

THE TOOLS OF ESTATE PLANNING

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In assisting your clients in their estate planning needs, understanding your clients' personal goals and understanding the application of the tools available to achieve those goals are essential to the estate planner. Although the goals of many clients are similar, the determination of a client's goals may ultimately be the most difficult part of estate planning. However, gaining a solid understanding of the tools available to the estate planner will also give you insight into understanding your client's goals. This presentation will review some of the issues your client may face, then it will focus on the tools of estate planning available to solve those problems.

I. Identifying Adverse Situations Faced by Your Clients

A. Probate

1. If the gross value of the client's estate exceeds \$100,000, then all assets owned by client after his or her death will be probated
 - a. The Gross Estate includes all separate property and one-half of the community property, but
 - b. Does not include assets that transfer by operation of law on the decedent's death (such as joint tenancy and beneficiary designations) and value of assets registered with the Department of Motor Vehicles
2. Cost of Probate
 - a. Attorney Fees
 - b. Administrator Fees
 - c. Various other costs and Fees
3. Time Delay for Probate
4. Privacy Lost in Probate

B. Wrong Person Inheriting Assets

1. Unless you choose otherwise, upon your death your assets are distributed under the California rules of intestate succession

2. Rules vary depending on character of property (i.e. community or separate)
- C. Right Person Inheriting Assets at Wrong Time
1. Too early – may be a disincentive to self development for a child
 - a. Education
 - b. Career
 2. Too late – guardian for children may not have discretion to distribute funds for minor’s benefit in a manner desired by parent
 - a. Education
 - b. Lifestyle
- D. Income Taxes During Life
1. Taxes on dividends and interest on investments
 2. Taxes on disposition of investments
 3. Shifting income to a trust is no longer advantageous
- E. Income taxes after death
1. Capital gains on sale of property – stepped up (or down) basis
 2. Income in respect of a decedent
- F. Estate taxes upon death
1. Estate taxes apply to value of all assets owned by the decedent and certain other assets in which the decedent possessed certain rights or benefits at time of death. Three common deductions from the taxable estate
 - a. Unlimited marital deduction
 - b. Unlimited charitable deduction
 - c. Applicable Credit (Unified Credit) – Equivalent to \$1,500,000 (2005) in transfers (and going up)
 2. Tax is based on graduated rate applied to all lifetime taxable gifts and taxable estate at death

- a. Lifetime taxable gifts -- Transfer made for less than fair market value, except legal obligations, less gifts of a present interest
- G. Estate taxes upon spouse's death -- same rules apply, but proper use of applicable credit rather than marital deduction can save assets from estate taxation
- H. Generation skipping transfer taxes (GSTT) – Generally applicable any transfer to a person two generations below the donor
 - 1. Exemption applies to \$1,500,000 (2005) in transfers, allocated during life and after death
 - 2. If exemption is applied to a trust, all growth in the excluded portion of the trust is protected from GSTT
- I. Inability or unwillingness of client to manage assets – Normally as a result of incapacity
 - 1. Lack of organization -- "lost assets"
 - 2. Failure to adequately invest -- lost earnings or unnecessary risk
 - 3. Failure to pay taxes -- penalties
 - 4. Susceptibility to undue influence from "strangers, family or friends"
 - 5. Court intervention through a conservatorship
- J. Turmoil in operation of business if client were suddenly unable to continue in operating -- Unpleasant transfer of a business to selected successors
- K. Stress associated with knowing that "everything is not in order"

II. Estate Planning Tools

- A. Basic Estate Planning Tools
 - 1. Will -- Document recognized under California law as the decedent's directions regarding disposition of his or her assets
 - a. Achieves goal of choosing the persons or entities who should receive your assets.

- b. Can do everything a revocable trust can after the death of the testator, except avoid probate–Executor implements the instructions in the Will with the oversight of the Court
 - c. Will is typically document used to nominate guardians for minor children
 - d. When used in conjunction with a revocable trust, the will is used to “pourover” to the trust assets not previously placed in trust
2. Revocable Trust
- a. Avoids probate
 - b. Provide instruction on the use of assets for the benefit of the settlor during the settlor's life
3. Post death benefits of Will or Revocable Trust
- a. Allows creation of new trusts on death that can:
 - (1) Protect unified credit -- Bypass Trust
 - (2) Provide spouse with income and principal as needed, then on spouse's death direct the assets to persons chosen by the first spouse -- Qualified Terminable Interest Property ("QTIP") Trust
 - (3) Maximize efficiency in use of exclusion from Generation Skipping Taxes
 - b. Provide distributions to any other person or entity, in trust or free of trust, now or in the future and under any other reasonable condition the settlor may desire
 - c. Provides some privacy (notice to heirs)
4. Durable Power of Attorney -- Allows an agent to act for you under certain circumstances
- a. If not based upon incapacity, then may be used when principal is not "available"
 - b. If based on incapacity, then only effective after the incapacity of principal
 - (1) Primary purpose is to avoid conservatorship

- (2) Conservatorship may still not be avoided if it is necessary to protect the estate against undue influence
- 5. Joint tenancy, pay on death accounts and other methods of holding assets that avoid probate
 - a. Transfer which take effect automatically on death are nonprobate transfers
 - (1) Benefit -- avoids probate
 - (2) Problem -- may limit spouse's ability to get a full step-up in basis for capital gains purposes – proof of character as separate property or community property
- 6. Intervivos gifts -- gift during life of donor
 - a. Benefits
 - (1) Avoids probate
 - (2) Allows donor to see donee enjoying gifts during donor's life
 - (3) Very simple administration
 - (4) If gift tax results, the tax paid is removed from the estate and is not itself taxed
 - (5) Future growth of assets is not taxed in the estate of donor
 - b. Negatives
 - (1) Donor may still need assets
 - (2) Donee may not be ready to receive assets (impact work ethic)
 - (3) Donor has no control over donee after gift is completed
 - (4) Third parties may acquire rights in the gift (spouses)
 - (5) Gift tax may result
 - (a) Often, even if donor has excess funds to pay the tax and payment of tax provides benefit, donor is adverse to payment of such tax
 - (b) Taxable gifts equals total value of gift less value of present interest up to \$11,000

B. More Sophisticated Estate Planning Tools

1. Irrevocable Trusts

- a. Normally results in a completed gift to the trust beneficiaries
 - (1) Intervivos gifts discussed above

- (2) Gift to irrevocable trust is not a gift of a present interest. With addition of "Crummey" withdrawal rights, a portion (or all) of the gift can be transferred into a gift of a present interest
 - b. Incomplete gifts
 - (1) If donor retains certain types of control over, or benefits from, the trust, then trust will be "Grantor Trust".
 - (a) Effect on gift and estate taxes
 - (b) Effect of income taxes
 - c. What should the irrevocable trust hold –
 - (1) Insurance
 - (2) Investments
 - (3) Family business
2. Noncharitable Split Interest Trusts
- a. Characteristics common to split interest trusts
 - (1) The "gift" to the beneficiary is the remainder interest in a trust in which the grantor retains the current interest
 - (2) No transfer tax due upon delivery of property to beneficiary at end of trust term
 - (3) Intervivos gift which reduces the estate by any gift taxes paid
 - (4) Possible negative -- usually the tax benefits are compromised if the grantor does not live to the end of the trust term.
 - (5) Additional negative -- no step up in basis
 - b. Qualified Personal Residence Trust ("QPRT") -- Allows grantor to put home in trust for benefit of grantor for a period of years; at the end of that period the home goes to a named beneficiary or a trust for the benefit of the beneficiary
 - (1) If the grantor does live until the end of the trust term, grantor and beneficiary can "agree" upon renting the home to the grantor
 - (2) A negative is that grantor will lose control over "his or her" home--remedy this by including a lease provision in the QPRT

- c. Grantor Retained Annuity Trust ("GRAT")
 - (1) Grantor retains right to receive an annual annuity based on initial value of the trust assets
- d. Grantor Retained Unitrust ("GRUT")
 - (1) Grantor retains the right to receive an annual payment equal to a predetermined percentage of the trusts assets valued each year
 - (2) A negative is that if the assets held in trust are not readily marketable, then valuations each year could be costly

3. Charitable Split Interest Trusts

- a. Charitable remainder trusts
 - (1) Similar to GRAT and GRUT described above except that remainder beneficiary is a charity
 - (2) Benefit is that trust can sell assets free of income taxes (but distributions will be taxable)
 - (3) Another benefit is income tax deduction for value of remainder interest to be paid to charity
 - (4) Depending on interest rates, benefit of charitable trust may not outweigh costs unless donor really desires to make gifts to charity
- b. Charitable lead trust
 - (1) Charity gets annuity or unitrust amount and third party gets remainder interest
 - (2) Gift tax based on remainder value—possibility of no gift tax if gift is “zeroed out”
 - (3) Income tax deduction for value of charity's income interest

4. Closely Held Entities

- a. One benefit is discounted value of interests in the entity for transfer tax purposes based on:
 - (1) Restrictions on sale
 - (2) Lack of control of entity
 - (3) Lack of market for partnership interests
 - (4) Minority interests (related to control)
- b. Second benefit is ability to control income distributions

- c. Types of entities
 - (1) Family limited partnership
 - (2) Limited liability companies
 - (3) "S" corporations
- 5. Increasingly more sophisticated estate planning – Example: installment sales to a defective grantor trust of interests in a family controlled entity

III. Costs of Implementing Estate Planning

- A. Monetary costs
 - 1. Consulting experts
 - a. Lawyer
 - b. Accountant
 - c. Broker
 - d. Financial Planner
 - 2. Initial set-up of estate planning
 - 3. Periodic review of estate planning with applicable expert
 - 4. Yearly maintenance of entities created for estate planning
 - 5. Valuations as needed
 - 6. Effect on property taxation
- B. Commitment to certain investments
- C. Loss of access to assets
- D. Loss of control over assets
- E. Stress of addressing estate planning issues

IV. How Does the Client Decide?

- A. Simple decisions made intuitively
(Example -- cost of preparing and maintaining trust versus cost of probate)

- B. More complex decisions made by estimating costs and benefits
- C. Very complex decisions made by cost/benefit analysis by expert