

— Insight on Estate Planning

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Do you know the impact of the 2010 estate tax repeal on your estate plan?

On Jan. 1, 2010, a one-year repeal of the federal estate tax went into effect, throwing many estate plans into disarray. The repeal also applies to the generation-skipping transfer (GST) tax, while the gift tax lives on with a top rate of 35% (10 percentage points lower than in 2009) and a \$1 million lifetime exemption (the same amount as in 2009).

As of this writing, these changes are still in effect, and the future of the estate tax remains uncertain — a repeal of the repeal (retroactive or prospective) or other changes may even have been signed into law by the time you're reading this. But one thing is certain: It's critical to review your estate plan to assess the impact of the current tax laws and to prepare for what the future might bring.

Will your estate plan work in 2010?

If you die while the estate tax is repealed, there's a risk that your estate plan won't work

as expected. It's common for estate plans to call for the establishment of a family trust (for the benefit of children or other descendants) and a marital trust (for the benefit of the spouse).

Some plans contain formulas that automatically allocate the amount that is exempt from estate tax to the family trust with the balance going to the marital trust. If there's no estate tax, this type of formula may place your entire estate in the family trust, effectively disinheriting your spouse. Further, depending on the rules in your state, you may create a significant *state* estate tax liability.

This result is easily avoided with an amendment, but it's important to review your plan to make sure it will achieve your objectives.

Could your family's income tax bill increase?

Another issue to watch out for is a tax law change that's attached to the estate tax repeal:

a modification of the carryover basis rules that has significant *income* tax implications. Previously, the income tax basis of most inherited property was "stepped-up" to its date-of-death fair market value. As a result, recipients of such property could sell it immediately without triggering capital gains taxes.

For 2010, the automatic step-up in basis is eliminated, though



estates can allocate up to \$1.3 million to increase the basis of certain assets plus up to \$3 million to increase the basis of assets left to a surviving spouse. What does this mean for people who die this year? For those with substantial amounts of appreciated assets, the potential income tax liabilities imposed on their heirs may offset some or even all of the estate taxes they save because of the repeal.

To soften the blow of the modified basis rules, consider leaving highly appreciated assets to your spouse or donating them to charity and leaving other assets, that are less highly appreciated, to your family. Keep in mind that taxpayers have the burden of establishing tax basis, so be sure you have good records to support the purchase price of any expenses that increase your basis in a capital asset.

Could your transfers to trusts be affected?

Consult your estate planning advisor before you transfer any assets to trusts this year. Why? Another change Congress made for this year only imposes gift tax on certain transfers that weren't taxable before.

Previously, it was possible to place certain assets in a trust to take advantage of your beneficiaries' lower income tax rates, while also avoiding gift tax by structuring the transfer as an "incomplete gift" (by retaining the right to change beneficiaries, for example). With the estate tax repealed, Congress apparently was concerned that taxpayers could use this technique to avoid both gift and estate taxes, so the law treats these transfers as taxable gifts in 2010.

Be aware that the literal language of this provision appears to impose gift tax on transfers to charitable remainder trusts. Arguably, Congress didn't mean to do that, but exercise caution pending further guidance.

What about next year?

Still another issue is that there's uncertainty about what will happen *next* year. Absent

Congressional intervention, in 2011 the estate and GST taxes will return, with top rates of 55% and \$1 million exemptions. (The GST tax exemption will, however, be adjusted for inflation.) The gift tax rate also will increase to a top rate of 55%, and the lifetime exemption will remain at \$1 million.

One way to address this uncertainty is to make the most of the annual gift tax exclusion this year. The exclusion, which allows you to give up to \$13,000 (\$26,000 for married couples) to any number of recipients free of any transfer taxes, probably won't be affected by future legislation.

If you die while the estate tax is repealed, there's a risk that your estate plan will not work as expected.

Other strategies include making taxable gifts while the tax rate is only 35% and making gifts to your grandchildren while there's no GST tax in effect. Of course, these strategies might backfire if Congress retroactively increases the gift tax rate and reinstates the estate and GST taxes.

What should you do?

Uncertainty about the future of gift, estate and GST taxes makes estate planning a challenge, but there are additional techniques you can use to hedge your bets. For example, you can design your will or revocable trust in a way that maximizes the benefits of qualified disclaimers or powers of appointment, enabling your spouse or others to direct your assets in the most tax-efficient manner.

For specific guidance with regard to your personal estate and tax situation, seek the counsel of appropriate professional advisors. Your advisors can help you review your plan and make any adjustments necessary to ensure that it continues to meet your expectations. ■

Teach your children well

Education is the key to an estate plan that leaves your desired legacy

Joel and Nancy were more concerned about sharing their values with their daughter, Isabel, than they were with sharing their wealth. They wanted to provide Isabel with a solid financial safety net, but they also wanted to impress on her the importance of education, hard work and philanthropy.

To help achieve these goals, Joel and Nancy established an incentive trust that provided Isabel with a modest income to meet her basic

needs, and conditioned the bulk of her inheritance on obtaining a college degree, maintaining gainful employment for at least five years and other desirable behaviors. Isabel met the trust's conditions and received a \$5 million distribution at age 28.

She blew through her entire inheritance by age 35.

There are two important lessons to be learned from this example. First, when it comes to teaching children about money management, even a well-designed estate plan is no substitute for education and experience. And second, an all-or-nothing approach often backfires.

Trusts don't teach ...

An incentive trust can be an effective estate planning tool, but there's a fine line between encouraging positive behavior and controlling your children's life choices. A trust that's too restrictive may incite rebellion or invite lawsuits.

Incentives can be valuable, however, if the trust is flexible enough to allow a child to chart his or her own course. A so-called "principle trust," for example, gives the trustee discretion to make distributions based on certain guiding principles or values without limiting beneficiaries to narrowly defined goals.



But no matter how carefully designed, an incentive trust won't teach your children critical money skills.

... parents do

There's no one right way to teach your children about money. It depends on your circumstances, their personalities and your comfort level.

If your kids are old enough, consider sending them to a money management class. For younger children, you might start by giving them an allowance in exchange for doing household chores. This helps teach them the value of work. And, after they spend the money all in one place a few times and don't have anything left for something they *really* want, it teaches them the value of saving. Opening a savings account or a CD, or buying bonds, can help teach kids about investing and the power of compounding.

For families that are charitably inclined, a private foundation can be a great vehicle for teaching children about the joys of giving and the impact wealth can make beyond one's family. For this strategy to be effective, children should have some input into the foundation's activities.

There's still a place for incentive trusts, but if you leave wealth to your children with strings attached, communication is critical to ensure they understand your motivations and the values you're trying to reinforce. (See "Opening the lines of communication" at right.)

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Learning from their mistakes

In addition to teaching your children about money management principles, it's important to give them practical experience so they can learn from their mistakes. Unfortunately, many parents take an all-or-nothing approach, either transferring substantial

Opening the lines of communication

Your estate plan can be a powerful teaching tool, but only if your children or other beneficiaries understand the lessons you're attempting to impart. To avoid hurt feelings — or even litigation — it's important to discuss your plans with your family.

Perhaps you're limiting your children's inheritance so they can make their own way, providing nothing more than a financial safety net so they won't end up on the street if they fail. Or maybe your plan encourages financial success by making matching gifts equal to the amount of income your children earn each year.

Whatever approach you choose, ensure that everyone in the family is on the same page. There are many ways to achieve this, including informal discussions, family letters explaining your intentions, structured family meetings and family mission statements.

amounts of wealth all at once or making gifts that are too small to provide meaningful lessons.

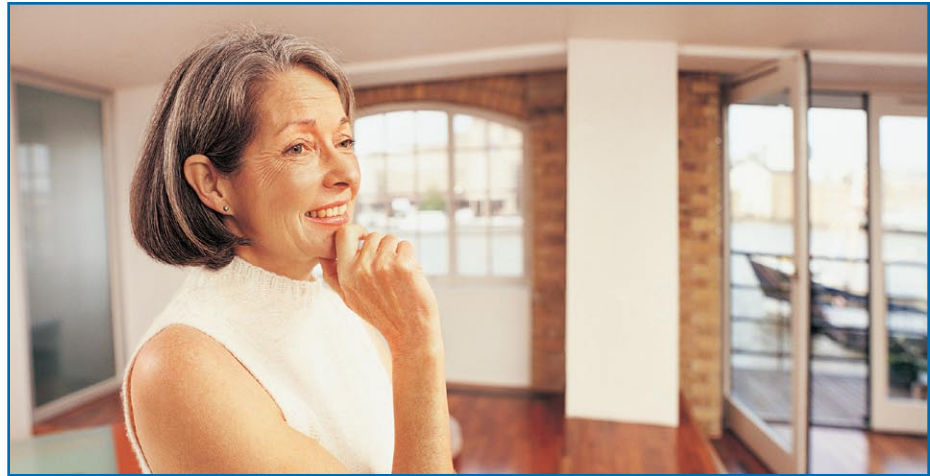
Trust distributions should be large enough so that your kids have something significant to lose, but not so large that their entire inheritance is at risk. For example, if your child's trust is worth \$2 million, consider having the trust distribute \$200,000 when your son or daughter reaches age 21. This amount is large enough to provide a meaningful test run of your child's financial responsibility while safeguarding the bulk of the nest egg.

A lasting legacy

An important goal of estate planning is to leave a lasting legacy, not just for your children but for future generations as well. Educating your children about saving, investing and other money management skills can help keep your legacy alive. ■

The installment sale: A viable option for transferring appreciating assets

Are you considering transferring real estate, a family business or other assets you expect to appreciate dramatically in the future? If so, an installment sale may be a viable option. Its benefits include the ability to freeze asset values for estate tax purposes and remove future appreciation from your taxable estate.



Giving away vs. selling property

From an estate planning perspective, if you have a taxable estate it's usually more advantageous to give property to your children than to sell it to them. Why? Because by gifting the asset you'll be depleting your estate and thereby reducing potential estate tax liability, whereas in a sale the sale proceeds generally will be included in your taxable estate. (This article is written assuming the estate tax will be in effect in the year of death. For information on the current status of the estate tax, see "Do you know the impact of the 2010 estate tax repeal on your estate plan?" on page 2.)

An installment sale gives you the flexibility to design a payment schedule that corresponds with the property's cash flow as well as with your and the buyer's financial needs.

But an installment sale may be desirable if you've already used up your \$1 million lifetime gift tax exemption or if your cash flow needs preclude you

from giving the property away outright. When you sell property — at fair market value — to your children or other loved ones rather than gifting it, you avoid gift taxes on the transfer and freeze the property's value for estate tax purposes as of the sale date. All future appreciation benefits the buyer and won't be included in your taxable estate.

Because the transaction is structured as a sale rather than a gift, your buyer must have the financial resources to buy the property. But by using an installment note, the buyer can make the payments over time. Ideally, the purchased property will generate enough income to fund these payments.

Advantages and disadvantages

An advantage of an installment sale is that it gives you the flexibility to design a payment schedule that corresponds with the property's cash flow as well as with your and the buyer's financial needs. You can have the payments increase or decrease over time, or even provide for interest-only payments with a balloon payment of the principal at the end of the term.

A disadvantage of an installment sale over strategies that involve gifted property is that

you'll be subject to tax on any capital gains you recognize from the sale. Fortunately, you can spread this tax liability over the term of the installment note. But, you'll want to keep in mind that, as of this writing, the low 15% long-term capital gains rate is scheduled to be in effect only through 2010, though Congress may extend it. Check with your estate planning advisor for the latest information.

Also, you'll have to charge interest on the note and pay ordinary income tax on the interest payments. IRS guidelines provide for a minimum rate of interest that must be paid on the note.

On the bright side, any capital gains and ordinary income tax you pay further reduces the size of your taxable estate.

Simple technique, big benefits

If you have an asset that you expect to greatly appreciate in the future, such as a family business or real estate, and would like to transfer it to loved ones, an installment sale might be a beneficial addition to your estate plan. But bear in mind that this simple technique isn't right for everyone. Consult your estate planning professional to help determine if an installment sale is right for your situation. ■

Estate Planning Pitfall

You haven't provided for the removal of a trustee

When estate planning, most people put a great deal of thought into selecting the right trustees to carry out their wishes and protect their beneficiaries. But it's also important to establish procedures for removing a trustee in the event that circumstances change.

Failing to do so doesn't mean your beneficiaries will be stuck with an inadequate trustee. But they'll have to petition a court to remove the trustee for cause, which can be an expensive, time-consuming and uncertain process. Making the process more onerous is the fact that courts are generally reluctant to remove a trustee that was hand-picked by the trust maker.

Grounds for removing a trustee vary according to state law, but typically include:

- Conflicts of interest or lack of cooperation with beneficiaries,
- Insolvency or bankruptcy (if it would jeopardize trust administration),
- Mismanagement, fraud or other misconduct,
- Poor health, or
- Legal incapacity.



To avoid the need for court intervention, include procedures for removing a trustee in your trust agreement. You might allow beneficiaries to remove a trustee without cause if they're dissatisfied with his or her performance. Or you might provide for removal of a trustee under specific circumstances defined in the trust agreement.

Your trust agreement also should include a list of successor trustees. If one trustee is removed, the next person on your list becomes the new trustee. Another option is to appoint a trust protector — a "super trustee" empowered to make certain decisions, including firing a trustee and appointing a new one.