer Tax System

1. Gift tax
2. Estate tax
3. Generation-skipping transfer ("GST") tax
4. Gift tax vs. Estate tax

C. Property Tax (Prop. 13)

1. Spousal transfers
2. Parent-child exclusion (Prop. 58)
3. Entity transfers

D. Probate Costs vs. Estate Tax

1. Probate administration (Will) vs. Living Trust
2. No difference in taxes between Will and Trust

III. TRANSFER TAX ISSUES AND PLANNING

A. Transfer Tax Exclusions, Deductions, Exemptions

1. Marital deduction

2. Applicable exclusion (unified credit)

3. Annual exclusion from gift tax (and GST tax)

4. GST planning

5. Charitable deduction planning [§ III.D. below]

6. Disclaimers

    a. Pay gift tax instead

    b. PTP credit

B. Payment of Taxes

1. Deferral of Tax

    a. Marital deduction planning

    b. Election to defer payment (I.R.C. §6166)

2. Funding the tax liability

    a. Sale of assets

    b. Life insurance

    c. Buy-Sell arrangements

C. Trust Planning

1. Revocable living trusts

2. Specialized (irrevocable) trusts

a. Irrevocable insurance trust

b. Liability concerns

c. Tax planning

d. "Special needs" trust for disabled beneficiary

e. MediCal planning

D. Charitable Deduction Planning

1. Tax reduction/"cost" of gift

2. Increased cash flow

3. Split interest (private/charitable) [§ V.H. below]

IV. SUMMARY

A. Basic (Minimum) Estate Planning Documents

1.	Will plus:	DPA - Property DPA - Health Care
2.	Revocable Trust plus:	Will DPA - Health DPA - Property

B. Need for Review/Update of Estate Plan

1. Changes in family or business situation

2. Increase/Decrease in wealth

3. Changes in law

V. ADVANCED PLANNING AND TECHNIQUES

A. Irrevocable Life Insurance Trust

B. Qualified Personal Residence Trust ("QPRT")

C. Grantor Retained Annuity Trust ("GRAT")

D. Income Tax Grantor Trust ("IDGT")

E. Non-Family Grantor Retained Income Trust ("GRIT")

F. Family Limited Partnership ("FLP")

1. Mechanics

2. Benefits

G. Sale to Income Tax Grantor Trust

1. Mechanics

2. Benefits

H. Charitable Planned Giving

1. Split interest trust techniques

   a. Charitable remainder unitrust (“CRUT”) [memo attached]

   b. Charitable remainder annuity trust (“CRAT”)

   c. Pooled income fund (“PIF”)

   d. Qualified terminable interest property (“QTIP”) plus charitable remainder

   e. Charitable lead trust (“CLT”)

2. Charitable gift annuity

3. Remainder interest in residence or farm

4. Undivided interest in property

5. Bargain sale

APPENDIX B

EROSION OF ASSETS BY TAX

Transfer Tax: Effect of 45% estate tax on assets passing to the third generation

Parents' estate assets:	$1,000,000
Less: estate tax	(450,000)
Assets passing to children:	550,000
Less: estate tax on children	(247,500)
Assets passing to grandchildren:	302,500
Less: estate tax on grandchildren	(136,125)
Assets remaining:	$166,375

Retirement Plan Assets

Value of plan assets:	$2,000,000
Estate taxes (@ 45%):	(900,000)
Income taxes at 40% (U.S. and state):	(400,000)
Assets remaining:	$700,000 (= 35%)

APPENDIX C

CREDIT SHELTER PLANNING

There is an "unlimited" marital deduction for property passing to a person's spouse for federal estate tax purposes, and for community property as well as separate property. As a result of the marital deduction, it is possible to avoid completely all death taxes in the estate of the first spouse to die ("first spouse"), regardless of the size of the estate, by deferring such taxes until the death of the surviving spouse.

Although there would be no tax upon the death of the first spouse if an unlimited marital deduction is used, the marital deduction property of the first spouse would be taxed in the surviving spouse's estate "on top" of the surviving spouse's own property. Because of this "stacking" of a married couple's combined property in the surviving spouse's estate, the unlimited marital deduction should be coordinated in the estate plan with the "applicable exclusion" (formerly "unified credit"), which enables each person to transfer a specified dollar amount free of tax to anyone by lifetime gift or at death. The tax-free transfer amount is $3,500,000 in 2009.

In the plan document (Wills or Revocable Trust), the unlimited marital deduction gift should be reduced by the amount of the first spouse's property that can be sheltered from tax by the credit. This credit amount will pass to a trust drafted to avoid inclusion in the surviving spouse's estate (a "bypass" or "credit shelter" trust). Because of the large size of the credit, it may be that much or even all of the first spouse's property will be in the bypass trust. This is beneficial because the property in the bypass trust will not be subject to tax in the estate of either spouse, even if it appreciates greatly.

In the absence of a bypass trust to "shelter" the first spouse's credit amount, there would be no tax on that property at the first spouse's death because of the unlimited marital deduction; however, on the surviving spouse's death, the property would be stacked on top of the surviving spouse's property and subject to tax. Effectively, therefore, the first spouse's credit would be forfeited. If a couple's combined property exceeds

$3,500,000 at the death of the surviving spouse, the tax savings from this credit shelter planning would be 45% of the excess.

APPENDIX D

INCOME TAX GRANTOR TRUST

For Federal income tax purposes, a trust will be considered to be owned by the grantor if it is structured in a manner that violates one or more of the grantor trust rules set forth in I.R.C. §§671-679. A trust may be established intentionally to violate one or more of the grantor trust rules (called an "intentionally defective grantor trust" or "IDGT"). If properly set up, the trust will be excluded from the grantor's estate for Federal estate tax purposes; however, both the income and principal portions of the trust will be taxed directly to the grantor. The purpose of structuring the trust in such a way is not only to shift the future growth in the value of assets from the grantor's estate to the beneficiaries (which is the case with any irrevocable trust) but to free the trust or the beneficiaries from income tax liability. In addition, the grantor's payment of the income taxes will serve to decrease the value of the grantor's taxable estate.

Subpart E of Subchapter J of the Code contains the provisions that specify when a grantor will be treated as the owner of a trust for income tax purposes. Specifically, §§671-679 provide that a grantor will be treated as the owner of a trust if and to the extent that the grantor retains an economic interest in the trust income or corpus or that the grantor retains any one of a list of enumerated powers. The following is a summary of some of the relevant grantor trust provisions:

§673 – Reversionary Interests. The grantor shall be treated as the owner of any trust in which the grantor has a reversionary interest in either the trust corpus or income if the value of such interest, as of the inception of the trust, exceeds 5% of the value of the trust.

§674 – Power to Control Beneficial Enjoyment. The grantor shall be treated as the owner of a trust in which the beneficial enjoyment of the corpus or income is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

§675 – Administrative Powers. The grantor shall be treated as the owner of any trust in which the grantor retains any of the following powers: a power to deal for less than adequate and full consideration; a power to borrow without adequate interest or security; or a power of administration (including the power of substitution) that is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. In addition, the grantor will be deemed the owner of a trust in which the grantor has borrowed the corpus or income and has not repaid the loan (unless there is adequate interest and security).

§676 – Power to Revoke. The grantor shall be treated as the owner of any trust in which the grantor or a nonadverse party retains the power to revest title to the trust property in the grantor.

§677 – Income for Benefit of Grantor. The grantor shall be treated as the owner of any trust in which the income is distributed to or used for the benefit of the grantor or the grantor's spouse.

Because a trust that intentionally violates one of these provisions is treated as owned by the grantor, the grantor must include all items of trust income, deduction and credit in computing his taxable income as if the grantor had received the items directly. In fact, the provisions of §§ 671-679 may attribute items of both income and principal to a grantor, and the particular type of power or economic interest retained by the grantor will determine whether the grantor will be deemed the owner of the income only, the principal only, or both the income and the principal.

APPENDIX E

GENERATION-SKIPPING TRANSFER TAX

There is now a generation-skipping transfer tax ("GST"), which is imposed on transfers of assets (whether outright or in trust) to persons who are more than one generation below the transferor's generation (e.g., grandchildren). The tax is in addition to the estate and gift tax, and is imposed at the maximum rate of that tax (currently 45%). Planning for the GST tax makes sense where assets which pass to children may not be consumed during their lifetimes and, therefore, will ultimately pass to grandchildren. In that case, in the absence of GST planning, the assets would be diminished twice by a 45% tax: once when the assets pass to children, and again when the assets pass to grandchildren.

Each person has a $3.5 million exemption from the GST tax (as of 2009). Planning for the GST tax would involve retaining a portion (or all) of each child's share of an estate in trust for the child's lifetime (and perhaps beyond) in order to reduce taxes at the child's death. For a married couple, by utilizing each spouse's GST exemption, a total of $7 million worth of assets (plus all appreciation of the assets during the child's lifetime) could be passed to the grandchildren's level (and future levels), undiminished by the GST tax or by estate taxes in the children's estates. Further, the children could be beneficiaries and even trustees of the GST trusts during their lifetimes. Also, an independent trustee could have a fully discretionary power to distribute principal to the children. The tax savings of this type of planning over the generations could be enormous.

Example: A couple with an estate that they intend to leave to their children must decide whether to leave all of the assets outright to the children or to carve out the GST exemption amount ($7 million) and leave that amount in trust for the children (the rest of the couple's property could go outright to the children). If the $7 million is left outright and grows to $14 million over the lifetime of the children, the grandchildren will receive about half that amount ($7.7 million) after taxation in the estates of the children. If, instead, the $7 million is placed in "GST Exempt" trusts for the children, then the full future value of that property ($14 million in the example) will pass to the grandchildren free of any tax. In fact, the economic benefit is

potentially greater because it is comprised of the future value of $3.5 million funded at the death of the first spouse plus $3.5 million funded at the death of the second spouse (rather than $7 million at the death of the second spouse). It can be seen from the foregoing example that the estate planning benefit of GST planning is the avoidance of tax at the death of the children. Thus, the economic benefit of the planning inures to the grandchildren. In a sense, therefore, GST planning is a form of estate planning at the children's level.

GST planning is a "no-lose" planning technique in almost any case; it becomes increasingly advantageous and advisable to the extent that (i) an estate is large; (ii) the children during their lifetimes might not need (not won't need, but might not need) all of the GST exemption amount ($7 million of assets at the parents' level); and (iii) the children expect to pass assets on to their children. Practical drafting components at the children's level help make GST planning a "no lose" proposition:

- It is only the GST exemption amount ($7 million in the aggregate) that need be retained in trust. Assets in excess of that amount could be distributed outright. Note, however, the non-tax advantage of keeping assets in trust that is listed as the last point below.

- Importantly, a child could be a beneficiary (even the sole beneficiary) and Trustee of the GST exemption amount allocated to the child in trust. Therefore, the assets in the GST trust would not be "locked away" from the child; rather, the child could receive all of the income and could receive principal for health, maintenance or support. Moreover, the child—as Trustee of the trust—could have complete control over investment and other administrative matters.

- The terms of a GST exempt trust can be anything that makes sense. For example, the terms could provide that the trust is for the child during the child's lifetime, then for the child's children (and spouse, if desired). Or, the terms could provide that the trust is a "spray trust" for the current benefit of the child and the child's

children (in the latter case, there would need to be a non-beneficiary trustee).

- Children could be treated differently. While keeping the overall distribution equal, one child's share could contain a GST component (in trust) and another child's share could be distributed outright. The exemption amount ($7 million) could be allocated between or among children equally, all to one child (e.g., if only one child has children) or in any other fashion.

- Potential non-tax advantages of a trust disposition for children (possibly in excess of the GST exemption amount) are that the trust assets could be protected from creditors of the child, and a trust could ensure that the assets would not be diverted to a child-in-law.

APPENDIX F

SECOND-TO-DIE LIFE INSURANCE

Under a typical estate plan, there will be no estate tax payable until both spouses are gone. At that point, however, an estate tax will be imposed (at a tax rate of 45%) on the aggregate value of a couple's assets in excess of an exclusion amount. Techniques such as a qualified personal residence trust ("QPRT"), a grantor retained annuity trust ("GRAT") and a charitable remainder trust ("CRT") are ways to reduce the tax that will have to be paid while still transferring the assets—or the value (QPRT), appreciation (GRAT) or income stream (CRT) of the assets—to children.

An irrevocable insurance trust does not reduce the estate tax that will have to be paid, but is a technique to generate cash proceeds to pay the tax (when both spouses are gone), without the proceeds themselves being subject to tax. Also, if a charitable remainder trust is used in the estate plan, insurance can serve to "replace" the remainder interest that goes to charity. In that way, one can obtain the benefits of a charitable remainder trust without "losing" the value of the principal placed in the trust.

Insurance is useful to generate proceeds to pay the tax in order that assets do not have to be sold. Normally, insurance is an asset like any other, so that the proceeds themselves are subject to tax. If the insurance is not owned by the spouses, however, then (under current law) the proceeds would not be subject to tax. Therefore, it may well make sense to have life insurance which is owned either by an irrevocable trust or by children.

Second-to-die life insurance is often advisable because it pays proceeds only when both spouses are gone (which is when the tax will be due) rather than on the death of the first spouse (when no tax will be payable). The premiums for second-to-die life insurance are lower than for insurance on one person's life. Second-to-die life insurance is often combined with a charitable remainder trust because the extra cash flow generated by a remainder trust defrays the cost of the insurance premiums.

APPENDIX G

QUALIFIED PERSONAL RESIDENCE TRUST

Estate Planning Purpose. A qualified personal residence trust ("QPRT") is a trust, the primary asset of which is the grantor's principal or secondary residence that is held for the personal residence of the grantor for a specified term of years. At the end of the term, the residence will be distributed to the grantor's children or to a new, continuing trust. The benefit of a QPRT is that, at the cost of a current but discounted gift tax, the residence at its future value (including any appreciation in the value of the residence over the term of the trust) will pass to the remainder beneficiaries free of any gift or income taxes. The QPRT must be funded with a personal residence, or with cash to be used to purchase a personal residence. In addition, a reasonable amount of cash may be transferred to provide for expenses.

Gift and Estate Tax Benefit. The transfer to a QPRT is a completed transfer for gift tax purposes. The amount of the gift is computed by subtracting the present value of the grantor's retained interest from the value of the residence placed in the trust. The present value of the grantor's retained interest is calculated using a discount rate equal to the IRS's assumed interest rate for the month in which the trust is created. The rate in effect for April 2009 was 2.6%. ***Example:*** At the April 2009 2.6% assumed interest rate, if a couple ages 65 and 65 (nearest birthdays) transfers a personal residence valued at $2,000,000 into two separate QPRTs (e.g., an undivided 50% to each), claims a 25% valuation reduction for the fractional interests, and retains a "reversion" (the right to a return of the trust property if he/she dies before the end of the trust term), then the QPRTs, in the aggregate, would constitute a taxable gift as set forth below and would transfer to the children the Ending Value shown.

Residence Valued at $2,000,000
Placed in 2 QPRTs by a Couple Ages 65, 65

Trust Term	Taxable Gift	Effective Discount	Ending Value @ 4% Appreciation
5	1,195,515	40%	2,433,306
10	899,520	55%	2,960,489
15	622,290	69%	3,601,887

Assuming that each grantor survives the trust term of his/her QPRT, the only portion of the value of the residence placed in the QPRT that will be subjected to transfer tax will be the taxable gift portion at the time of transfer to the QPRT. The taxable gift portion can be sheltered from the payment of gift tax to the extent of each grantor's available applicable exclusion (a cumulative, lifetime exclusion of $1,000,000). After the trust term ends, the entire value of the property in the QPRT, including any appreciation of the property during the term of the trust, will pass to the remainder beneficiaries free of any transfer tax.

Income Tax. The QPRT is a "grantor trust," meaning that any trust income is taxed to the grantor directly (because the trust asset is a residence, no income is expected). Also, with grantor trust status, the trust's deductions (e.g., for real estate taxes) and real property tax benefits (e.g., IRC §121 capital gain exclusion) remain available to the grantor.

Termination. At the end of the trust term, the residence will be distributed to the grantor's children, either outright or in a continuing trust. Because the trust is treated as a completed gift for gift tax purposes when created, and because the grantor will have paid tax on any trust income earned before termination, the distribution at the termination of the trust will be free of any gift tax or income tax. The remainder beneficiaries will have a basis in the trust property equal to the grantor's basis in the property ("carryover basis").

Use After Termination. If the grantor wishes to retain the use of the residence after the end of the trust term, the grantor can lease the property for fair rental value. A better result would be achieved if the grantor could repurchase the property from the trust for fair market value while the trust is still a grantor trust (e.g., just prior to the end of the trust term). A repurchase would avoid any income (capital gain) tax consequences, would allow the remainder beneficiaries to receive cash rather than the residence, and would avoid the carryover basis problem noted above because (if the grantor reacquired the residence and retained it at death) the tax basis of the property would receive a step-up in basis. Unfortunately, however, the IRS has issued a Regulation that requires QPRT trust agreements implemented after May 16, 1996 to prohibit the repurchase of the residence by the grantor.

Other Requirements. If the personal residence is sold during the term, the trustee may use the sale proceeds to purchase a replacement personal residence within two years. Alternatively, the trust will convert into a grantor retained annuity trust ("GRAT"), which will preserve most of the transfer tax benefit.

Death Before Term. If the grantor dies before the trust ends, the full value of the property will be included in the grantor's estate for tax purposes. Therefore, the grantor should select a term for the QPRT with this risk of inclusion in mind. Due to the unified nature of the gift and estate tax systems, however, no "double taxation" would result in the unfortunate event of the grantor dying during the term. For tax purposes, the transaction will effectively be treated as if it had not occurred.

APPENDIX H

GRANTOR-RETAINED ANNUITY TRUST

Estate Planning Purpose. A grantor retained annuity trust ("GRAT") is a trust that pays an annuity to the grantor for a specified term of years. At the end of the term, the property remaining in the trust will be distributed to the grantor's children or, preferably, to a grantor trust drafted to receive the remainder. The benefit of a GRAT is that any income and appreciation generated by the trust assets in excess of the IRS's assumed interest rate at the time of creation (2.6% for April 2009) will pass to the remainder beneficiaries free of any income or gift taxes. The value of the grantor's interest in the assets is "frozen" at its value at inception plus a fixed annual return calculated at the IRS's assumed interest rate at that time.

Gift Tax Benefit. The transfer to a GRAT is a completed transfer for gift tax purposes. The amount of the gift (of the remainder interest), however, can be structured to be nearly zero. This is done by adjusting the annuity rate and the term of the trust to make the present value of the retained annuity interest equal to the property transferred to the trust plus the IRS assumed interest rate. To ensure that the transaction has substance, at least a small taxable gift should be triggered. ***Example:*** If $1,000,000 of assets is transferred to a GRAT, then at the April 2009 2.6% assumed interest rate, a 11.48% annuity for 10 years would generate a gift of $436.

Income Tax. The GRAT is a grantor trust; therefore, all of the trust income is taxed to the grantor directly. This is helpful from an estate planning standpoint because it means that the taxes on income do not diminish the trust.

Annuity. The annuity amount must be paid to the grantor on an annual basis. If the income earned by the trust assets is not sufficient to pay the annuity, principal can be used. Because of the grantor trust income tax status, there are no income tax consequences from distributing principal, even if the property distributed has a value in excess of basis. Alternatively, the Trustee could borrow funds from a third party, unrelated to the grantor, to pay the annuity. The Trustee could not borrow funds to pay the annuity from the grantor nor could the Trustee pay the annuity with notes.

An alternative annuity payment structure authorized by the Treasury Regulations should usually be utilized. The Regs allow the annuity payout rate to start low and to increase each year by up to 20%. Although the payout rate in the later years is higher than it would be with a fixed payout rate, the economics of a reduced payout rate in the early years more than makes up for the larger payments required in the later years.

Termination. At the end of the trust term, any remaining trust property will be paid to the members of the grantor's family (e.g., a grantor trust for children). *If the cumulative return (principal growth plus income) generated by the trust assets over the term of the GRAT has exceeded the IRS's assumed interest rate at the start of the GRAT, there will be assets to distribute.* ***Example:*** In the example above with the IRS assumed interest rate at 2.6%, if the GRAT earned 0 % income per year but the trust principal grew at 8% per year, then the amount distributable at the end of the term, after payment of a $114,800 annuity to the grantor for 10 years, would be $495,868 per $1 million of initial value contributed to the GRAT. Note that this amount is distributable to the family trust free of tax at the end of the GRAT even though no tax was paid when the GRAT was established. The example assumes annual appreciation of 10%. The actual amount distributable tax-free at the end of the GRAT will be the cumulative "total return" (income plus appreciation) in excess of the IRS's assumed interest rate at inception and will be affected somewhat by the source of the return as between income and growth.

For comparison with the above example, if the IRS's assumed interest rate at inception were higher, the result would be less favorable. For example, if the assumed interest rate were 6.0%, then the amount distributable at the end of the term would be $191,650 per $1 million of initial value contributed to the GRAT.

Using an increasing annuity payout improves the results. In the examples above, with the assumed interest rate at 2.6%, the annuity payout rate could start at a low 4.59% and increase by 20% each year. The payout rate and annual annuity payment for each year are shown on the following chart:

Year	Payout Rate	Annual Payout
1	4.5900%	$45,900
2	5.5080%	55,080
3	6.6096%	66,096
4	7.9315%	79,315
5	9.5178%	95,178
6	11.4213%	114,213
7	13.7056%	137,056
8	16.4467%	164,467
9	19.7361%	197,361
10	23.6833%	236,833

With an increasing annuity the amount distributable at the end of the term would be $616,375 per $1 million of initial funding. If the assumed interest rate at inception were 6.0%, the amount distributable at the end of the term would be $$246,700 per $1 million of initial funding.

Because the trust is treated as a completed gift for gift tax purposes when created (even though the gift will have been manipulated to be of nominal value), and because the grantor will have paid tax on all trust income earned before termination, the distribution to the family trust at the termination of the trust will be free of any gift tax or income tax.

Discountable Asset. If a GRAT is funded with assets that can be discounted for lack of control and lack of marketability (e.g., stock in a closely held company, limited partnership interest), dramatic value shifting can be achieved, without gift tax, even if the GRAT does not earn an annual total return (income plus appreciation) greater than the IRS assumed return at inception. Normally in such a case, there would be nothing to distribute to the remainder beneficiaries because the trust principal plus the assumed return will have been paid to the grantor through the annuity in order for there to have been a gift of zero. If, however, the funding assets can be discounted, a GRAT may serve to transfer an amount to the remainder beneficiaries free of tax even if the GRAT's return is less than the IRS assumed interest rate at inception because the discount amount constitutes, in economic effect, a return in excess of the IRS assumed rate. ***Example:*** In the example above, if the funding assets can be discounted by 40% for lack of control and lack of marketability, and if the GRAT earned a

return equal to the IRC §7520 rate (2.6% for April 2009) for a term of 2 years, then the amount distributable at the end of the term, after payment of a $311,400 annual annuity to the grantor for 2 years, would be $518,688. Note that this amount is roughly the amount of the discount for gift tax purposes. The example demonstrates that a GRAT may serve to transfer the discount amount to the remainder beneficiaries free of tax if the GRAT's return equals the IRS assumed return at inception. If the GRAT's return is less than the assumed return, less than the discount amount will be transferred; if the return is greater than the assumed return, more than the discount amount will be transferred.

Valuation. There is not a "valuation risk" with a GRAT. The annuity payout formulation would be self-adjusting, so that if the assets placed in the GRAT were deemed by the IRS to be of a greater value than claimed, the effect would simply be to increase the amount of the annuity; there would still be no significant gift tax payable. Also, if the GRAT did not increase in value sufficiently to cause the tax-free transfer of a large amount of assets to the remainder beneficiaries, there would at least be no "downside" (other than the transaction costs). In that event, the grantor would not be worse off than if the GRAT had not been created.

Death Before Term. If the grantor dies before the end of the term of the trust, a portion or all of the GRAT will be included in the grantor's estate for tax purposes. The included portion would be that fraction of the corpus that would be required to be invested at the IRS's assumed interest rate (as of the grantor's date of death) to produce annual income equal to the annuity payment. Although a portion of the GRAT would be included in the grantor's estate, the estate tax economic result is not worse than if the GRAT had not been created.

APPENDIX I

FAMILY LIMITED PARTNERSHIP

A limited partnership is a business association that includes one or more "general partners" and one or more "limited partners." General partners have an active responsibility for partnership business and are personally liable for the partnership's obligations (in the same manner as outright owners of the partnership's assets). Limited partners are not active in the partnership's business; their liability for partnership obligations is limited to the value of their partnership interests. Limited partnerships are treated in the same way as general partnerships for tax purposes: generally, all income and deductions of the partnership are "passed through" to the partners, in proportion to their interests in the partnership, so that the partnership itself is not separately taxed.

A family limited partnership (in which the partners are all members of the same family) is legally similar to other limited partnerships, but can serve specialized purposes. Family limited partnerships can be particularly helpful in providing for the control of a family business, for providing centralized management of investment assets, for the orderly transfer of control of a business or investment assets over time, and for favorable treatment of the business and investments for estate and gift tax purposes.

The limited partnership format can help some family members assume or continue management of the assets as general partners, while others retain or receive investment interests as limited partners.

For tax purposes, the value of limited partnership interests may qualify for substantial discounts compared to the underlying value of partnership assets. The discounts may be claimed because the partnership interests represent fractional, non-controlling interests in the partnership that confer no rights to the underlying partnership property or to the management of partnership business. Limited partnership interests of this nature are generally not marketable, a fact that further supports a discount. The discounts can result in greater value being transferred to children with no gift tax or with reduced gift tax. If limited partnership interests remain in the parents' estates upon their deaths, similar discounts may be claimed for

estate tax purposes, reducing the tax payable. An appraiser is retained to calculate the discounts.

In several recent court cases, the IRS has mounted successful attacks against family limited partnerships ("FLPs") used for estate planning purposes. The IRS attacks are based on Internal Revenue Code Section 2036, which includes in a taxpayer's taxable estate all property transferred by the taxpayer over which the taxpayer at the time of death (1) retained a right to possess or enjoy the transferred property or (2) retained the right (alone or in conjunction with others) to control the beneficiary enjoyment of the transferred property. As applied to a FLP context, if a parent establishes a FLP and retains too much control over the FLP or the FLP assets, then upon the parent's death, Section 2036 requires that the full underlying value of the FLP assets (without a discount) will be included in the parent's taxable estate.

APPENDIX J

SALE TO AN INCOME TAX GRANTOR TRUST

The sale of assets to a grantor trust in exchange for an installment note is a technique for shifting the future growth in the value of the assets from the estate of the grantor/seller to the trust beneficiaries. With a sale of assets to a grantor trust, no gain will be recognized on the sale because, for income tax purposes, the trust is considered to be the same taxpayer as the grantor.
In Rothstein v. United States, 735 F. 2d 704 (2nd Cir. 1984), the Second Circuit questioned the effect of grantor trust status on transactions between the grantor and the trust. The facts in Rothstein, greatly simplified, involved a grantor who bought appreciated stock from an irrevocable trust in exchange for an installment note. The trust loaned the grantor the purchase price in a seller financing, and the grantor then exchanged the stock for the assets of a liquidating company. The court held that, notwithstanding the fact that the grantor trust rules required the grantor to include all items of trust income, deduction and credit in his own income, the trust was still a viable entity for purposes of the sale transaction and thus the sale was a bona fide, taxable transaction.

The IRS rejected Rothstein in Rev. Rul. 85-13 when it ruled on almost identical facts that the trust and the grantor were a single taxpayer and, therefore, a bona fide sale transaction was impossible. The Service explained its decision not to follow Rothstein as follows: “It would be anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction and credit, and yet, retain its vitality as a separate entity capable of entering into a sales transaction with the grantor.” The result of Rev. Rul. 85-13 is that a transaction between the grantor and a grantor trust is not a sale for income tax purposes, so that gain or loss is not recognized and the acquirer of the assets does not obtain a cost basis in the assets.

The Treasury adopted this position in 1980 with Reg. §1.1001-2(c), ex. 5, which involved the purchase of partnership interests by a grantor trust and stated that tax on the transfer would not be triggered unless and until grantor trust status was subsequently lost. The Tax Court affirmed this

position in Madorin v. Commissioner, 84 TC 667 (1985). In Madorin, the grantor transferred a partnership interest to a grantor trust, which later became a separate, taxable, nongrantor trust. The court distinguished Rothstein on the grounds that it did not deal with the issue of perfection of a grantor trust, but the Madorin court clearly takes a different view of §671 than the Second Circuit did in Rothstein. Here, the court stated that the grantor should be treated as if he personally owned the partnership interest that was transferred to the trust. However, the court noted that at the time the trust ceased to be a grantor trust, the grantor effectively transferred the partnership interest and recognized gain on the transaction.

The IRS has, on occasion, argued for the imposition of tax on sales to grantor trusts, although such arguments have been rejected by both the Eighth Circuit and the Tax Court. For example, in Swanson v. Commissioner, 518 F.2d 59 (8th Cir. 1975), the IRS argued that the proceeds of a life insurance policy on the grantor's life that was purchased by a trust were taxable income because the policies had been transferred to someone other than the insured. The IRS argued that the trust was a taxable entity regardless of the fact that the grantor was deemed to be the owner of the trust for purposes of taxing the trust income. The Tax Court and the Eighth Circuit both rejected the argument.

Notwithstanding a few opportunistic reversals of position by the IRS, such as Swanson, the Service has relied on Rev. Rul. 85-13 on a number of occasions in finding a sale to a grantor trust to be a nontaxable event. For example, in Rev. Rul. 87-61, a U.S. citizen transferred appreciated property to a foreign situs trust of which he was deemed to be the owner under §671. The IRS ruled that the §1491 foreign transfer excise tax did not apply to the transfer because the grantor continued to own the property. However, when the grantor renounced his grantor trust powers, the excise tax was imposed as if the transfer had then occurred.

The IRS also approved the concept of a sale of appreciated assets to an intentional grantor trust in PLR 9535026. In that Private Letter Ruling, a parent established an irrevocable trust for the benefit of his three children. The trusts were then divided such that one separate trust for each child held the assets contributed by the parent and another trust held the assets that each child had contributed to his or her own trust. Each child then

proposed to sell stock to his or her respective trust in exchange for a promissory note. The trustees of the child's trust would pay interest to each child for a term of twenty years, and a balloon payment of principal would be paid at the end of the term. The notes issued by the trusts were secured by the stock transferred. In the Private Letter Ruling regarding the transaction, the IRS ruled, among other things, that the trusts would be considered grantor trusts under §§ 675 and 677 and that the sale of stock to the trusts would not trigger any capital gain income tax payable by the child. The trust assumed the child's basis in the stock, and the child was responsible for reporting all items of income, deduction and credit on his or her individual income tax return.

Given the IRS's explicit rejection of Rothstein in Rev. Rul. 85-13 and its frequent reliance on such Ruling, it appears that the Service has settled on the position that a grantor and a grantor trust are one taxpayer. It is possible that the Service could reverse its position, or even carve out an exception for transactions entered into for the purpose of avoiding estate tax, but it's not clear that the courts would acquiesce.

Consequences of Loss of Grantor Trust Status. The above analysis applies only to a transaction involving a grantor and a grantor trust. In the event that the grantor trust powers (e.g, powers to substitute assets and to borrow via an unsecured loan) are renounced or released, grantor trust status will be lost and, according to the Madorin case and Reg. §1.1001-2(c), the assets will be deemed to have been transferred in a taxable transaction at that time.

Under the Madorin rationale, as well as that of Treasury Reg. §1.1001(c) and Rev. Rul. 77-402, the loss of grantor trust status could result in a deemed sale at that time. The facts in the authorities listed above involved a grantor transferring a tax shelter to a grantor trust. At the point the tax shelters were on the brink of income production, the grantor renounced his powers over the trust, thereby causing the phantom tax shelter income to be taxed to the trust rather than the grantor. In each case, the loss of grantor trust status was treated as a transfer of the tax shelter to a new nongrantor trust, thus causing the grantor to recognize gain on the disposition under Code §1274.

The law dealing with the treatment of an installment note upon the death of the grantor is unsettled, and there are a number of views regarding the income tax consequences of loss of grantor trust status prior to the payment in full of the note. In the event of the grantor's death, one possible analysis of the loss of grantor trust status is that the sale would be viewed to have occurred immediately before the grantor's death. In that event, gain would be recognized to the extent the balance due on the note exceeded the basis in the assets sold to the trust, and the assets would acquire a basis equal to the amount due on the note. The problem with this analysis is that, according to Rev. Rul. 85-13, gain cannot be recognized on a transaction between the grantor and a grantor trust while the grantor is alive.

Another analysis might treat the sale as if it had occurred immediately after the death of the grantor. However, this analysis requires a presumption that the grantor owned the assets at the time of death, and if the note sale was a valid transaction, then the assets ought not in fact be included in the grantor's estate. In addition, it's not clear how the basis would be adjusted, if at all, in this scenario.

Although the treatment of the note on the death of the grantor is not certain, it is likely that the note would be included in the grantor's estate, such that his heirs would inherit the installment obligation. However, it is not clear whether gain on the note would be calculated as the gross profit that the grantor would have made on the sale had it been subject to income tax liability at the outset or whether the full remaining balance on the note would be treated as gain. In any event, the assets in the trust would likely not receive a step-up in basis upon the death of the grantor even though the note might be included in the estate of the grantor.

The only way to avoid the foregoing uncertainties, including the possibility of cancellation of indebtedness income, is to pay the note off in full prior to the death of the grantor.

APPENDIX K

COST OF CHARITABLE GIFT

Income Tax:

	No Gift	Gift
Income	$100,000	$100,000
Gift	0	$25,000
Taxable Income	$100,000	$75,000
Tax (@ 33%)	($33,000)	($25,000)
Net	$67,000	$50,000

Actual cost of making a $25,000 gift (difference in net amounts): $17,000

Estate Tax:

	No Gift	Gift
Gross estate	$1,000,000	$1,000,000
Gift	0	$100,000
Taxable estate	$1,000,000	$900,000
Tax (@ 45%)	($450,000)	($405,000)
Net	$550,000	$495,000

Actual cost of making a $100,000 gift (difference in net amounts): $55,000

APPENDIX L

CHARITABLE REMAINDER TRUSTS

A donor may wish to transfer property to a charitable remainder trust, providing for a fixed or variable payment (based on a percentage of the value of the trust assets) for himself or herself and/or one or more other beneficiaries, and naming a charitable organization as the remainder beneficiary of the trust property. If the technical requirements for such a trust are met, the donor will receive present income and gift tax deductions measured by the value of the remainder interest which is being donated. The property will be included in the donor's taxable estate at death, but will be fully offset by an estate tax charitable deduction.

A qualified charitable remainder trust is tax-exempt. The transfer of appreciated property to the trust will not result in taxable gain to the donor; and the sale of the property by the trust will not result in taxable gain to the trust. Thus the donor's appreciation in the property can be "unlocked": the trust may sell appreciated property (tax free) and diversify or reinvest in high yield investments for the donor's benefit (as lifetime beneficiary) without the usual capital gains tax cost to the donor.

Under a "tier system" for taxation, the trust distributions received by the donor or other trust beneficiaries may be taxable at the lower capital gains rates, and may even be tax free. Additional income tax savings may be obtained by spreading the trust payments among several non-charitable beneficiaries, and/or by naming trust beneficiaries who are in low income tax brackets. Moreover, the trust assets will be excluded from the donor's probate estate, thus reducing or eliminating the cost and delays involved in a probate proceeding.

A donor can select from among three basic trust forms: the charitable remainder annuity trust, the charitable remainder unitrust, and the pooled income fund. Each may be created either by inter vivos gift during lifetime, or by Will to take effect at the donor's death.

(1) **Charitable Remainder Annuity Trust.** The charitable remainder annuity trust is based on a specified percentage (at least 5%) of the initial value of the trust. Therefore, this vehicle will provide a fixed annuity payment regardless of fluctuations in the trust income and in the value of the trust assets. After the initial contribution, no further contributions may be made to the annuity trust.

(2) **Charitable Remainder Unitrust.** The charitable remainder unitrust is based on a specified percentage (at least 5%) of the value of the trust as valued annually. Therefore, this vehicle will provide a variable payment, will be responsive to economic change, and will be less vulnerable to erosion caused by inflation. Additional contributions may be made to a unitrust subsequent to the initial contribution.

The donor can (but need not) limit the unitrust payments to the annual income of the unitrust, and can also provide that deficiencies in the unitrust payments caused by the limitation of payments to trust income are to be made up in years when the trust income exceeds the unitrust amount. Thus, the trustee of an "income only" unitrust with a "makeup" provision could invest in low-yield, growth assets until the donor's retirement, whereupon the assets could be converted to high-yield assets and the deficiencies made up. The donor would receive a present income tax deduction and reduced payments when his or her tax rates are high; and, after retirement, would receive increased payments when his or her income tax rates are reduced.

(3) **Pooled Income Fund.** The donor may choose to contribute to a pooled income fund. A pooled income fund is comprised of property contributed by a number of donors. Each donor's contribution is added to the fund, and he or she receives a share of the fund's income proportionate to his or her contribution. The fund, like a mutual fund, provides the donor with diversification and professional management of his or her investment.

APPENDIX M

DESCRIPTION OF CURRENT (2001) TRANSFER TAX LAW

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") repealed the estate and generation-skipping transfer taxes—but not the gift tax—beginning in 2010. Then, under EGTRRA, the repeal will itself be repealed in 2011 by a built-in "sunset provision," unless new legislation is enacted to implement the repeal. In the absence of new legislation, the rules in effect in 2001 will be reinstated.

Prior to 2010, the top estate, gift and generation-skipping transfer ("GST") tax rates are gradually reduced. As seen in the chart below, the rate reductions are modest. The exemption amounts from estate and GST tax are increased in steps, as shown in the chart. The gift tax is retained, with a single increase in the lifetime exemption amount to $1 million in 2002 and a residual (in 2010) top gift tax rate equal to the top individual income tax rate.

The following is a chart showing how the estate tax and GST tax exemption amounts increase, and how the top tax rates decrease under EGTRRA:

Year	Estate and GST Exemption	Top tax rate
2002	$1 million	50%
2003	1 million	49
2004	1.5 million*	48
2005	1.5 million	47
2006	2 million*	46
2007	2 million	45
2008	2 million	45
2009	3.5 million*	45
2010	N/A (taxes repealed)*	Top ind. rate, 35% (gift tax only)

**N.B. Gift tax: The exemption amount remains at $1 million.*

If the estate tax and GST tax repeal is enacted in and after 2010, the present rules providing for a fair market value (i.e., "stepped-up") income tax basis for property acquired from a decedent will be eliminated and replaced with a modified "carry-over" basis. This means that, for purposes of computing capital gain, inherited assets will not receive a full basis adjustment equal to the value of the assets at the date of death as is now the case. Instead, appreciated inherited assets will retain the decedent's basis, which may result in substantial capital gains taxes when the inherited property is sold. EGTRRA does provide for a limited increased basis: an aggregate increased basis of $1.3 million may be allocated to a decedent's assets; and an additional aggregate increased basis of $3 million may be applied to assets passing to a surviving spouse.

CONSIDERATIONS FOR ESTATE PLANNING

Prospective Nature of Transfer Tax Changes

EGTRRA imposed a complicated array of phase-in rules and effective dates, with many provisions not coming into effect for several years. The benefits were backend loaded, with modest increases in the transfer tax exemption amounts until 2009 and modest tax rate reductions until repeal in 2010. Unless Congress and the President agree on a new estate tax law, the 2001 exemption amounts and transfer tax rates will be automatically restored in 2011.

The cost of permanent transfer tax repeal is approximately $600 billion. For that reason, the state of the economy could well lead to suspensions of either or both of the scheduled increases in the exemption amounts and the scheduled reductions in the top tax rates. Apart from budget concerns, people with estates under $3.5 million and couples with estates under $7 million may oppose repeal after 2009 because the loss of the increased basis at death will trigger an otherwise avoidable tax to their beneficiaries.

Under EGTRRA, states suffered a reduction in what for many states was an important source of revenue. Most states abandoned individual inheritance tax regimes in favor of receiving a portion of the estate taxes paid to the federal government. EGTRRA phased out the portion of the estate tax

payable to states to zero by 2005. Many states enacted their own transfer taxes or to increase other taxes to recoup the shortfall.

Implications for Estate Planning Structure

The structure of most estate plans is based on federal transfer tax concepts. The most common structure for a married couple is to pay no tax on the death of the first spouse by employing a formula that carves out the amount that is exempt from estate tax and retains it in a "bypass" or "credit shelter" trust (for the benefit of the surviving spouse or other beneficiaries) or distributes it to non-charitable beneficiaries. The rest of the assets are typically allocated to a marital deduction gift.

If there is no federal estate tax, the exemption amount may be all of the first spouse's assets, in which case there will be no marital deduction gift. If the plan allocates the exemption amount to children or other beneficiaries, an intent to provide for the surviving spouse would be subverted and the non-marital portion could be overfunded. If the exemption amount is retained in a bypass or credit shelter trust of which the surviving spouse is the primary beneficiary, the surviving spouse is protected but an intended distribution to the other beneficiaries would be undermined.

If transfer tax repeal is implemented, self-adjusting no-tax formulas will have no place and offer no guidance for allocations between non-taxable shares (marital or charitable) and taxable shares. Therefore, allocations among spouses, children, charity, and other beneficiaries will need to be reviewed, reconsidered and reconfigured. On the other hand, if the taxes are not repealed, such formulas are highly desirable to minimize and postpone transfer taxes. It may, therefore, make sense for plans to have dual provisions: provisions to apply if transfer taxes have been repealed and provisions to apply if transfer taxes have not been repealed or have been reinstated.

Implications for Appreciated Assets

The limited increased basis provisions will shelter substantial appreciation from capital gains tax: $3 million for assets transferred to a spouse plus $1.3 million for assets transferred to anyone, plus another $1.3 million for assets

transferred on the death of the surviving spouse. Even though the present values of those 2010 amounts are much less, the amounts apply to $5.6 million of appreciation in the assets, not merely to the fair market value of the assets. To the extent of the increased basis available, hard-to-value assets should be valued generously to maximize basis. For appreciation in excess of the increased basis amount, there will no longer be any advantage to holding the underlying assets until death to avoid capital gains tax. For unsheltered appreciation, life insurance may be used to provide liquidity to pay capital gains tax in much the way that it is often used now to pay the estate tax. Insurance may also be used to pay the ordinary income tax generated by retirement plan benefits, for which basis adjustment is not relevant.

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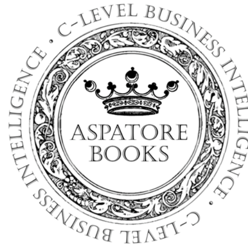

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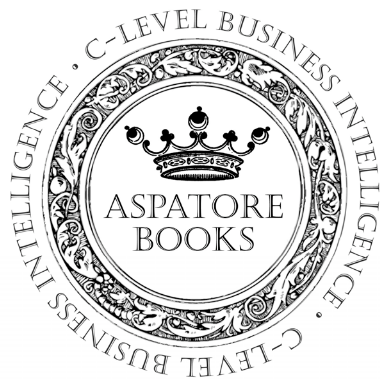
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