Insight on Estate Planning

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Be flexible!

Estate planning for an uncertain future

It's said that the only thing certain is change, and nowhere is this more true than in estate planning. Given the estate tax's uncertain future, it's more important than ever to build flexibility into your estate plan.

The state of the estate tax

During the last several years, exemption amounts have increased while tax rates have dropped. Under current law, the estate tax will disappear in 2010, only to reappear in 2011, when the exemptions and rates are scheduled to spring back to their 2001 levels. (See "Changing exemption amounts and tax rates" on page 3.)

But lawmakers are expected to change the estate tax regime before 2010. Rather than keep the repeal in place, Congress may well preserve the estate tax but with a higher exemption amount (between $3.5 million and $5 million, for example).

Be prepared

With a range of possibilities — from no estate tax to the lowest exemption amount and highest tax rate in a decade — in mind, review your situation and explore techniques for building flexibility into your estate plan. The right approach depends on your particular circumstances, but here are a few strategies to consider:

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Give it away. The simplest strategy is also one of the most effective. The annual gift tax exclusion allows you and your spouse to give up to $12,000 each (adjusted annually for inflation) to an unlimited number of recipients free of gift tax and without using any of your lifetime gift tax exemption, currently $1 million. So, for example, if you have three children and five grandchildren, you and your spouse jointly could make tax-free gifts to them of up to $192,000 per year.

These gifts shrink the size of your estate, resulting in substantial savings in the event of an estate tax increase. But even if estate tax rates go down and the exemption amount goes up, a gifting strategy can't hurt.

You might even consider making gifts that exceed the annual

Changing exemption amounts and tax rates

Year	Estate and GST tax exemptions[1]	Gift tax exemption	Highest estate and GST tax rate	Highest gift tax rate
2008	$ 2 million	$ 1 million	45%	45%
2009	$ 3.5 million	$ 1 million	45%	45%
2010	Repealed	$ 1 million	N/A	35%[2]
2011	$ 1 million[3]	$ 1 million	55%[4]	55%

[1] The estate tax exemption is reduced by any gift tax exemption used during your lifetime.
[2] Equal to the highest marginal income tax rate, which is currently scheduled to be 35%.
[3] GST tax exemption will be indexed for inflation.
[4] The benefits of the graduated estate and gift tax rates and exemptions will be phased out for estates and gifts over $10 million.
Source: U.S. Internal Revenue Code

exclusion amount and use up some or all of your $1 million lifetime gift tax exemption. Although this reduces the size of your estate tax exemption down the road (assuming, of course, that the estate tax isn't repealed), you might be better off giving away certain assets now to remove any future income or appreciation in value from your estate.

Just say no. A qualified disclaimer is a refusal by a beneficiary to accept an interest in property. It's "qualified" if it's in writing, is delivered within a specified time period and meets certain other requirements. The disclaimed property then passes to a contingent beneficiary according to the terms of the will or trust.

If your estate plan is designed properly, your spouse or other beneficiaries can use qualified disclaimers to achieve the best tax results depending on the financial circumstances and applicable estate tax laws at the time. For example, Steve's estate plan provides for all of his wealth ($5 million) to go to his wife, Aliza, but also provides that any amounts Aliza disclaims go into a bypass trust — also known as a credit shelter trust.

If all of Steve's assets go to Aliza, the unlimited marital deduction shelters them from estate taxes on his death, but his estate tax exemption is wasted. When Aliza dies, her estate will be subject to tax to the extent it exceeds her exemption amount.

If the exemption is $3.5 million and the estate tax rate is 45%, for example, the estate tax on the $5 million she inherited from Steve would be $1.5 million x 45%, or $675,000. Plus any appreciation on the $5 million and any other assets in her estate also would be subject to the 45% estate tax.

A bypass trust, on the other hand, would provide Aliza with an income interest for life, after which the assets would go to her children or other beneficiaries. The trust assets would *bypass* her estate and use Steve's exemption to reduce or eliminate estate tax on them.

Steve's estate plan gives Aliza the flexibility to determine the best course when Steve dies. If, at that time, the estate tax exemption is $3.5 million, she may want to disclaim $3.5 million and allow it to go into a bypass trust, a strategy that takes advantage of both of their exemptions and avoids estate taxes.

On the other hand, if the estate tax has been repealed or the exemption amount has been increased to $5 million, Aliza may want to accept the entire inheritance. Of course, if the estate tax is later reinstated or the exemption amount is lowered, Aliza's estate may be subject to estate tax.

The GRAT escape. A grantor-retained annuity trust (GRAT) allows you to remove substantial amounts of wealth from your estate, together with any future appreciation in value, while retaining an income stream. At the end of the

trust term, the assets are transferred to your children or other beneficiaries tax-free.

There are a couple of disadvantages to this strategy. First, it works only if you outlive the trust term, so the term shouldn't be too long. Second, the initial contribution of assets to the trust is subject to gift tax if it exceeds your available gift tax exemption — an unnecessary expense if the estate tax is ultimately repealed or the exemption amount is increased beyond the size of your estate.

Fortunately, IRS regulations allow you to structure a GRAT in a way that minimizes (or, in some cases, eliminates) gift taxes.

Revisit your plan

These are just a few examples of strategies you can use to build flexibility into your estate plan to make the most of any tax changes Congress devises. You should review your plan now to ensure it's ready for anything.

Leaving a lasting legacy with a dynasty trust

The idea of leaving a legacy that lasts for hundreds of years — or even perpetually — has a certain romantic appeal. But romance alone shouldn't be the driving force behind your estate plan.

A dynasty trust can preserve substantial amounts of wealth — and shelter it from federal gift, estate and generation-skipping transfer (GST) taxes — for generations to come. But a dynasty trust isn't an end in itself. First, you need to ask yourself what you hope to accomplish with your estate plan. Only then can you determine whether a dynasty trust or other estate planning vehicles will best help you achieve your goals.

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A recent phenomenon

The concept of a trust that can last "forever" is a relatively recent one. Up until around 10 years ago, virtually every state applied the "rule against perpetuities," which limits a trust's life span. The rule is complicated, but in general it prevents trusts from lasting more than 100 years or so.

During the last decade, however, there's been a trend among the states to abolish or relax the rule against perpetuities. Today, around half the states have either eliminated the rule or extended the limit to several hundred or even 1,000 years.

Perpetual growth

Your contributions to a dynasty trust are considered taxable gifts, but you can minimize or avoid gift taxes by taking advantage of your lifetime gift tax exemption (currently $1 million) and your

annual gift tax exclusion (currently $12,000 per recipient, $24,000 for gifts by a married couple).

And don't forget that you've got a $2 million estate tax exemption — or whatever is left of it — to use at your death. To transfer as much wealth as possible to your dynasty trust, allocate your remaining GST tax exemption to it to ensure that your dynasty trust can benefit your grandchildren and future generations without triggering harsh GST taxes.

Also consider leveraging your GST tax exemption by funding the dynasty trust with life insurance policies or property that's expected to appreciate significantly in value. So long as your exemption covers the value of your contributions, any future growth will be sheltered from GST tax.

After you fund the trust, the assets can grow and compound indefinitely. The trust should be designed to make distributions to your children, grandchildren and future descendants according to criteria you establish. So long as your beneficiaries don't gain control over the trust, the assets will bypass their estates. As an added bonus, you could structure the trust as a grantor trust so that you pay any taxes on the trust's income, and (at least during your lifetime) the assets are free to grow without being eroded by taxes.

Allowing a trust to grow for several generations can produce enormous amounts of wealth. For example, a trust funded with an initial contribution of $1 million and earning an average annual return of 6% will be worth more than $18 million in 50 years and almost $340 million in 100 years (assuming no income taxes or distributions).

Practical considerations

If you think a dynasty trust might help you achieve your estate planning goals, talk to your advisors about the practical requirements for establishing one. You don't have to live in a perpetual trust state to take advantage of this technique; generally, it's just a matter of specifying the applicable state law in the trust agreement.

And there may be other requirements, such as being required to appoint at least one trustee who resides in the state whose laws govern the trust — a bank or other corporate trustee, for example — and locating at least some of the trust assets in that state. These rules vary from state to state, so choose carefully. Typically, the most attractive states are those that allow perpetual trusts and have no state income tax.

A lasting legacy

A dynasty trust can be a powerful tool for creating a legacy that lasts for decades or even centuries. Before establishing a dynasty trust, however, discuss your estate planning goals with your advisors and determine whether it's the right tool for the job.

Dynasty trust planning ideas

So, how can a dynasty trust help you achieve your estate planning objectives? Why would you want to preserve your wealth for distant descendants whom you'll never meet when you have children and grandchildren who can enjoy your generosity while you're alive to see it? There's no short answer to these questions, but here are a few ideas to consider:

Supplemental assistance. If your estate plan already provides for your immediate family with resources to spare, a dynasty trust can be a nice supplement to your plan, allowing you to provide for future generations as well.

Providing a safety net. You may be reluctant to turn your kids into "trust fund babies" by allowing them to live off their inheritances. You can design a dynasty trust to ensure that your children, grandchildren and future generations pursue their own careers while at the same time providing them a safety net in the event they're unable to pay for health insurance, medical care, education, housing or other necessities.

Sweetening charity. A dynasty trust can be a great tool for encouraging charitable giving. For example, you might provide for the trust to make "matching distributions" to beneficiaries equal to a percentage of the charitable contributions they make each year.

Powers of appointment

Why decide today when you can put it off until tomorrow?

One potential problem with wills, trusts and other traditional estate planning tools is that they force you to make decisions about how your wealth will be distributed years or decades in advance. A power of appointment may solve that problem. It's a document that authorizes another person — such as a family member or trusted advisor — to designate who will receive certain property.

Two types of powers

Powers of appointment come in two forms: general powers and limited (or special) powers. The distinction is important, not only because it defines the level of authority conferred, but also because it can have significant tax implications. When someone receives a *general* power of appointment over property, the property is included in his or her taxable estate. When a person receives a *limited* power, generally there are no estate tax consequences for him or her.

A general power of appointment authorizes your designee (called the "holder") to direct your property to *anyone*, even to him- or herself. A limited power of appointment allows the holder to direct distributions to certain people, or a certain class of people — such as children and grandchildren — under specified circumstances. It can also be used to benefit the holder, provided distributions are limited based on "ascertainable standards" related to the holder's health, education, maintenance or support.

Careful drafting is critical because an innocent slip of the pen can have disastrous consequences. For example, under federal law a power "which is limited by an ascertainable standard relating to health, education, support, and maintenance" isn't considered to be a general power of appointment. But a document that allows distributions for the holder's "comfort, welfare or happiness" would likely be considered to confer a general power of appointment because it goes beyond the basic necessities of life.

It's also important to specify a backup, or "taker in default," if the original holder declines or is unable to exercise the power of appointment.

Discretionary spending

Even the most comprehensive estate plan can't anticipate every possibility. A power of appointment allows you to postpone certain decisions until more information is available. The holder has the discretion to distribute your wealth in a manner that best fulfills your estate planning goals.

For example, Jerry has a daughter, Elaine, and three young grandchildren. He plans to set aside a portion of his wealth for his grandchildren, but he doesn't want them to rely on the trust to support themselves; he'd like to encourage them to achieve some measure of success on their own.

One option is to have his advisors draft an incentive trust that conditions distributions on good behavior. Jerry can define good behavior to mean virtually anything, from obtaining a college degree to staying gainfully employed to becoming more involved in socially responsible activities.

These trusts can be effective, but what happens if a situation arises that the trust doesn't address? Suppose one of Elaine's children lands an unpaid internship with a stock brokerage firm. The position doesn't meet the trust's definition of "gainful employment," but it's a worthwhile pursuit that's designed to lead to gainful employment.

To build more flexibility into his estate plan, Jerry gives Elaine a limited power of appointment to allocate assets among her children as she sees fit. This gives her the discretion to determine how the property will be distributed and in what amounts, and even allows her to leave out one or more children if she feels they haven't lived up to Jerry's expectations.

Powers of appointment come in two forms: general powers and limited (or special) powers.

Generating tax savings

You also can use a general power of appointment to avoid generation-skipping transfer (GST) taxes. The GST tax is a flat tax imposed at the highest marginal estate tax rate (currently 45%) on transfers that skip a generation (to a grandchild, for example). There's a GST exemption, which is $2 million in 2008. Once you exceed the exemption, however, generation-skipping transfers are subject to GST tax *in addition* to estate taxes.

Let's say that Jerry, from our previous example, has used up his GST and estate tax exemptions. If he puts an additional $6 million in trust for his grandchildren, nearly 80% of that amount will be devoured by estate and GST taxes.

Suppose, instead, that Jerry gives a general power of appointment to Elaine, whose estate tax exemption (currently $2 million) and gift tax exemption (currently $1 million) are intact. Although the power of appointment constitutes a taxable gift from Jerry to Elaine, it avoids GST tax. And even though the property will be included in Elaine's estate, she can use her exemptions to shield a portion of the assets from gift and estate taxes, resulting in a lower overall tax burden.

A matter of trust

Unless you have a crystal ball, it's difficult to predict what your family's circumstances will be years or decades from now. If you have someone you can trust to carry out your wishes when that time comes, a power of appointment can be an effective and flexible tool. ▪

Estate Planning Pitfall

Your will or trust doesn't name contingent beneficiaries

Estate planning is difficult because it forces you to plan for your own death. And to plan effectively, you should consider an even less pleasant scenario: the possibility that your children or other family members might die before you.

Failure to consider this possibility and to name contingent beneficiaries can derail your estate plan should the unthinkable happen. Why? Because all the effort you put into planning your estate could be for naught if a primary beneficiary isn't there to receive it.

If a primary beneficiary predeceases you and you haven't named contingent beneficiaries for the assets that beneficiary was slated to receive, it will be as if you had died without a will. The property will pass to your surviving family members, if any, according to state intestacy laws, and the result may be dramatically different from what you had planned. Even worse, if you have no surviving heirs, your wealth will become property of the state.

To ensure that your wishes are fulfilled, name at least one contingent beneficiary for each primary beneficiary. Your contingent beneficiaries can be virtually anyone you choose, including distant family members, friends or even charitable organizations.

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