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"ESTATE PLANNING - LUXURY OR NECESSITY?"

by: Samuel J. Owen

Estate Planning must consider tax savings and consequences but must primarily be concerned with the client's present and anticipated estate and dispositive desires.

Estate planning involves vehicles and procedures which primarily deal with possible disability and probable post-death conditions. Estate planning looks toward reduction of estate taxes, and also conditions during the lifetime of the client with a view toward the reduction of income taxes.

ESTATE ORIENTED PLANNING PROCEDURES AND VEHICLES

- **Do nothing - die intestate** - This is a totally unacceptable procedure for any person with an estate of any size. The state laws of descent and distribution prevail, with all their generally unsatisfactory results. No will is made of record for future generations. Laws can change with unintended results from state to state.
  NOTE: Colorado law changed July 1, 1995.

- **All assets in joint tenancy** - This is slightly better than doing nothing but presents severe problems in the event of simultaneous death, inactivity by surviving joint tenant, difficulty in planning should planning ever be undertaken, and over qualification of the marital deduction. Also, no will of record.

- **The "simple will"** - This approach has the advantage of planned disposition of assets with alternate heirs and devisees, but it still retains an inability to provide for minor children and other disabled heirs and devisees. Appropriate in certain cases.

- **Will and testamentary trust** - This offers far broader estate planning opportunities for minors, disabled heirs and devisees, and can assist heirs and devisees who are in need.

- **Will and testamentary trust with planning for marital and non-marital trusts** - This approach protects children of first spouse to die from carelessness of surviving spouse, provides maximum amount of tax savings to surviving spouse and children, contains maximum use and flexibility of the federal estate tax marital deduction, avoids the necessity of a conservatorship for minor children and allows maximum tax savings in the event of the death of both parents while children are minors.

- **Revocable Living Trust** - This devise provides the ultimate in premortem and postmortem flexibility and tax savings. Properly prepared, it is as close to "ideal" as any method of devise can be. It assures all the advantages of a will with testamentary trust, avoids substantive probate, assures privacy and guarantees continuity of management of assets.

- **Multi-Generational Trusts** - This devise makes the estate trust estate of the beneficiaries of a decedent "*bullet proof!!* The trust becomes immune to most creditors and estate taxes after the decedent's death. The beneficiaries' trust(s) can be designed to survive <u>in perpetuity</u>. Everyone can shield up to $1,100,000 from future estate tax and can shield the balance from creditors. Everyone with children should seriously consider the benefits of this planning technique.

<u>LIFETIME DISABILITY PLANNING AND ADVANCE DIRECTIVES</u>

- **Durable Power of Attorney (Financial Matters)** - Everybody should have one. The "durability" language must be set forth in the agreement. The instrument provides continuity in business and financial affairs, according to the agreement, should the principal be unable to make informed decisions about business and financial matters. It can be used for both personal and real property. <u>Caution must be used in selecting an agent</u>.

- **Supplemental Provisions to Durable Power of Attorney** - It is important for the principal to consider giving the agent the power to make gifts. This may assist the agent in qualifying the principal for Medicaid. It also permits the agent, in larger estates, to reduce estate taxes by utilizing the $11,000 per year per donee annual exclusion.

- **"Living Will" -** A living will is a *medical* declaration expressing a person's wish to reject medical or surgical treatment in very limited situations. Colorado has traditionally recognized the right of a competent person to accept or reject medical or surgical treatment affecting his person. Advances in medical science have made it possible to prolong dying through the use of artificial, extraordinary, extreme or radical medical or surgical procedures. During this process the body may respond to these procedures, but the mind may be lagging and the patient may be unconscious or otherwise incompetent to accept or reject these decisions. Many persons feel that a living will covers the "typical nursing home situation". The problem is, the living will covers only *terminal situations*, and does not cover the situation where one is not terminal.

- **Medical Durable Power of Attorney -** The authority of an agent to act on behalf of the principal consenting to or refusing medical treatment, including artificial nourishment and hydration, may be set forth in a medical durable power of attorney. The medical durable power of attorney may include any directive, condition or limitation of an agent's authority. This has been set forth and clarified in the "Colorado Patient Autonomy Act", effective June 4, 1992.

FEDERAL ESTATE AND GIFT TAXES

All taxable gifts and the estates of all decedents are taxable under a single, unified tax rate. The tax is computed by deducting a single, lifetime credit from a "Tentative" tax as set forth in the rate table which follows.

- **Federal Estate Tax** - Federal tax is levied against all estates; the tax will only be payable, however, if the amount of the "Tentative" tax exceeds the amount of the estate's available Unified Credit (see below). The value of the taxable estate includes the value of all property the decedent owns at death, plus the value of all taxable gifts made after 1976 (and, in certain cases, the amount of the gift tax paid by the decedent, as well). Federal gift tax paid is deductible from the estate tax.

- **Federal Gift Tax -** All completed gifts in excess of $11,000 (except gifts of future interests) to any one person in a single year are subject to tax. I call this the *"Christmas present exclusion"*. Married persons may make joint gifts to third parties, thereby being effectively taxed at lower rates and also doubling the annual exclusion to $22,000 per donee.

In May 2001 Congress passed the *Economic Growth and Tax Relief Reconciliation Act of 2001*. This act substantially changes the Estate and Gift Tax. From 2002 to 2009 the Estate Tax is gradually phased out, until in 2010 there is no Estate Tax. However, the law has a built in "sunset" provision and on January 1, 2011 the Estate Tax is reinstated as it exists today with a $1,000,000 exemption. On January 1, 2002 the lifetime exclusion amount for Gift Tax purposes increased to $1,000,000. This exclusion is in addition to the $11,000 annual exclusion. The Gift Tax exclusion is set to remain at $1,000,000 with no further adjustments.

TRANSFERS TO YOUR SPOUSE

The law (new as well as old) has no ceiling on transfers by gift or at death between spouses who are citizens of the United States. They are not taxable. It should be noted, however, that transfers between resident alien spouses (i.e. non-U.S. citizens) are not exempt, as in the case of spouses who are citizens.

ESTATE TAX RATES FOR DECEDENTS DYING AFTER DECEMBER 31, 2001

After December 31, 2001, the top marginal estate and gift tax rate starts to fall - gradually. In 2002, it falls to 50 percent, applicable to amounts in excess of $2.5 million instead of 55 percent and 60 percent in 2001. After 2002, the top rate drops more slowly (by one percent each year), until it levels off at 45 percent for the 2007 to 2009 period for amounts in excess of $1.5 million. The other estate tax rates up to 45 percent and the corresponding bracket amounts, however, do **not** change. They remain the same over the entire nine-year phase out period.

ESTATE TAX RATES AFTER THE TOP RATE LEVELS OFF AT 45% IN 2007

(A) Amount Subject To Tax More Than -	*(B) Amount Subject To Tax Equal To Or Less Than -*	*(C) Tax On Amount In Column (A)*	*(D) Rate of Tax On Excess Over Amount Column (A) (Percent)*
$ 1,000,000.00	*$ 1,250,000.00*	*$ 345,800.00*	41
1,250,000.00	*1,500,000.00*	*448,300.00*	43
1,500,000.00	*Over 1,500,000.00*	*555,800.00*	45

EXEMPTION FOR DECEDENTS DYING AFTER DECEMBER 31, 2001

Calendar Year	*Exemption*
2002 and 2003	$1,000,000.00
2004 and 2005	$1,500,000.00
2006, 2007 and 2008	$2,000,000.00
2009	$3,500,000.00
2010	Unlimited
2011	Back to $1,000,000.00!

The Economic Growth and Tax Relief Reconciliation Act of 2001 made many substantial changes in the Estate and Gift Tax Law. I anticipate that more changes will be made in the law between now and December 31, 2010. There are two presidential elections and four congressional elections between now and then. Also, the world has changed since the Act was passed. Planning your estate remains an important tool for protecting your assets for future generations.

CHANGES IN THE CARRYOVER BASIS

Starting in 2010, a system called *"carryover basis"* will replace today's *"stepped-up basis"* for property that passes to another person after a decedent's death. This eliminates the only "good tax result" following a person's death. This "system" replaces the estate tax with a modified income tax system of taxing assets of a decedent.

The carry over basis system means, a decedent's heirs or devisees who sell property they inherit from the decedent, will have the same amount of taxable gain that would have resulted if the decedent had sold the property. Every estate (except for estates of nonresident aliens) will be entitled to increase, by a maximum of $1,300,000, the basis of assets to the date-of-death value of the assets of a decedent's estate. Thus, if the decedent's estate has noncash property worth $6,000,000 on the date of death, having an adjusted basis of $1,000,000, using this limited, modified basis step-up provision, the basis of this property can be increased to $2,300,000. If a surviving spouse receives the assets, an additional $3,000,000 in basis step-up is available.

Planning pitfalls and opportunities exist in the allocation of the $1,300,000 basis increase. For instance, who receives the basis increase and which assets receive the step-up in basis? Who keeps track? The IRS? I don't think so.

The bad news: The heirs and devisees of an estate of a single person worth $3,500,000 or less may be worse off after phase-out of the estate tax than before. Before repeal, in 2010, the estate would pay no estate tax and the estate's assets would pass to heirs and devisees with a full basis step-up. After repeal, the estate will pay no estate tax but the heirs and devisees step- up will be limited to actual basis plus $1,300,000. So, what is happening is the decedent who has an adjusted basis of less than $2,200,000 will be worse off ($3,500,000 less $1,300,000) as the "repealed" estate tax is replaced with a vibrant new source of income tax.

- **Creation of a "Credit Shelter" Trust on the Death of the First Spouse** - This technique shields from estate tax, a maximum amount equal to the amount of the unified credit, which represents an Exemption Equivalent of $1,000,000 in 2002 to $3,500,000 in 2009. The technique involves creating a trust on the death of the first spouse for the life of the surviving spouse. The trust provides the surviving spouse with all of the income, principal for needs and provides the surviving spouse a limited power of appointment. This trust continues to offer protection from creditors for a surviving spouse in addition to tax savings.

- **Revocable Living Trust** - Ideal for asset management, protection against disability, assures privacy and avoids substantive probate. Client chooses the trustee and successor trustees. Often referred to as "*Super Joint Tenancy*" because it offers all of the advantages of joint tenancy, none of the disadvantages of joint tenancy and many advantages not offered by joint tenancy.

- **Generation-Skipping Transfer** - Federal estate tax law seeks to impose an estate tax on the transfer of wealth to each successive generation. However, each client is entitled to "skip" the next generation below them in an amount not to exceed $1,100,000.00. This amount can skip successive generations in perpetuity. This technique should not be overlooked for even modest estates, as it is a ticket to preserving your hard earned estate from future generations' taxes and creditors.

- **Qualified Terminable Interest Property Trust** - Called the "QTIP" trust, this device is recommended for second marriages or step-families. A QTIP qualifies for the estate tax marital deduction on the death of the first spouse, is taxable on the death of the second spouse, but assures direction and control of a decedent's assets. Its primary use is to avoid disinheriting of a decedent's heirs while at the same time benefitting a decedent's second spouse. In other words, its application is to avoid a stepparent from disinheriting stepchildren, while at the same time providing for the stepparent.

- **Charitable Split Interest Trust** - The charitable split interest trust has the following tax implications:

  - The client receives a current income tax deduction for the value of the charitable remainder interest at the time of the transfer of the property to the trust;

  - The transfer is reported for federal tax purposes, but the value of the interest passing ultimately to charity is permitted as a gift tax deduction;

  - If the Settlor of the trust dies within the term of payments reserved to the Settlor, there will be an estate tax deduction for the value of the charitable remainder determined as of the Settlor's death.

The charitable deductions for the remainder interest passing to the charity are available only if the trust is qualified as prescribed by the Internal Revenue Code.

- **Grantor Retained Interest Trusts** - Property may be placed in trust by the Settlor, which instead of granting the beneficiary a term of years, reserves a term of years to the Settlor. Generically, such a trust has been referred to as a Grantor Retained Interest Trust or GRIT. The gift of the remainder is a taxable transfer, but the actuarial value of the reserved term of years reduces the amount of the gift. If the Settlor outlives the term of the trust, the corpus of the trust is removed from taxation in the Settlor's estate.

The estate tax advantages of trusts in which the remainder is transferred to others and the Settlor retains an income interest, is that the gift element of the transaction is only the present value of the remainder interest after taking the reserve term of years into account. The gift value of the remainder interest, however, does not receive an annual exclusion ($11,000 per year per donee) and requires application of the grantor's Unified Credit. A disadvantage of the GRIT is that the corpus of the trust must be transferred to the remainder persons during the life of the Settlor, if the trust value is to escape inclusion in the grantor's gross estate.

If the Settlor survives the trust term, the value of the gift is frozen, thus moving future appreciation from the grantor's estate. The gift must be complete in order to remove the gift from the grantor's estate and accomplish the valuation freeze.

A form of a GRIT is a Qualified Personal Residence Trust, or QPRTs. With a QPRT, a contingent reversion to the Settlor is permitted, which results in an even further discounting of the remainder interest.

- **Irrevocable Life Insurance Trusts** - Called an "ILIT", the irrevocable life insurance trust avoids inclusion of the client's life insurance in the taxable estate of the client. For a deep discount represented by annual premium payments of less than $11,000 per year per person, a client is able to remove the death benefit created by the payment of the life insurance premiums from the client's estate at death, still provide for the surviving spouse, and exclude the life insurance from the surviving spouse's estate as well. An ILIT can be tied into a generation-skipping transfer trust and provide life income and support for the client's spouse and the children of the client and pass to the client's grandchildren and even further generations in perpetuity; all with no income tax or estate tax and without utilizing the client's lifetime Equivalent Exemption! This is a very popular device.

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