The New Rules of Estate Planning
6th edition

By Bob Carlson

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The New Rules of Estate Planning
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Introduction
Why Bother With Estate Planning?

- Estate planning and estate taxes are something only the very rich worry about.
- I want everything to go to my spouse, so I don't need to worry about estate taxes or planning.
- Congress repealed the estate tax for middle income Americans.
- I don't have many assets, so I don't have estate planning issues.
- I bought life insurance so I wouldn't have to worry about estate planning.
- My living trust solves all my estate planning problems.
- My spouse and I own everything jointly; that's all the estate planning I need.
- My assets are worth less than $10 million, so I won't have estate problems.

These are the explanations people give most frequently for ignoring estate planning or putting it on the backburner. Unfortunately, these comments are myths, half-truths, or are based on misinformation. The truth is more like this:

- Everyone needs an estate plan—no matter the value of the estate.
- An estate plan is about much more than taxes.
- One goal of an estate plan is to ensure your comfort, care, and financial security for life.
- Without an estate plan, it could take a long time and cost a lot of money before your heirs receive anything from your estate.
- A will or a life insurance policy by itself is not an estate plan.
- A living trust solves only a few estate planning issues but not all of them.
- Many Americans have more valuable estates than they realize.
- When your estate is valuable enough to be taxable, leaving everything to your spouse might increase over-all taxes and cause other problems.

The Real Goals of Estate Planning

There was a time when tax reduction was the main focus of most estate plans, even for middle class families. Back then, the estate tax was imposed on estates worth more than $600,000.

Even then, a host of other issues were covered in good estate plans. Now, with all but a few estates exempt from the federal estate tax, those other issues are, or should be, at the forefront of estate planning. That's a good thing for many people. Too often, the other issues didn't receive enough attention. Now, estate planners are making sure they are fully addressed.

The first step in developing an estate plan is to define your goals. Every person and family is unique and has some unique goals that need to be identified. Yet, there are common traits that lead to common goals.

The first step is to consider the broad goals that are common to most estate plans. After thinking about them, other goals and wishes are likely to occur to you, and that will help the estate planner flesh out the details of your plan. The common, broad goals of estate planning are:

- Transfer your assets quickly and efficiently to the next owners.
- Ensure your comfort, care, and security for the rest of your life (and the same for your spouse).
- Minimize the costs and delays that often are part of the estate settlement process.
- Enhance family harmony, or at least avoid increasing family disharmony.
- Ensure wealth reaches the intended beneficiaries.
- Preserve the wealth, which could mean protecting it from costs, delays, and taxes.

It also could mean protecting the wealth from mismanagement, fraud, waste, and other events that often prevent family wealth from surviving.

- Ensure that your financial and medical matters are managed if you aren't able to manage them.

You can see that estate taxes aren't the main obstacle to leaving the legacy you want. You worked a long time to build your estate. Be sure that it supports you for the rest of your life and, if possible, provides a meaningful legacy for your family, charity, or other objects of your affection.

Great—and Small—Fortunes Lost

You probably have heard of the fortunes that have been lost because little or no estate planning was done. In fact, there are books and websites detailing how famous fortunes were lost or diminished because of poor or no estate planning.

For example, Elvis Presley's fortune went from over $10 million at his death to a little over $3 million after estate taxes and other costs were paid; Marilyn Monroe's estate went from a little over $800,000 to less than $425,000 after subtracting taxes and other costs.

The list goes on and on. In some cases, assets went to someone the deceased probably didn't want to have them, because the estate plan was out of date or improperly prepared. In other cases, potential heirs engaged in disputes over who should receive the assets. In many cases, a large share of the assets went to lawyers for the different sides who were arguing over what the deceased's intentions were.

These disputes depleted the estates and split the families.

What you don't often hear is how these problems are not exclusive to the rich and famous. The same things happen to the estates of many executives, small business owners, professionals, and other ordinary Americans. These stories are much more tragic, because after a large fortune is depleted, a small fortune often remains. But when a small fortune is depleted, a modest amount or less remains.

Over the years, I have written much about estate planning and estate and gift taxes. In many articles in my monthly newsletter, Retirement Watch, I've explored numerous aspects of estate planning and described dozens of ways to safeguard wealth for a spouse, other loved ones, and charity without cutting back on one's own lifestyle.

An article, however, is not enough by itself to help people plan and organize their estates. Estate planning is a large field with many considerations. It also is subject to many changes. Even when an estate is fairly simple, a number of issues must be addressed before an estate plan is complete and can accomplish the owner's goals. That is why I periodically compile and expand the estate planning information in one report.

This report discusses the key estate planning issues in one place and helps one efficiently understand the information and plan an estate. Past editions of this report have been very popular. I like to think that is because the reports are written so that the non-professional can understand them, and they cover a wide range of estate planning issues instead of focusing on one issue or tool. I also try to use practical examples to explain the concepts.

It seems that each edition contains a version of this sentence: Since the last edition was published, estate planning has changed dramatically. And it's always been accurate. It's also accurate this time.

The most significant changes, of course, were in the tax law. The law was changed several times beginning in 2001 with the estate tax actually being repealed for one year. The latest changes have been updates to the 2017 Tax Cuts and Jobs Act. The changes should have caused every will and estate plan to be rewritten.

Estate planning also was affected by many other changes other than the federal estate and gift tax. These less-publicized changes affect trusts, personal property, powers of attorney, IRAs, medical care, family relationships, and many other areas.

Significant changes in the stock market, interest rates, and the economy also affect estate plans and estate planning strategies. The growing number of digital assets (social media pages, email accounts, and more) changed the composition of estates and forced changes in the law and planning.

All these changes should cause people to reconsider their estate plans or to initiate them if they didn't already have plans. Estate planning always has been important, but it has grown in importance.

The baby boomers are at or reaching that stage of life when retirement and estate planning are primary concerns. In addition, the parents of many baby boomers still are alive and have estates to manage and plan. These groups of Americans are the wealthiest generations in history.

They own a large percentage of this country's assets, and how those assets are managed will influence the performance of the economy in coming years and also is likely to affect government policies.

At a minimum, this book should enable you to intelligently discuss your estate with a planner and save time and money in the planning process. For many of you, the report will generate ideas that otherwise wouldn't have made their way into the estate plan and will enrich your heirs by thousands of dollars.

When you and an estate planning professional work together, the odds are low that the IRS, attorneys, and others you didn't intend will be your main beneficiaries or that major portions of your estate will be lost to unnecessary expenses and mismanagement. A good estate plan will put more after-tax, after-expense wealth in the hands of your heirs and without much delay.

Robert C. Carlson

Chapter One
The New Focus of Estate Planning

A revolution has occurred in estate planning.

Estate planning was in turmoil from 2001 through 2018, but the tax law now is settled. The new rules and strategies are set, and for many people they are vastly different than they were before.

The turmoil began with the 2001 tax law that made multiple changes over 10 years followed by a scheduled reversion to the 2000 law. Then, a 2010 deal in Washington prevented the reversion and temporarily eliminated the estate tax for most people for two years. The 2010 law, with some modifications, became permanent in 2012, at least as permanent as the tax law can be.

In 2017, a few more changes were made in the estate and gift tax, and major changes were made in the income tax code.

The Tax Cuts and Jobs Act of 2017 made only a few direct changes in the federal estate and gift tax, but the changes had significant consequences. This law really was one of the more sweeping sets of changes in decades. Significant changes should be made in wills, trust, portfolios, and strategies.

The change that received the most attention is the increase in the lifetime estate and gift tax exemption that means less than half of one percent of estates are estimated to be liable for federal estate taxes under the law. Many folks believe that since they no longer have to worry about estate and gift taxes, they don't have to worry about their wills or estate plans.

That's a wrong and dangerous thought. Your estate planning problems weren't solved by the law. They were changed.

Many people delayed developing or revising their estate plans because of the many changes that occurred following 2000. If you put creating or revising your estate plan on hold until the law settled down, now is the time to work with your estate planner on a new or revised plan.

There's a window of opportunity to increase significantly your family's after-tax wealth and take other stops that will enhance your legacy and increase your loved one's financial security.

In the Tax Cuts and Jobs Act, the only direct change in estate and gift taxes was the doubling of the lifetime exemption amount. The individual lifetime exemption was increased to $10 million for an individual, which could be $20 million for a married couple. The exemption amounts are indexed for inflation retroactively. For 2022, the exemption amount was $12.06 million for an individual and $24.12 million for a couple. Those amounts will be indexed for inflation each year, as of 2022 the exemption amount is $12.06 million.

The rest of the federal estate and gift tax is unchanged. The tax is calculated the same way, and the top rate is 40%. The annual gift tax exclusion is $16,000 per person for 2022. There's still an unlimited marital deduction for gifts and bequests between spouses. The lifetime exemption remains portable between spouses. The charitable contribution deduction isn't altered, and the tax basis of inherited property can be increased to current fair market value when received by the beneficiary. All the strategies that reduced estate and gift taxes before tax reform still are effective.

So, why do most people need to review their estate plans?

First, a few notes for those few people who are wealthy enough they might be subject to estate and gift taxes under either the 2017 or 2018 laws.

The exemption amount is scheduled to revert to the 2017 law after 2025 if Congress doesn't make a change in the meantime. That means in a few years you might not be able to transfer as much wealth tax-free as you can today.

Consider how much wealth you want to remove tax-free from your estate while you can.

You might want to make direct gifts or put assets in vehicles such as irrevocable trusts, perhaps creating dynasty trusts that can benefit several generations.

Or you can shift assets to family limited partnerships and limited liability companies, among other strategies. It's a tough decision because you have to anticipate the future actions of Congress. Will it keep the current exemption amount, decrease it, or even eliminate the estate tax?

Remember, for gifts, the exemption amount that counts is the one in effect the year the gift is made. For estates, it's the exemption amount in the year the person dies. Under current law, people who die in 2026 will have half the exemption amount they would have had the previous year. At 1.5% annual inflation, the 2026 exemption amount is estimated to be $6.3 million per person if we revert back to the 2017 law.

Some people worry Congress will enact a "claw back" if we switch to a lower exemption amount in the future. Under a claw back, gifts that were tax free in the past become taxable if there's a lower lifetime exemption in effect the year the person dies than there was in the years of the gifts. But Congress has never done that kind of claw back before, and there's a good argument to be made that it would be unconstitutional as a retroactive tax. The IRS already announced that it would not impose a claw back through regulations or other policy moves. Of course, that could change under a future administration.

Another wildcard is that a change in control of Congress could trigger a move to reduce the exemption amount before 2025.

The bottom line is that people with estates that potentially are taxable under either current law or a reversion to the pre-2018 law should review the situation with their planners and consider making substantial gifts while the high exemption amount is in effect.

While everyone else is exempt from federal estate and gift taxes, they aren't exempt from estate planning. Your estate plan also needs a review and possibly some rewriting.

Beware old wills. Standard wills that were written under old estate tax laws often disinherit the surviving spouse or have other unintended consequences.

In a typical estate plan, a portion of the estate of the first spouse to die is transferred to a trust, called a bypass trust, credit shelter trust, A/B trust, and other names. The trust supports the surviving spouse during his or her lifetime and leaves the remainder to the children of the marriage. The rest of the estate goes primarily to the surviving spouse.

The trick is that the will usually says the amount that goes to the trust is the lifetime federal exemption amount. That made sense when the exemption was $600,000 or less. But at the current exemption amount (and the prior exemption amount of $5 million), in most families the surviving spouse would receive nothing outright. The entire estate would be put in the trust, and the surviving spouse would be dependent on distributions from the trust.

That's one of many reasons why most wills need to be rewritten or at least amended. Not only might the plan be obsolete and out of date, but the interplay of the current law and the terms of the will could have unintended consequences that are very negative for your loved ones.

Focus more on income tax planning. Income and capital gains taxes are more important to most people than estate and gift taxes, and the estate plan can play a key role in reducing income and capital gains taxes for both you and your family.

The tax basis of assets is a key consideration in your planning. When an asset is inherited, the beneficiary increases its basis to the fair market value on the date of the previous owner's death. The asset can be sold immediately tax-free. None of the appreciation that occurred during the previous owner's holding period is taxed.

But when an asset is received as a gift, either directly or through an irrevocable trust, the basis is the same as the previous owner's basis. When the beneficiary or trust sells it, all the appreciation is taxed.

That's why it can make sense to hold for life assets that have appreciated a lot. They aren't likely to be subject to the federal estate tax, plus their appreciation can avoid capital gains taxes when your heirs inherit them through the estate. During your lifetime, it's best to make gifts of assets that haven't appreciated much but that you anticipate will appreciate. Incorporating this kind of income tax planning in your estate plan can increase your family's after-tax wealth.

Should you make gifts? Using the annual gift tax exclusion, as of 2022, you can make up to $16,000 in gifts to a person without reducing your lifetime exemption. You can make these tax-free gifts to as many people as you want each year.

When the lifetime exemption was $1 million or less, even many middle-class families were advised to make annual gifts to remove assets tax-free from their estates. Now, unless your estate might exceed the lifetime exemption, estate taxes aren't the motivation to make gifts.

Instead, consider the nontax reasons for making gifts. Of course, first determine how much you can consider giving during your lifetime without putting your financial independence at risk. Then, decide if you'd rather see loved ones benefit from those gifts now instead of after you're gone and, if so, how you'd like them to benefit. Some people think heirs should wait to receive an inheritance, no matter how long that takes. Others would rather see how their gifts are used and contribute when their loved ones need the money.

The point is now your preferences and financial situation, not the tax law, should determine your giving strategy.

Rework old strategies. Many existing estate plans have strategies that were motivated primarily by tax reduction. These include irrevocable trusts, life insurance trusts, family limited partnerships, and more.

Take a fresh look at these strategies with your estate planner. In some cases, you'll want to dismantle or modify the strategies, if you can. In other cases, you'll find there are good nontax reasons to continue them, such as creditor protection and more efficient management.

For example, suppose you transferred assets to an irrevocable trust years ago to remove their value and future appreciation from your estate. Now, the higher lifetime exemption makes it unlikely they'd be subject to the estate tax in your estate. But they've appreciated a lot, so the trust or your heirs will face capital gains taxes on the appreciation when the assets are sold. It might be better to have those assets back in your estate so heirs can increase the basis to fair market value after you pass away.

Many trusts allow you to swap assets of equal value for the trust assets. You can transfer cash or property that hasn't appreciated much to the trust and take back the appreciated assets. Hold them in your estate for life, so your heirs can increase the tax basis when they inherit. If the trust doesn't allow a swap, state law might allow a "decanting" that

involves swapping assets with a new trust you created. All trusts you create in the future should allow swaps and decanting.

Explore these and other ways of changing the current strategies in your plan.

Consider residence changes. Trusts pay taxes on income and capital gains they don't distribute. You might be able to relocate a trust to a low-tax or no-tax state without disrupting your estate plan. Discuss it with your planner as a potential way to reduce taxes for years at little cost.

While you're at it, consider your own residence. About 20 states retain an estate or inheritance tax or both. If you live in one of those states, you might discuss with your estate planner the advantages and disadvantages of changing your legal residence to a state with no estate or inheritance tax.

Review charitable giving. The Tax Cuts and Jobs Act means fewer people will receive tax benefits from charitable gifts made either during their lifetimes or through their estates.

One way to still receive tax benefits is to make charitable gifts through IRAs, whether the gifts are made during life or through your estate. You also should consider bunching contributions to make large gifts, such as by using a donor-advised fund. There are other charitable strategies to consider as part of your estate plan, which are discussed in this book. They can provide multiple benefits, such as avoiding capital gains taxes and generating lifetime income.

Emphasize the nontax factors. The old tax laws distorted estate planning to make it mostly about tax planning in many people's eyes. In fact, there are more important estate planning goals than tax reduction and always have been.

An estate plan is to ensure that you are taken care of the rest of your life and that your wealth is transferred to the people you want to have it. A good estate plan ensures these goals are accomplished with as much efficiency and as little cost as possible. A good estate plan also can smooth family relationships, while a bad plan makes bad family relationships worse and even turns good relationships into bad ones.

I discuss these and many of other issues of estate planning in the rest of this book. Now that the estate tax law is settled for a while, it's time to stop procrastinating, consider these factors, and put a plan in place that will enhance your legacy and meet your nontax goals.

As I emphasized earlier and can't emphasize enough, don't conclude from the changes, as many have, that because you no longer have to worry about the federal estate tax, you don't have to worry about estate planning. Also, don't conclude that you don't have to consider taxes at all in your estate planning.

You still need an estate plan. Everyone does, regardless of the value of his or her estate. There are many nontax factors that always were an important part of each estate plan but were given less attention in the past because of the importance of estate taxes. Now, those other issues can receive the attention they should. Also, taxes other than the federal estate tax should be an important part of most plans, and you have to look at taxes differently.

Because few estates will face a federal tax burden, now we can focus on the real issues of estate planning. Failure to have a plan or to have a quality, updated plan likely will lead to dissipation of much of your lifetime's wealth by forces other than federal estate taxes. A nonexistent or inadequate plan is an impediment to achieving your plans and goals for the wealth and often leads to family disputes and disharmony.

Every estate has a host of significant issues other than federal taxes that need to be addressed. We're going to discuss those issues in this book. We'll cover federal estate and gift taxes for those who are fortunate enough to have to worry about them. You'll learn strategies for reducing those taxes as much as possible while still meeting your other goals. We're also going to discuss all the other issues that should be considered in every estate plan.

10 Basic Rules For Every Estate Plan

Despite the importance of estate planning and the new stability in taxes, too many people aren't doing anything about their plans. They've fallen into the habit of procrastination. That's a mistake. You don't know when your estate plan will be needed, and for most people the nontax elements of a plan are more important than the tax issues.

Another problem is that an estate plan should be tailored for the individual. Contrary to what you'll hear in some estate planning seminars and from some advisors, there aren't many strategies that should be in *every* estate plan. But there are some basic rules and guidelines that apply to every estate plan, whether it is worth $500,000 or $500 million. If you don't follow these rules, you likely will do damage to your heirs and perhaps leave them believing you weren't fair.

For procrastinators and those who simply don't know how to begin the estate planning process, here's a checklist of the essential first steps and principles. Regardless of the value of your estate or your age, these basic rules and guidelines should apply. You and your attorney will draft an effective plan by paying attention to these guidelines, regardless of what the tax law is or might become.

- Do something. Too many people use uncertainty or tough decisions as an excuse not to have a plan. Some people can't resolve issues such as who should be the executor or trustee or the guardian of their children. Some can't

decide how much to leave to charity, or perhaps the estate planner is proposing a tool they don't quite understand or aren't comfortable with yet.

Don't let these issues leave you with no estate plan or an out-of-date plan. If you can't pull a complete plan together, at least do the minimum necessary, such as having a basic will and powers of attorney. You can do an estate plan in installments. Or you can do most of the plan but defer a decision on one or two difficult issues. Assemble a plan now that at least covers the essentials. Then, work toward a more robust plan as you learn more about the tools available, refine your goals, and resolve disagreements.

- Keep track of your estate. There's a story that legendary comedian W.C. Fields didn't think banks were safe, so he diversified by stashing his money in relatively small amounts in banks all over the country. He didn't keep a master list of the banks, and his heirs never were sure they found all the money, though they spent resources trying to track down all the accounts. Fields probably knew how to find everything, but he didn't give anyone else all the information.

Different variations of this story occur remarkably frequently in estates of all sizes. The estate owner doesn't have a master list or file of all the property and debts, and the files aren't in great shape, at least not for someone who doesn't know the filing system. In those cases, all the property might not be located, or the estate spends a lot of time and money trying to locate it. Your estate planner also can't deliver the best advice without an accurate list of your assets and liabilities. At a minimum, you should update a complete list of your assets and liabilities once a year and share this with the person (or persons) named as executor in your will as well as your estate planner. And make sure your executor knows where to find all the documents to back up the financial statement. Even better is a complete list of all your key financial items, including online accounts. For help compiling a list, use my report, *To My Heirs (should these have hotlinks)*, available for purchase through the Bob's Library tab on www.RetirementWatch.com.

- Estimate cash flow. Many people overlook cash flow when developing an estate plan. But the cash flow and sources of cash are important. Debts must be paid. Lawyer's fees and other expenses will be incurred. The expenses of running and maintaining the estate's property must be paid, and the dependent survivors have their regular living expenses to pay.

Of course, if taxes are due, they must be paid with cash. Estimate how much cash the estate will need and where it will come from. If the estate won't have enough cash, reconsider the plan. You can sell some assets now, provide that some people will get property instead of cash, buy life insurance, or give the executor instructions on how to sell your property. Many estate planners advise limiting specific cash bequests to only a few special cases to avoid leaving the estate with a cash flow problem.

- Choose executors and trustees. Most people spend a lot of time on their plans, and then select the executors and trustees as an afterthought, often automatically choosing the estate planning lawyer as executor and the bank recommended by the lawyer as trustee. Those might or might not be the best choices for you. Unfortunately, a good estate plan can be ruined if the wrong people implement it. Give a lot of thought to who should execute your plan. We'll cover this issue in more detail later in this book.
- Anticipate conflicts and try to reduce them. Many estates have built-in conflicts that could have been resolved. For example, if kids don't get along. Now, if you are always mediating their disputes, then they aren't likely to amicably manage assets or decide how to divide them. Perhaps they should be given separate ownership of assets, different voting rights, or someone else should help make decisions about the property. You probably shouldn't have will provisions that require them to share assets or agree on how things are to be managed.

Other times the different roles of an individual create conflicts. A classic conflict is when a spouse is made trustee, receives income from the trust, and the children receive the trust property that remains after the spouse dies. Often, the children end up believing that the spouse invested for maximum current income at the expense of earning capital gains for the future. Your estate plan should avoid such built-in conflicts. At best, they lead to hard feelings and at worst lead to expensive litigation.

- Don't search for a perfect solution. An estate plan is a balancing act. An estate plan strikes a balance between your goals, the needs of your family, the tax law, and perhaps other factors. For example, reducing taxes often means either giving up control of property now or leaving everything to your spouse. So, there is a tradeoff between taxes, control, and distribution. You also have to decide whether to leave assets to your heirs directly or with some restrictions, such as through trusts.

A good estate planner will present you with several alternative plans to meet your goals. Each will handle the tradeoffs in different ways. You choose the alternative that strikes the balance you prefer.

- Don't be a control freak. Some controls can be a good idea, such as when a beneficiary is young, doesn't have good judgment, or lacks experience handling a meaningful amount of money. In such cases, property should be put in a trust that restricts distributions for a while.

But some people go further and dictate in detail how wealth is and is not to be invested and distributed. There are trusts saddled with restrictions that require them to be invested in Treasury bills, gold stocks, or the stock of certain companies, to name just a few examples. Trustees, executors, and heirs need to be able to adapt to changing circumstances, including events you never anticipated.

- Make your general plan known. If you don't tell heirs your plans, they will develop expectations. Feelings can be hurt when they are surprised after your death. That can lead to anger or bitterness that will be taken out on others in the family. Also, heirs might plan their finances with certain expectations about your estate plan and find themselves in a difficult situation when their expectations aren’t realized. You should let people know generally how they’re affected by your plan. For example, if you aren't going to treat heirs equally, will leave money to charity, or know that someone is expecting certain property, it is important to let the affected people know ahead of time. Likely heirs also should have a rough idea of the value of your estate and how much will be passed to them.
- Don't circulate your will. While you want the general outline of your plan known among those affected, don't circulate the will or other documents. You likely will need to update it every few years, and any change in the details gives someone a reason to be upset. Also, having different versions of a will circulating over the years makes an expensive will contest more likely.
- Keep it as simple as possible. Some people and their attorneys get so wrapped up with the latest estate planning tools that they overlook simpler strategies that will accomplish their goals. Be sure complications are necessary to meet your goals before putting them in your plan.
- Things change. Your estate plan never is final. The property you own, and the values change. The members of your family change through births, deaths, marriages, and divorces. Your goals might change. You might be inclined to leave more or less to charity or specific heirs over time. You need to meet with your planner at least every two or three years to review changes in your financial picture, family, and goals as well as the tax law and other laws.

Remember that any mistakes in your estate plan will live long after you. Follow these rules and you'll end up with an estate plan that works well for you and your heirs.

Reviewing Your Estate Plan Essentials

You need a complete, up-to-date estate plan now more than ever, regardless of the value of your estate. Every estate has a host of significant issues other than federal taxes that need to be addressed. We’ll be diving into details throughout this book. To prepare you, here’s a roadmap of the key issues of every estate plan. You’ll be looking for solutions to each of them that meet your goals, resources, and other factors.

Medical care. That’s right. Medical care is a vital part of a good estate plan. The plan should define how your medical needs will be addressed in different circumstances.

First, you’ll need documents that provide which decisions will be made and who will make them in case you aren’t able to. That means you need a medical power of attorney or medical care directive and perhaps a living will. You also should consider if you want documents such as a do- not-resuscitate order. You need to focus on both the terms and scope of the documents and, especially with the power of attorney, selecting the person or people to make decisions. You can find details about these documents later in this book.

The financial aspect of your medical care also should be covered. Be sure you have adequate insurance or resources to cover most types of medical care.

Do you have or should you buy long-term care insurance? If not, are you planning to qualify for Medicaid for any long-term care needs, or do you plan to meet the costs from your assets and income? Have you looked at policies that combine life insurance or an annuity with long-term care benefits? Neglecting this issue too often leads to a burden on loved ones, an estate being depleted to pay for care, and sometimes the next generation’s nest eggs being depleted.

Avoiding disputes. It doesn’t matter how much or how little wealth you have. When an estate owner doesn’t develop a plan, conflict and chaos often follow. Children, even adult children, can fight over how assets are divided and managed. The presence of a second spouse or other players can make the conflicts worse.

You shouldn’t be content with thinking “the kids can work it out.” Any estate planner will tell you they often don’t. Even when an estate doesn’t seem to be worth much, there’s a need to clearly state how you want it divided and handled. In most families, there’s usually at least one person who’ll look for something to fight about with the others if you leave an opening. Almost every estate planner can tell you stories of families spending far more on legal fees than an item or estate was worth.

Probate. You might not be worried about estate taxes, but the probate process can cost a lot of money and delay settlement of your estate. Probate is the system that ensures your debts are paid, your assets are distributed how you intended, and your heirs have clear legal title to assets.

Some states have a streamlined and less expensive process, at least for smaller estates, under the Uniform Probate Code. But a number of states still use the older, expensive, cumbersome process. You need to find out which type of state you live in and what would be involved in probating your estate.

When the state has an unattractive probate process, consider avoiding the probate process and how to do it. You can use a living trust, partnerships, limited liability companies, joint title, and other tools. Each has advantages and disadvantages. Discuss them with an estate planner to select the best tools for you.

When you live in or have property in more than one state, the processes of both states must be considered. The bulk of your estate will be governed by the state in which you are resident, and any real estate will be controlled by the state where it's located. To avoid probate in two states, you might want out-of-state real estate owned through a trust or limited liability company instead of in your name.

Beneficiary forms. IRAs, annuities, employee retirement plans, life insurance, and some other assets aren't affected by your will. They are inherited by whoever's named in the beneficiary designation forms. Be sure these forms in both your records and those of the firm sponsoring the asset reflect your current wishes. If you don't do anything else toward estate planning, take this easy step.

Care of others. You might be helping or anticipate having to help a relative or other person. It might be an elderly parent or other relative. It could be a child or grandchild that has needs. If so, you probably want to develop a plan to ensure they have help when it's needed. That might mean buying life insurance or establishing a trust for their benefit.

Asset management. You're probably managing your investments and other assets well. You're following good advice. You probably also determined who you want to inherit and benefit from the investment portfolio and other assets next. But who will manage the portfolio? Is your surviving spouse or other member of your family capable? Do they have the knowledge and skills to manage your assets and make them last a long time? Have you even discussed this with them?

If not, you need a plan.

One option is to lift the burden from the loved ones, just as you have for years. Plan to have one or more money managers invest the assets.

If that's your plan, find a money manager now. Don't expect loved ones who don't know how to manage money to be able to select a good money manager.

You can test-drive managers by giving one or more managers a portion of your portfolio to manage now. That lets you see not only how they perform but how well they communicate and provide customer service. They'll be in place for you to examine, and over time you can let your spouse or other heirs know that you believe the manager is good and that they should continue to use the firm's services when they inherit the portfolio. If it's the wrong manager, you'll find out soon and be able to make another choice.

Succession. When you own businesses, real estate, or complicated assets, such as a collection, succession planning is a must. Look for someone in your family who's able and interested in continuing management of the assets. Then, plan the transition in management or ownership. Don't wait. With businesses and complicated assets, it often takes five years or more of planning for a succession to be successful.

When there's no suitable successor in the family, you might look for one or more associates who can continue management. They might want to buy the business from the estate or be willing to manage it while family members continue ownership. Or you should develop a plan for how the asset will be sold and the proceeds distributed to your loved ones.

You need to develop a succession or sale plan now. Too often, when a plan isn't in place the value of the asset isn't maintained during the transition. The estate doesn't receive the full value the business once had. Sometimes the entire value of the asset dissipates.

You might have other issues to address, but these are the most common non-tax estate planning issues. Some of these you might be able to resolve on your own. But it's best to meet with an experienced estate planner and discuss the goals and ambitions for your wealth, family, and the rest of your life. Then, you can identify the issues and develop a plan.

The Turnabout in Tax Planning

Most of us don't have to worry about taxes in estate planning because of the estate tax break. (For those that do, we'll discuss estate taxes and planning to reduce them later in this book.) Yet, taxes still should figure in your estate plan as much as ever. Instead of focusing primarily on federal estate taxes, your tax planning should focus on two other areas. First, you need to focus on reducing federal capital gains and income taxes over the long term. Second, you also need to focus on reducing state taxes on income, capital gains, estates, and inheritances.

Here's the key issue now. When property is included in your estate, most of the time the tax basis of the property is increased to its current fair market value. For example, let's say you purchased mutual fund shares for $10,000 years ago and they now are worth $20,000. If you sell today, you'll pay capital gains taxes on that $10,000 gain. If you give the property to your children to remove it from your estate, which used to be the recommended strategy, they'll take the same

$10,000 tax basis you had and eventually have to pay capital gains taxes on that gain and any additional gain when they sell.

Continue to hold the fund shares, however, and they'll be included in your estate. The tax basis will increase to their fair market value at that time. The estate or your heirs who inherit can sell the shares immediately and owe no capital gains taxes. Your loved ones will receive the full value of the shares, not an after-tax value. Or they can continue to hold the shares. Eventually, when they sell, they'll owe capital gains taxes only on the appreciation that occurred while they owned the shares.

Bottom line: The longtime rule to remove assets from the estate through direct gifts or transfers to trusts might not be the best advice today. It might be better to hold appreciated and appreciating assets. You'll avoid federal estate taxes unless your estate is very valuable, and you and your heirs will avoid capital gains taxes on the appreciation.

Your estate's tax planning strategy should consider all the taxes that might be imposed on an asset. There is the federal capital gains tax, plus any similar tax your state imposes. There also are the stealth and add-on taxes that increase as income rises, including the 3.8% net investment income tax and Medicare premium surtax, taxation of Social Security benefits, and the alternative minimum tax. All of these might be avoided by your family when you hold appreciated assets and have them included in your estate.

Even wealthy people who might have part of their estates subject to the federal estate tax should reconsider the extent to which they want to remove assets from their estates. These other taxes cumulatively could total more than the maximum 40% federal estate tax, especially if your state doesn't have its own version of the tax.

Holding assets in the estate isn't the ideal strategy in every case. If your state is one of the 20 or so plus the District of Columbia (as of this writing) that has some form of estate or inheritance tax or both, you need to compare the tax from holding the asset in your estate to the income tax that would be owed if you transferred the asset now to a loved one. Remember to consider the income tax rate your beneficiary would pay, not that you would pay. For example, if you live in a state with an estate or inheritance tax but your children live in a state without an income or capital gains tax, you might save money by giving appreciated property to them now instead of holding it in your estate.

You can see that tax planning is more complicated now. Sometimes the right move is intuitive You need to evaluate I don't know what the text is doing here. each of the potential taxes that would fall on each asset before deciding whether or not to give property now or hold it.

Here are some general rules:

Prime candidates to be held in your estate are appreciated investments and your personal residence. Depreciated investment and business real estate also would avoid income and capital

gains taxes by remaining in your estate. Appreciated art, gold, and collectibles are likely to be worth holding in the estate because they are subject to a higher maximum capital gains rate—28%—than most other assets. Any patents, trademarks, and copyrights created by you also are good to hold in the estate, because your tax basis is likely to be zero, but a beneficiary of the estate can increase the basis.

On the other hand, there's no tax reason to hold cash. Also, variable annuities and qualified retirement plans (including IRAs and 401(k)s) don't receive an increased basis after the owner's death. All the distributions will be treated as ordinary income whether taken by you or your beneficiary. You might save money by paying those taxes now instead of later.

Rethinking Trusts

The 2017 law created some unexpected costs for people who executed estate plans that included trusts under the old law.

Suppose your estate will be less than $12.06 million but is valuable enough to be subject to estate taxes under the old law. Under the old law you transferred assets to a trust to remove them from your estate, because that made a lot of sense under the old law. The trust and beneficiaries have the same tax basis in the transferred assets that you had. Capital gains taxes will be due when the assets are sold. That was fine under the old law, because the potential estate taxes were higher than capital gains taxes. Under the current law, however, your estate isn't subject to federal estate taxes. The assets still will be subject to capital gains taxes when the trust or the beneficiaries sell them. Now, the trust might be an unnecessary expense. It doesn't save estate taxes anymore. If you had held the assets, there wouldn't be a federal estate tax, and the capital gains taxes could be avoided when your estate or heirs sold the assets.

Of course, there are non-tax reasons for creating trusts, and we'll discuss those in detail later. But there are many times when tax avoidance was a prime reason to create trusts under the old estate tax law, but trusts don't provide a tax advantage under the new law.

If you set up trusts under the old law that don't make as much sense now, you might be able to take actions to adapt to the new law, if the trust terms allow it.

One strategy is to exchange assets with the trust. Take highly appreciated assets out of the trust and replace them with other assets of equal value that don't have as much built-in gain.

It also might be possible to change the trust terms so that you are considered the owner and the assets are included in your estate for tax purposes only. That would cause the assets to be included in your estate and receive the increase in basis for those who inherit them.

Your estate planner will have to review the trust to see if such steps are possible. Today's estate tax law requires a different approach to planning. Strategies that once were cutting edge now might be unnecessary or costly. Review your existing plan and meet with your planner to adjust it for the latest law.

Grasping the Risks of Estate Plan Neglect

Many people have their estate plans on the backburner.

They know the estate tax changed a lot in recent years and probably will change again. Many believe that since the current generous estate-tax exemption exceeds the value of their estate, they don't need to worry about an estate plan.

That's a big mistake, as I've emphasized. An estate plan includes many more phases than tax planning. Neglecting a plan can lead to far worse consequences than higher taxes. You need to be sure all the details are in order and up to date to avoid a disaster.

Two fairly recent cases show why procrastinating about or neglecting an estate plan is dangerous.
In the first case, a family corporation's ownership was divided among the husband, wife, and two adult sons. The wife passed away first. There apparently was no will, and no estate proceedings were undertaken. The husband passed away some years later. He had a will, and his estate was processed. The husband's estate tax return assumed the wife's shares had passed to the husband and assigned a modest value to all the shares he owned.

The IRS revalued the husband's shares, giving them a value of $142 million and assessing taxes. The IRS argued that when the husband's shares were combined with his late wife's, he had control of the corporation. That put a high value on the shares. If his wife's shares had been inherited by others, the husband would have had a minority ownership interest, and his shares would have a lower value.

The sons eventually located a will the wife had prepared years earlier. Under that will her shares were bequeathed to a trust for the two sons. The result under that will was that the husband owned only a minority interest in the business, not the majority initially assumed by both the IRS and his estate.

The Tax Court accepted the wife's will as valid and said since the husband owned only a one-third interest in the corporation, a substantial discount was applied to the value of his shares.
It's nice for the sons that they found their mother's will and convinced the Tax Court to follow its terms. But you can see the obvious problems here. The wife apparently didn't let anyone know about her will, so it never was filed for probate. The husband and sons all assumed that the husband inherited the shares and controlled the corporation for years, and the sons filed their father's estate tax return to reflect that.

The husband also didn't do his homework. There was a long history of a lack of corporate activity. The wife's shares never were recorded on the corporate books in anyone else's name, and there were no board meetings or other activities for years. The husband also didn't bother to determine the consequences of inheriting his wife's shares. If the court had ruled that the husband had inherited the wife's shares, his lack of other estate planning would have resulted in additional taxes of millions of dollars. If in the meantime the father and sons had disputes over corporate actions, the issue of ownership of the wife's shares would have created problems. (*Est. of Richard*, TC Memo. 2012-173)

In another case, a man made a substantial gift. He died before filing a gift tax return or paying the gift taxes. His executor was unaware of the gift, so his estate never paid the gift tax or took any other action related to the gift. The IRS located the gift while auditing the estate and notified the executor that the taxes needed to be paid.
The executor ignored the IRS and distributed the estate to the beneficiaries and a charity.

The IRS told the executor he was personally liable for the unpaid gift taxes. The court agreed. Since the executor became aware of the gift and the unpaid taxes, he was personally liable for the debt if he distributed the estate without paying the taxes.

The deceased was at fault for not paying the gift tax and filing the gift tax return after making the gift. He also apparently didn't leave records that made it easy for the executor to know there was an unfiled gift tax return.

The executor here obviously didn't receive good legal advice. Probably the most important mistake here was the selection of the executor. Too many people name executors as an afterthought. You need to name someone who's going to pay attention to details, know when advice needs to be sought, and follow that advice. You don't want someone like this executor who's going to ignore details and treat the IRS cavalierly. (*MacIntyre*, D.C., Tex.)

Good Plans Are Not All About the Money

Estate planning isn't all about the money. At least, it's not if you want the plan to be successful. You should know that at this point in the book. I've said for years that estate planning isn't all about taxes. You need an estate plan even when the estate isn't likely to be hit with federal estate taxes. You also need to take another step and realize that a good estate plan isn't focused on the money, the will, or the trusts,

Few wealthy families have their wealth last beyond the generation that earned it. Here's some data from a survey, by The Williams Group. It found that among very wealthy families, 70% lose their wealth in the generation after the one that created it. The wealth is gone during the third generation for 90% of the families. The results are similar for families that don't qualify as very wealthy but that pass something from one generation to the next.

When people are contemplating their estates, they worry the following generation might lose the money because of mismanagement, an economic downturn, or government actions. But those rarely are the causes of dissipated wealth.

The Williams Group's study also found that most of the time family wealth didn't disappear because of outside forces such as the economy, an industry downturn, poor investments, or politics. Wealth fails to make its way through most families because of problems within the families.

Underlying the data about money are stories about the family members and relationships. Advisors to the wealthy generally believe members of wealthy families lack a sense of direction and have low self-esteem. There tend to be high rates of suicide and drug use. Relationships between family members also tend to be bad. The younger family members often blame those who created the wealth for these problems.

In particular, there's a lack of communication and trust. In short, the families are dysfunctional, and that's the greatest threat to wealth and to your estate plan, no matter how big or small your estate is.

It's almost enough to make you decide estate planning isn't worth the time and expense. But don't fall into that trap. You can break the traditional cycle.

The first generation generally isn't open with the following generations about how much money they have, how it was accumulated, the first generation's philosophy about money, and what it will take to keep it growing.

While 90% of wealthy families fail to maintain their wealth, there are 10% who do, and you can learn from those successful families.

Your focus should be on giving more than money, however much you have. A survey conducted for Allianz in 2005 found that most Baby Boomers believe it is 10 times more important that their parents pass on to them memories, stories, and values than to pass on money, this was reconfirmed by Allianz in 2012.

In a 2012 survey for U.S. Trust, only 44% of wealthy Baby Boomers (those with at least $3 million in wealth) said they had a responsibility to leave wealth to their children. About 31% of the Boomers thought it wasn't important to leave a financial inheritance and said they would rather leave it to charity.

There isn't a single key to ensuring a successful estate plan, but there is a clear process that works. You need to involve the children and grandchildren in the inheritance planning process, and the process involves more than money. The best estate plan on paper doesn't work if the assets and plan are dumped onto the children without any preparation. Most people don't involve their children in financial matters early enough. Parents should be talking with their children about money from an early age, but it's never too late to start if you didn't start early.

First, you need to be clear about what the money means to you and what its purpose is. You also should know what's important to you in general, the things that you value.

You also need to consider how you communicate and how others in your family communicate. Everyone has a different communications style. When the styles don't mesh and no one tries to modify his or her style, there is no communication. Consider how your family members communicate and decide if your style can be modified during family get-togethers to improve communication.

The next steps are clear and should become a pattern over time.

The family should spend time together regularly. When the family is spread around the country, it might be an annual together of the whole family with smaller gatherings when convenient for some members. These should be social gatherings with nothing related to money or estate planning unless it arises naturally. The older family members should take opportunities to pass on family stories, values, and messages. The children are never too young or too old to start this. There also should be an effort to hear what's important to the other family members.

Once communication is improved, there can be more formal, planned gatherings periodically to discuss the family wealth and plans for it. Ideally, this leads to a process in which the children are involved in decisions about the money.

This should be a gradual process. You want to impart your values and experience and teach the children about handling money. But you want a transition, because you don't want decisions made that endanger your lifestyle or the wealth. Many people find the transition is best when children are first involved in choosing the objects of charitable gifts. This can increase their understanding of where the money came from and what's needed to ensure it is there in future years.

You need to break the traditional cycle in which the family patriarch or matriarch who accumulated the wealth retains a tight hold on it until death. Then, the children suddenly have full responsibility for it. Things work out better when the transition is gradual.

At some point, your financial advisors are invited to meet the family and explain their roles in shepherding the money. Some financial professionals like to meet separately with family members so they can learn things that people aren't willing to say in front of other family members. The estate planner could explain the current plan. An investment advisor can explain the portfolio and the strategies for it. These experts probably can explain things and answer questions better than you can, or family members might be willing to ask them questions they wouldn't ask you.

The most successful wealthy families eventually establish a formal process. They often form a family council and might have a family charitable fund with a board of family members that chooses the gifts. They bring in experts on family wealth to moderate discussions.

Ask your estate planner about involving your family in the estate planning process or for a referral to someone who helps with the process. You can contact The Heritage Institute (www.theheritageinstitute.com) or read their novel, *What Matters* by Cam Thornton and Rod Zeeb.

Chapter Two

Estate Planning Is Much More Than Tax Reduction

Now, only the very wealthy have to worry about estate planning.

That's what many people believed after the 2001 tax law and believe even more after the 2017 law. That belief will cost their heirs a lot of money.

Estate planning is more than tax reduction. Estate planning ensures that your wealth is transferred to whom you want in the way you want, with minimal cost, delay, controversy, and conflict. Lack of a solid estate plan has destroyed the wealth of many families—even when taxes weren't a factor. The devastation is more traumatic for those who weren't significantly wealthy to start.

Some years ago, *Fortune* carried an important article, "Great Fortunes Lost." The article described how a number of family fortunes were lost by their heirs. The article said that there are three basic causes of lost fortunes: business fiascoes, incompetent or wasteful heirs, and general disasters. But another cause, and one that is at the heart of the examples in the article, is estate planning. In this chapter, I will give you some proven ways of avoiding these disasters. After all, though a number of great fortunes were lost by the heirs, many great and not-so-great fortunes have survived through several generations. I want your fortune, no matter what its size, to be one that survives and thrives.

Estate planning now focuses more on how much to give, when to give, and in what form to give. You can focus on these issues instead of primarily on taxes. Reducing or avoiding costs, including probate and its delays, become more important to you than in the past. Other issues to focus on include controls that can be put on gifts and inheritances, so heirs won't waste them; how to benefit more than one generation; ways to protect assets from creditors and in-laws; and simplifying the estate.

The rest of this chapter will cover the many important nontax aspects of estate planning.

Cutting Major Cash Drains From Your Estate

An estate plan should be designed to protect your assets from taxes, creditors, waste, and other cash drains both during your life and when it is time for your heirs to take over. Here are some essential tools every estate should consider for conserving your estate's cash.

Two Key Documents

An estate plan might contain many documents. Estate plans that fail, however, often do so because of two key and usually overlooked documents. Take care that these documents are in your estate plan and meet your needs.

The first document to consider is the <u>durable power of attorney</u>. Most of us won't ever use this document, and all of us hope it won't ever be needed. Accidents and illnesses happen, unfortunately, and the power of attorney acts as an insurance policy when they do. As with other forms of insurance, the document must be prepared in advance, or it won't be available when it is needed.

Too often, a person has plans for managing assets during his or her lifetime and has a will and estate plan that take care of wealth after his or her death.

Yet, no provision is made for managing the assets if the individual were to become incapacitated. This gap can be expensive, embarrassing, and expensive.

Insurance statistics indicate that at most ages an individual is more likely to become disabled for a few months than to die. What happens to your money and other property if you are disabled?

If you have not made any provisions, often nothing can happen. Any property that is solely in your name, including your business, legally cannot be sold or managed by anyone other than you. Your family can't tap your checking or investment accounts. Investments can't be bought or sold, even if some people know you would have wanted those actions taken. The employees of your business are limited in the actions they can take. Your family can't even borrow against the equity in your home to raise cash for any medical care you might need. Joint ownership eliminates some, but not all, of these problems. With joint ownership, your joint owner usually can write checks but cannot sell assets or borrow against them, though the rules vary from state to state and also can be altered by a joint ownership agreement.

In case you become incapacitated and unable to manage affairs, someone needs to step in to pay bills and manage assets. Many people assume a spouse can take these actions. Unfortunately, a spouse can manage only joint accounts. Otherwise, the spouse has no more rights to handle your accounts or business than a stranger does. For some types of property, such as real estate, the signature of each spouse might be required before any action can be taken.

Without a power of attorney, in order to manage your assets your family would have to go to court and get an order that you are incompetent. Someone would have to be appointed to manage your affairs. This procedure is costly, time-consuming, and potentially embarrassing. In addition, the court often appoints your closest relative and that might not be the person you would want to handle your financial affairs.

A power of attorney gives a named person or persons, known as an attorney-in- fact or agent, the legal right to act for the person who signed the document, known as the principal. A general power of attorney grants the agent the

authority to act for the principal in all matters. A limited power of attorney, as the name implies, grants the power to act on certain specified matters, such as financial affairs, that are named specifically in the document.

A power of attorney can be revoked at any time. The standard power of attorney

expires automatically when the person signing the document is incapacitated. Unfortunately, that is the time you most need someone to act for you. That's why the durable power of attorney was developed. When the proper language is in the document, the power of attorney continues in effect after the person signing it becomes incapacitated. All states now recognize the durable power. With it, the attorney-in-fact will be able to act when the principal is unable to.

A potential drawback to the durable power of attorney is that it is valid when you sign it, even when you are not incapacitated. That means there is a possibility that the person named as attorney-in-fact is not trustworthy and could take actions with your assets right away. There are very few instances of someone abusing this power, probably because the principal still is around and mentally capable. Most people and financial institutions will double check to ensure that you really authorized the document and aren't able to act. An approach that gives you protection is to execute a durable power of attorney but have your estate planning attorney or other trusted advisor retain all documents until your family tells the attorney that there is a need.

Some states recognize an alternative document, the springing power of attorney. This power takes effect only after a disability occurs. Some people are more comfortable with this approach because they aren't turning over power when they are healthy. There are disadvantages to the springing power of attorney. First, not all states recognize it. Second, for it to take effect there must be a definition of disability and a process for having you declared incapacitated. That could make the document less effective than the durable power, and disagreements could lead to court action that the power of attorney was partly created to avoid.

Perhaps the best protection is careful selection of the attorney-in-fact. You are giving very broad powers to this person. While the immediate concern after a disability is ensuring that bills are paid and other routine matters are handled, the attorney-in-fact will have the ability to sell assets and re-invest or distribute the proceeds unless you prohibit that.

It is tempting to name a spouse or adult child as the power holder, and that might work well in many cases. Be sure to name someone whose judgment you can trust. For example, if there is a sharp market decline while you are incapacitated, do you want someone who is going to sell all your equities, or do you want someone who will adhere to the long-term plan? Is there someone who can judge when to change a long-term plan and when to stick with it?

Another protection is to name more than one attorney-in-fact. That can protect against both fraud and bad judgment. On the other hand, that means two signatures are required for everything. The two individuals have to be near each other and able to meet regularly. A compromise arrangement is to require two people to act on significant actions such as the sale of assets but allow one person to be attorney-in-fact for routine matters.

Be sure to name at least one alternate attorney-in-fact, because something might happen to the original.

It is not enough to sign one document. Most financial services companies have their own forms and will accept only those forms when someone asserts a power of attorney. You need to contact each financial service company at which you have an account, own a safe deposit box, or have a relationship. Ask for copies of their forms, how many copies they will want on file, and how old a copy can be before they want a fresh one on file. Unfortunately, your attorney can draft the best power of attorney form and have it be almost useless because your financial institutions insist on their own forms. When you change financial institutions, be sure to ask for new power of attorney forms as part of the process.

People who live in more than one state—such as those who live in colder climate states most of the year but spend the winter in warm weather states—need to be sure that their documents are effective in each state. It might be necessary to have one document executed for each state.

You decide how much power to give the attorney-in-fact. You might want to grant a general power of attorney that covers all matters. A broad power such as that is a hedge against a long disability. Another option is to limit the power to financial matters or to matters named in the document. Estate planning also is a consideration. A power holder can make gifts or other transfers of assets under a general grant of power of attorney. The IRS, however, will not recognize the tax effects of gifts made by a power holder unless the document specifically states that the holder is authorized to make gifts of property. Be sure this language is in your power of attorney.

If you are considering a limited power of attorney, keep in mind there could be disputes. Something might come up that you didn't foresee or that someone argues is not covered by the powers listed in the document. That always is the risk of giving a limited power of attorney.

You also should have protections against abuse.

For example, in 2007 New York philanthropist and heir Brooke Astor was in the headlines with lurid allegations that her son and lawyer were using a power of attorney to subject her to a substandard lifestyle, conserving her wealth for themselves instead of spending it on their needs. After she died, criminal charges were filed alleging that the two stole her money. Her son eventually was convicted and served three months in prison before being released for medical reasons. He died in 2014.

The case highlights the importance of selecting the right person to name as your agent. In addition, you can add protection against an agent gone wild. Keep in mind that despite the potential problems, you should still want the POA. Someone needs to manage your affairs if you aren't able to, and it should be someone you selected and under terms you set. The key is to establish a balance between those goals and security.

Here are some protections to consider:

Require regular accounting. Most agents holding POAs are responsible only to themselves. A layer of oversight can dissuade an agent who is tempted to abuse his position.

The oversight can be simple. Require that copies of monthly statements of your accounts be sent to one or more other people. The recipients can be relatives or professionals, such as your attorney or accountant. The recipients can review them to see that no suspicious transactions are taking place and also that adequate amounts are being spent for your upkeep. Obviously, you want to pick someone you think isn't likely to collude with the agent.

Appoint multiple agents. Appointing two or more agents makes malfeasance less likely, though two agents wasn't enough protection in Mrs. Astor's case. The downside is that multiple agents can complicate matters, because two or more people have to approve everything and might be required to sign every check.

Appoint a protector. A solution I have recommended regarding trusts is known as a protector or supervisory agent. This is someone who has the right to review everything done by the agent and can replace the agent at any time for any reason. Again, collusion always is possible but having additional oversight reduces the probability of malfeasance.

Put details in the document. Mischief also can be reduced with a careful delineation of the agent's powers. As discussed above, consider specific details in the POA. Attorneys generally discourage putting too much detail in the document, because each item you put in can be subject to interpretation and dispute. But you might want to include some clear limits. Name the people who can receive gifts and, if you want, put annual and aggregate limits on the gifts. Some people prohibit the agent from receiving gifts or other payments, or they limit the amounts and circum- stances of such gifts. In some estates, specific items of property are precluded from being given away.

Have a side agreement. Some estate planners recommend the principal draft a separate letter of understanding that both the principal and agent sign. In this letter, the principal clearly states his or her intentions and desires about how the agent will manage the assets. The document has no legal effect. But it can be consulted by the agent and could influence an agent's actions. It also clearly expresses your intentions in case there is a dispute.

Lawyers have other terms and tools to increase the protections. Remember to balance these protections with the goal of enabling an agent to manage your affairs. The protections might make the agent's job more difficult and prevent someone from accepting the position.

The bottom line is that there is no substitute for carefully selecting the agent or agents. The POA should be given to someone who is both trustworthy and capable of handling the estate. One never can be certain how someone will act when faced with the temptations and responsibilities of the position, so some protections are in order. But the best protection is to carefully select the agent.

The power of attorney can be revoked or modified any time while you are legally competent. It should be reviewed every few years as part of a regular estate plan review. Consider the individual appointed, the powers granted, and whether all appropriate financial institutions have current forms. You also might want to talk with the attorney-in-fact periodically to ensure that your goals and desires for the assets are clear and that the person or people still are able and willing to serve.

An alternative to the durable power of attorney is the living trust. I will cover this in more detail later in this chapter, and many of you are familiar with the living trust. One little-known use of the trust is in disability planning. You are trustee or co-trustee when the trust is created. The trust should contain a succession clause which states who will take over as trustee should you die or become disabled. The provision also should define disability. This has all the advantages of the durable power of attorney. The main difference is that you must have all your assets legally owned by the trust for the succession clause to accomplish its purposes. That means transferring the titles to your home, cars, investment accounts, and other assets to the trust.

Even if you have a living trust, you also should have a power of attorney. No matter how diligent you are, there likely are assets that aren't part of the living trust. These assets can't be managed by someone without either a power of attorney or a court order.

A related document and the second key document is the health care durable power of attorney. This allows someone to make health care decisions when you are incapacitated.

For the last few decades, the living will has received a lot of attention. This document states the types of life-saving care that you want or don't want. Often it states general principles to guide doctors and might state preferences for a few situations. A common choice of language is that medical personnel should not use measures that would maintain the principal in "a persistent vegetative state."

Living wills are easy to execute. Most states now have standard forms that can be located on the Internet or obtained from various organizations.

The problems with living wills are that they are vague, do not cover all circumstances, and cannot keep up with changing medical technology and treatments. Also, surveys show that most living wills don't make their way into the medical charts and have no effect on treatment. Doctors either don't know about them, ignore them, or aren't sure how they apply to the situation they face. That's why a health care power of attorney is a better choice. Instead of trying to draft general principles to cover all situations, appoint someone who knows you to listen to the medical options and make decisions when you are incapacitated. These documents are recognized in all states and can be written to survive your incapacity. The durable power of attorney for health care can be personalized and keeps the courts from getting involved.

The power of attorney can be supplemented with a living will or other document that expresses your philosophy and wishes under at least some circumstances. The combination of a power of attorney and living will often is called an advanced health care directive.

Do not resuscitate/hospitalize. DNR and DNH orders for older patients are quite common, especially for those who are frail. Research indicates CPR rarely helps these individuals recover and instead makes their passings violent rather than peaceful. The reasoning for the DNH is that at some point people do not benefit from hospitalization for every new ailment or development. Instead, they should be kept comfortable wherever they are residing. Someone who agrees with those sentiments can decline in advance CPR or hospitalization or both.

HIPAA Authorization. This simple document authorizes medical providers to release medical information about you to the named persons without violating the privacy provisions of the Health Insurance Portability and Accountability Act of 1996. It can be incorporated into the other forms. Many medical providers won't even give details to spouses and family members now without the express authorization.

If you spend time in more than one state, check with an attorney to be sure that your documents will be effective in all states involved.

Your documents also can include non-medical instructions. You can give instructions regarding music, grooming, fresh flowers, and other aspects of your environment you'd like when you are receiving care.

Of course, all of your doctors should have a copy of any documents you execute and know how to get in touch with the agents named. Each of the agents should have a copy. Some family members also should have copies.

Making Health Directives Work

You can take steps to increase the probability that your instructions will be followed.

- Put it all in one document. A complete plan involves at least a health care power of attorney and living will-type document. You also can include other instructions discussed above. Consider compiling all this information in one document instead of in separate documents.
- Be sure it is valid. Some states require two witnesses for the documents to be valid. Others require three witnesses. A few require the documents to be notarized. Be sure the documents are valid in your state and any other states you regularly enter.
- Don't forget about travel. The law of wherever you are when health care is needed determines whether a document is valid. If you regularly live in or travel to other states, produce a document that is valid in the most restrictive state or prepare different documents that meet the requirements of different states. If you travel internationally, you should ask the estate planner your options for having a valid health care directive.
- Don't keep it to yourself. To reduce disagreements and misunderstandings among those around you, it makes a lot of sense to discuss details with the people you designate as agents and also general beliefs with your loved ones. Remember that a document, no matter how detailed, can't cover every possible situation. Your agents need to know your general beliefs so they can make decisions in specific circumstances that reflect your wishes.
- Consult different sources. Websites and books have sample forms. Estate planning attorneys each has his or her own forms developed over the years based on personal experience and philosophy. Consult several sources to get a taste of the available options.

Though I list a number of sources of forms and documents, I don't recommend that most people complete these documents on their own. This is part of an estate plan and should be finalized with the guidance of your estate planner. None of these tools provides a perfect solution. In most cases, difficult decisions will have to be made by loved ones. But you can ease the burden and provide a framework for making the decisions.

Keep in mind that most states allow a doctor or hospital to refuse to follow instructions for reasons of conscience.

Most of us need help in thinking about the difficult treatment decisions, whether for ourselves or others. A useful guide is a booklet written by a former chaplain at a nursing home. The booklet discusses the pros and cons of different choices and includes summaries of the scientific research on different treatments. You probably could benefit from *Hard Choices for Loving People*, by Hank Dunn (Quality of Life Publishing Co., 6210 Shirley St., STE 112, Naples, FL 34109; 1-877-513-990; www.hankdunn.com).

The health care power of attorney and durable power of attorney should be separate documents. One is for financial management, and one is for health care decisions. You probably want different people as the attorneys-in-fact under these documents.

Powers of attorney should be created early in the estate planning process as essential parts of every estate plan. Be sure to work with an experienced estate planning attorney so the documents will fill your needs.

Who Decides? The Ted Williams Saga

The post-mortem activities involving baseball great Ted Williams spotlight an estate planning issue that rarely is discussed: Who has the final say on the funeral and burial arrangements?

Most of you will recall that after Ted Williams passed away, his son apparently had the body flown to a firm in Arizona, where the body was frozen in cryonic suspension. Williams' other children say that he always wanted his body to be cremated. The son produced a note signed by Williams stating that he wanted the cryonic treatment. After discussions between the two groups of offspring failed to resolve matters, the dispute moved to the courts.

This series of events, while sometimes amusing tabloid fodder, also raises serious questions about estate planning. Not everything is controlled by your will. The fate of IRAs and retirement accounts, for example, is controlled by the beneficiary designation form filed with the plan sponsor. Section 529 college savings plans might or might not be controlled by your will, depending on the state plan.

What about your funeral, memorial service, and the disposition of your body? Control over the remains depends on state law, and the rules vary widely around the country. This is an area in which you might have to do some extra work to see that your final wishes are fulfilled.

Only about half the states have a rule specifically requiring that the deceased's wishes regarding the body be followed. Among those states with specific laws, the rules vary considerably. My state of Virginia says that the written requests of the deceased must be followed. West Virginia says the deceased's wishes will prevail only when there is a prepaid funeral. Arkansas allows the next of kin to overrule only a request for cremation. Many states have no law covering the issue at all.

Even in the states that do have such a rule, enforcement is a question mark. If the deceased wanted one thing, and all the children want something else, there's not much to keep the children from going through with the arrangements they prefer. If all the children agree, who is going to complain? The funeral home, for example, might refuse to comply with the children’s wishes, but the estate executor could move the body to another funeral home.

The issue generally arises only when the next of kin disagree with each other. When that happens, things can get messy. If the kin go to court, a resolution could take some time. There are a few cases in which bodies were put on ice for years until courts resolved the final disposition of the bodies. One classic case took four years to resolve.

While rare so far, such disputes are likely to be more commonplace in the future because of today's many patchwork and dysfunctional families. Multiple spouses and children from different marriages make disagreements more likely. These families have far more than the usual sibling rivalries to send emotions surging. Ted Williams, for example, was married four times.

Another factor likely to increase such disputes is that the choices for disposing of (or preserving) remains are increasing. Now, one's remains even can be made part of a coral reef.

Whatever your state law, you can reduce the likelihood of a dispute and increase the odds that your wishes will be followed. Take these steps:

- Understand your state's law. You can find a summary of each state's law at the web site www.funerals.org, along with other information on this topic. If you spend time in more than one state, learn which state’s law will prevail.
- Put your wishes in writing. The more detailed your writing, the better. It always has been a good idea to write down any preferences you have about the final arrangements.

You probably want this document to be separate from the will or want to express your wishes in both the will and another document. That's because the will often isn't even opened until after the funeral. A disadvantage of a writing outside the will is that in some states only the will is legally binding. That’s why in those states you should consider putting the request in both your will and a separate writing. Distribute the separate writing to the appropriate people.

Be sure the writing is notarized. That reduces arguments that the writing was just a draft or not your real intentions, which became an issue in the Williams case.

- Let other people know your wishes. The more people who know your wishes and that you expressed them in writing, the more likely it is that your wishes will be fulfilled.
- The more of the final planning that you do, the more likely you are to have your final requests followed. It is possible to go as far as prepaying for the funeral, though I don't recommend prepaying, because it usually isn't a good financial deal.

One way to make things easier on your next of kin and get your final wishes granted is to use my workbook, *For My Heirs*. This is a compilation of worksheets, forms and documents that lay out your affairs and give instructions to your kin. It is available for purchase under the Bob's Library tab at www.RetirementWatch.com.

Plugging Leaks In Your Estate

You need a will, even if all your assets are owned by a living trust or held in joint title. Why do you need a will? It is unlikely that even if you have a living trust or other arrangement, all your assets will be covered by it. Any other assets will be covered by your will or disposed of according to state law. A will also can cover other issues such as guardians for children and small symbolic gifts to special individuals.

And the will can have several provisions in it to protect your heirs and your wealth. Here are some key will provisions that everyone should have or at least consider.

Estate liquidity is remarkably overlooked in estate planning. It is not enough to reduce taxes and probate. You must be sure the estate will have enough cash or liquid assets to pay the expenses it will face. These cash transfers include paying your debts, estate expenses, and for the management of property while the estate is processed. You might have a surviving spouse or other dependents who need help with their living expenses until the estate is settled. All of your planning could be for naught if the estate has to sell assets to raise cash for basic expenses.

In your planning, be sure to estimate estate liquidity. If there might be a cash shortage, consider buying life insurance or designating which assets should be sold first to raise cash for expenses. When the estate has a lot of illiquid assets, consider selling some of them now to ensure the estate will have enough cash to meet its needs and obligations.

A related issue is specific dollar bequests. Often a will states that someone is bequeathed a specific dollar amount. At the time the will is written, this bequest is a certain percentage of the estate, and the intent was to give that person that percentage of the estate.

But the size of an estate can change. Suppose an estate had a lot of common stocks or mutual funds. The owner wrote a will in the spring leaving specific dollar bequests to certain individuals and charities. The owner dies, however, and about the same time the stock market suffers a steep decline. Suddenly, the specific dollar bequests are a much larger portion of the estate because of the sharp decline of the value of the estate assets. Despite this, the specific dollar bequests would be paid first. The other heirs would receive whatever was left, which would be less than was intended. The same result could occur in an estate that holds real estate, collectables, a business, or any other substantial assets that fluctuate in value.

Your heirs often are better off if you limit specific dollar bequests. Except for fairly nominal bequests, most bequests should be made either by naming specific assets, by stating a specific percentage of the estate's value, or by a formula that states a specific dollar amount or a certain percentage of the estate, which is smaller.

Another key clause is the tax apportionment clause. This clause states whether the death and income taxes related to a particular asset will be paid by the individual inheriting that asset or by the residuary estate (the estate left over after specific bequests). It can be an important clause. If you do not state how the taxes will be computed, they will be paid out of the residuary estate. That means less for whoever gets the residuary estate, and that usually is your spouse or children. Make sure you go over the consequences of the tax payment clause thoroughly with your estate planner.

The same philosophy applies to the payment of debts clause. Will each heir in effect pay a share of the estate debts, or will they be paid out of the residuary estate? Perhaps whoever inherits each asset will be responsible for debts related to it. Or will you buy enough life insurance to cover the debt payments? Do not overlook this issue, or your residuary beneficiary could end up with far less than you intended.

A simultaneous death clause is standard in most wills but be sure yours has one. This clause states that if you and your spouse die within a certain time of each other, then each spouse will be treated as having predeceased the other. This is important for avoiding multiple estate taxes and costs. Without this clause, if you and your spouse are in a common accident many state laws say to assume that each survived the other. That means all your assets go through your estate, then go through your spouse's estate before they go to your children or other heirs. That could mean double taxes and double fees.

You probably want to set the time period in the simultaneous death clause at 90 days. Some state laws put the period at 24 hours or 72 hours. This means if you and your spouse are in a common accident but one of you dies a week

after the other, your assets will be hit with double estate costs. Most estate planners find that 90 days is a better time period for the simultaneous death clause.

Prepare Your Financial Emergency Kit

You might have solid investments and a good estate plan. But your planning isn't complete without a financial emergency kit. An ideal time to put one together is when you are working on your estate plan.

A financial emergency kit is a set of tools that can keep a difficult time from becoming much worse, and it can help avoid some problems. The time when a kit is most urgently needed is when you are incapacitated or disabled. Of course, you need to prepare the kit ahead of time for it to be available when you need it. There also are other times when one or more elements of the kit are needed. Here is my list of the essential elements of a solid financial emergency kit.

- Your records should be in order, up-to-date, and easy-to-find. Often, I run into people who know everything they own, its history, and where to find the records. That doesn't do your loved ones any good unless they can figure out all that. Organize things so that anyone can quickly get a handle on your finances. Then, let a few key people know where the records are. You might even walk through the records with them. Review and reorganize the records each year.

It is a good idea to include among the records a personal income statement and balance sheet (listing your assets and liabilities) that are revised about annually.

- Give someone a power of attorney to handle your finances. We've already reviewed this document, and it is an essential part of any financial emergency kit.
- Be sure you have cash, credit, or both. In an emergency, you or your loved ones shouldn't be bothered with finding and raising money. You should have three to six months' expenses in liquid assets that can be accessed easily and quickly. Money market funds or interest-paying checking accounts are good places for this cash.

It doesn't hurt to have credit lined up for longer-term situations or sudden large expenses. A crisis with time pressure is not a good time to be borrowing money or trying to sell illiquid assets. Most people these days can get a few credit cards with large borrowing limits. Another option is to set up a home equity line of credit that lets you draw on it simply by writing a check.

A margin loan against an investment portfolio is an easy, low-cost way to borrow money.

Ask your broker what is involved in getting a margin loan line of credit, what the cost is, and what forms they would need on file for money to be borrowed in an emergency.

Business owners should consider establishing a line of credit upon which the business can draw if cash is needed in a hurry.

- Keep your insurance in order. A personal liability umbrella often is an excellent, low- cost addition to a homeowners' policy. You can protect yourself against millions of dollars in liabilities for a few hundred dollars or less per year. The standard umbrella policy is for $1 million of coverage. But most people these days should seriously consider increasing that to $3 million or $5 million of protection. The umbrella will not cover liabilities incurred in your business or profession. So, line up separate liability coverage for business activities.

Disability insurance is an overlooked coverage. Statistically a person of almost any age is more likely to become disabled than to die. Of course, the odds of being disabled decrease if you work in an office and do not engage in any hazardous activities. If you get disability coverage, be sure that coverage is triggered when you are unable to perform your *regular job*. You won't get much benefit if the policy pays only if you are unable to perform *any occupation*. You can greatly reduce the cost of premiums by providing that the policy pays only if you are disabled for an extended period, such as more than 90 days or six months.

- Review all your beneficiary choices. These include IRAs, pensions, 401(k)s, life insurance, health insurance, and other benefits. It is not unusual for a person to have designated a beneficiary before getting married (or divorced) and never change it.

It is a good idea to name a contingent beneficiary for everything. Then, if for some reason the initial beneficiary does not take the benefit, someone else you chose will. Suppose you have three adult children and name them as co-beneficiaries. What happens if one of them dies? In most standard forms, the other two adult children split the property. Any children of the deceased adult child get cut out. That's why it is a good idea to review the beneficiaries and to understand what happens if your first choice doesn't get the benefits. You might need a lawyer's help to get the result you want.

Ask your employer or other plan sponsor who they have listed as the beneficiary and contingent beneficiary. Your records and will don't count. Only the records of the sponsor determine who gets the benefit.

- Start. It takes a while to put together the complete financial emergency kit. Don't feel you have to do it all at once. Line up one thing at a time. Once you have everything set up, it will be a fairly easy task to review and update the kit every 12 to 18 months. You'll be glad to have done all the work if you or your loved ones ever need to use the financial emergency kit.

Picking the Right Trustee — Don't Let Them Break Your Estate Plan

What's the biggest problem with most estate plans? Often it is not taxes or cash flow. Many times, the biggest problem is the trustee or executor that was appointed to carry out the estate plan.

Trusts are a key part of many estate plans. Later, we'll learn many situations in which one or more trusts could be beneficial. How the trustee administers the trust determines the quality of the estate plan. Unfortunately, there are many ways a trustee can destroy a solid plan.

A perennial problem is **fees**. Often no fee limits are placed in the trust agreement or con- tract with the trustee, allowing the trustee to increase fees at will, which some have done.

Investment performance also can be a problem. A bank trustee might feel obligated to hire the bank's mutual funds or asset managers to handle the trust's investments. At some trust companies, this results in high fees for mediocre performance.

Also, there can be **overnight changes** in the trustee. In the rapidly changing financial services industry, your local bank can be swallowed up by a series of larger banks. Soon, someone who never knew you and doesn't know anything about your family is managing the trust along with 250 others. There's no way that trustee (who probably won't stay in the job more than two years) can know your preferences or what is best for the family. The trustee also probably lives and works hundreds of miles from your home.

Let's look at a common situation that starts out right but ends up with very bad consequences.

Often, a person wants to provide adequate assets and income for the surviving spouse but is concerned about the spouse's ability to manage property or wants to ensure that a potential second spouse does not get the property. The solution is to write the will so that the property is put into a trust for the surviving spouse's benefit. The trust states that after the surviving spouse dies, the assets go to the couple's children. The will names a trustee to manage the property and dispense income and principal to the surviving spouse at the trustee's discretion.

These arrangements work fine for a while, and often work well for many years. But some trustees tend to invest very conservatively while some widows outlive their husbands by many years. The result after a decade or so of conservative investing coupled with inflation is that income payments from the trust no longer match the widow's standard of living. Some trustees compound this problem by arguing that one of their duties is to preserve assets for the children to eventually inherit, so they will not dip into principal to pay more money to the widow.

This problem is fairly common and becomes more common as life expectancies increase. An additional problem is that in many states trust beneficiaries do not have the power to change trustees unless that power is in the trust agreement, and some estate planners don't think to put that provision in the trust. This is a problem for children who are beneficiaries of trusts as well as for surviving spouses.

Once you are gone, your family might have no say in how the trust is managed. After all, that is one of the reasons trusts are created in the first place. The beneficiaries aren't supposed to have discretion. But the beneficiaries also have few options if the trustee performs poorly. Courts generally aren't willing to change a trustee unless the trust

agreement specifically allows it. Also, the trustee can use trust assets to pay for its defense against a suit. Some legal reforms are under way, but they aren't in place yet in most states.

For the trust to work, you have to set things up right in the first place. Here's what to do.

- **Don't make the trustee choice an after-thought.** Usually, at the end of the estate planning process, the attorney asks who should be named the trustee. The trust creator hasn't thought about it. Then the nod goes to a bank suggested by the attorney or one that has the creator's accounts.

Give the trustee as much thought as the rest of your plan. Interview several trust companies. Ask how they communicate with beneficiaries, how they make decisions about distributions, what kind of personnel turnover you can expect, and, of course, what the fee schedule is. Also check into how they will invest the trust.

Look beyond traditional trust companies during the search. Major brokerage firms and some mutual funds now actively seek this business and have active trust subsidiaries.

- **Consider appointing co-trustees.** Corporate and bank trustees have many advantages. They have the infrastructure to efficiently administer the trust and do the taxes. But they might not know what is best for your family or know your preferences. You can appoint a co-trustee who is a family member, friend, or professional advisor. The co-trustee can have the power to prevent expenditures and investments. You also can empower the co-trustee to approve fee changes or even change the corporate trustee. You can appoint one or more co-trustees.
- **Split trustee duties.** You can hire a corporate trustee to handle administration and taxes. Then provide for someone else to handle the investments. You can pick a firm or adviser you like. Or you can appoint a co-trustee or committee to handle the investments. Be sure fees are separated for the different functions.
- **Limit fees.** There's no reason for your trust not to put some kind of limit on fees. Some trust companies that won't want the work under that condition, but enough will. A good option is to have someone other than the corporate trustee, such as a co-trustee or a committee, approve fee increases.
- **Provide for removal of a trustee.** Amazingly, most trusts don't give anyone the power to remove trustees. That was partly due to IRS rules, but the rules were changed in 1995.

You probably don't want beneficiaries having the power to change trustees, especially if a point of the trust was to limit the beneficiaries access to the property so it would not be wasted. The original purpose of the trust might be voided if the beneficiary could shop for a friendly trustee. If you do give the beneficiary the power to change trustees, limit the power so it cannot be exercised more than, say, once every five years, and the new trustee has to be the same size or larger than the current trustee. You can put in other conditions if you want.

But you might allow the trustee to be changed and have the corporate trustee chosen by a co-trustee or a committee. If these people are familiar with both your wishes and the beneficiaries' needs, an appropriate trustee is more likely to be selected.

- **Write a letter.** A trust agreement cannot cover all circumstances because you cannot foresee everything. If a trustee has some discretion in handling the trust and making distributions, you might want to leave a letter that outlines what your intentions were and the actions you would prefer the trustee to take in certain circumstances. Those instructions might be helpful to the trustee when hard decisions or unexpected circumstances arise.

More strategies for trust and trustees are contained in the next chapter.

The Probate Decision and Living Trusts: Do You Really Want To Avoid Probate?

The probate process, as I mentioned before, is different from estate taxes. The difference is important to keep in mind. With so few estates subject to the federal estate tax, probate is a more important consideration for many estates.

The federal estate tax is how the IRS determines which assets and liabilities you had at death and what the tax on the estate is.

Probate is a state process. It is used to clear the title to the assets you owned, ensure that your debts are paid, and transfer legal title to the remaining assets to either your designated beneficiaries or the beneficiaries determined under state law.

Many assets avoid probate but are included in the gross estate for federal estate tax purposes. You can avoid both probate and estate taxes, but that means giving away all legal title and rights to the property.

Assets That Avoid Probate

Probate is avoided automatically for pensions (including IRAs and 401(k)s), annuities, and life insurance benefits. Title to these assets passes automatically to the beneficiary designated in the asset's documents, such as an IRA application. Some financial accounts also can avoid probate by using a Transfer on Death (TOD) registration. Most states have adopted the Uniform TOD Security Registration Act, although some have modified it. In addition, brokerage firms may decide whether or not to offer TOD registration. Many financial services firms now offer TOD registration if you ask for it. It works just like designating a beneficiary for an IRA. You complete the paperwork while you own the account. On your death, legal title passes automatically to the designated beneficiary without going through probate. The beneficiary has to take steps to have the account or securities registered in his or her own name, usually by sending to the transfer agent a copy of the death certificate with an application for re-registration of the account to securities.

Joint ownership also can avoid probate and is one of the most common ways to avoid probate, often referred to as the poor man's will or a will substitute. Joint ownership often has to be "joint tenancy with right of survivorship" or "tenancy by the entirety," depending on the state you are in, to avoid probate. There also is some protection against creditors. The creditor protection occurs because jointly owned property generally is not subject to the claims of one of the joint owner's unsecured creditors unless the other co- owner also was liable on or guaranteed the debt.

But there are disadvantages to joint tenancy.

When the first spouse dies, only one half of the jointly held property is included in the estate of the first to die. The marital deduction ensures there won't be estate taxes paid on that half of the property, and that half of the property also gets its tax basis increased to its fair market value when the first spouse died. This means the couple might have missed an opportunity to increase the basis of the entire property to its fair market value. That would have allowed the second spouse to sell the property without paying capital gains taxes. This is an important advantage with stocks, mutual funds, real estate, businesses, and other assets that have increased greatly in value.

Also, when property is jointly owned, each owner must agree to sell or make changes in the property. That reduces flexibility and can be a problem should a spouse become disabled or incompetent. Joint title also makes it difficult to use many estate planning devices, such as family limited partnerships and irrevocable trusts.

Some people hold property jointly with their children to avoid probate and as a will substitute. When property is owned jointly with a non-spouse, then the entire property is included in the estate of the first to die unless the other owner can show he or she contributed enough to buy a share of the property. That might or might not be a problem, depending on the potential tax burden of the estate.

Joint tenancy can cause tax problems even when the property will not increase estate taxes. Normally when a person inherits property, the tax basis of the property to that person becomes the fair market value of the property on the death of the previous owner. This is a way for a family to eliminate capital gains taxes on appreciated property. The owner holds the property until death, then the heirs inherit the property and get to step up the tax basis to the fair market value on the date of the previous owner's death. The property can be sold immediately at no capital gain.

But when property is jointly held, the surviving co-owner gets to increase the basis on only the half of the property that was included in the gross estate of the first owner to die. First, this creates complicated recordkeeping, because the property now must be treated for tax purposes as two properties with two separate tax bases. Second, when the surviving co-owner sells the property, half that wasn't included in the estate of the first owner to die will be fully taxed on the appreciation. In this case, creating a joint tenancy increased capital gains taxes.

A nontax disadvantage of joint tenancy is that it reduces flexibility. Local law determines the rights and duties of each owner and leaves the surviving joint owner with 100% ownership after the first joint owner dies. This means the property might not eventually be disposed of or managed the way you want, and that result could be avoided if the property were disposed of under the terms of your will or a trust. A joint tenancy also is more difficult to revise than a will or trust.

As a general rule, joint title to property should be minimized. A checking account, savings account, and the principal residence can be jointly held by spouses. But give serious consideration to having each spouse own other property separately.

Living Trusts

The living trust is perhaps the most frequently used way to avoid probate. The living trust is very popular in some states, and rightly so. But in some cases, it is overhyped. Plus, many individuals are not aware of some of the drawbacks and technicalities of living trusts.

A fourth advantage of a living trust is that it often is more difficult to contest than a will. The rules for will contests are rather well-established. But there are not many cases of someone successfully challenging the terms of a living trust. If you are excluding someone from your estate who might feel a right to part of it, you might find that a living trust provides better protection than a will.

A disadvantage of the living trust is that it is more involved than most people realize. You must do more than simply draw up the trust document. Legal title to all the assets you want covered by the trust must be transferred to the trust's name. This means changing the title on your homes, cars, financial accounts, and anything else that you want covered. This process is known as "retitling."

Too often, people do not go through the retitling process. Part of the reason is that retitling might cost money when real estate and automobiles are involved, depending on local law. Another reason is that retitling is inconvenient and time-consuming. There are many living trusts around that are useless because the individuals involved never retitled their assets.

A living trust also might make it more difficult to undertake some routine transactions, especially after the original trustee dies and the trustee must be changed. Banks, brokers and other financial institutions have very firm rules about their getting all the proper documentation after the death of the original trustee before anything is done with an account by a subsequent trustee. It can be time-consuming to change trustees, buy or sell investments, or undertake similar transactions when a living trust is involved. If you set one up, you should learn your financial institutions' paperwork requirements.

Remember that a living trust does not avoid estate or income taxes. It also doesn't eliminate the need for a will. You aren't likely to have all your assets covered by the living trust. So, you still need a will to handle the assets that aren't under the living trust.

The living trust avoids probate, helps in disability planning, and provides some privacy. But it creates some of its own problems.

Should You Avoid Probate?

A question that is rarely raised but should be is whether or not you really want to avoid

probate.

The traditional reasons for avoiding probate are that it is a very expensive, time-consuming process. Lawyers take a percentage of the estate off the top, often for simply having paralegals do some paperwork. Then, the courts and lawyers can take many months, sometimes years, to get the paperwork done and the assets distributed according to the will.

But some states have changed much of that. The required fee schedules for probate are gone in some states. So, the lawyers bill by the hour for work actually done. Your executor can negotiate rates plus do some of the legwork personally to further cut costs.

For small and medium sized estates, some states have created a streamlined probate process. The executor has nine months to file the federal estate tax return, and the streamlined pro- bate process is designed to have the entire estate cleared up in that time.

Probate isn't all bad. Some people believe it is an advantage to have everything about the estate and how it is distributed in the public record and reviewed by the court. There's less of a chance for shenanigans by the executor or others. Anyone who disagrees with how things are being handled can file a complaint with the court. The probate process also certifies title to the assets, making it more difficult for someone to challenge the ownership.

You should discuss both the advantages and the potential costs and delays of probate as part of the estate planning process. Have a full discussion with your planner to determine how much of your estate should go through probate.

Probate is not an all-or-nothing choice. Most estates are partly subject to probate and partly avoid probate. Some widely owned assets, such as IRAs and annuities, pass to their next owners automatically and without probate.

The question for you is how much of your estate you want to avoid probate.

When you spend time in more than one state, especially when you own real estate in two or more states, consider the probate situation in each state. Generally, the bulk of your estate is subject to probate in the state where you were a resident or domiciled. But real estate is probated in the estate where it is located. So, your estate might be subject to probate in more than one state without proper planning.

Whether you want to avoid probate depends largely on your privacy concerns, disability planning, and where you live. If you want privacy for your wealth, a living trust is preferable to the probate process. But if privacy is not a concern and you live in a state with modern probate processes, a living trust might not be worth your while. California, for example, still sticks by the old probate rules.

Living trusts are very popular in California, and rightly so. But that is not the case in every state.

Avoiding probate is not an automatic decision these days. You should discuss the pros and cons with your estate planner and see what is best for your situation.

Simple Ways To Protect Assets

Taxes, the IRS, attorneys, and estate processing costs are not the only enemies of your wealth. More and more people are concerned about creditors, especially those created by lawsuits. With the estate tax not a concern for most, insurance coverage being reduced, and lawsuits increasing, many people are more concerned with this potential leak of their wealth than they are about taxes. Even those who aren't afraid of being sued are concerned that creditors of their heirs might end up with the bulk of their estates.

Many people now are looking for asset protection strategies, including strategies that will protect wealth from the creditors of their heirs.

Fortunately, you can protect wealth without venturing into the world of offshore trusts, shady operators, and unethical or illegal schemes. You also shouldn't have to pay a fortune for an effective asset-protection package.

Let's start with a few general principles.

Your state law, with some supplements from federal law, controls the specifics of asset protection. Some states completely protect annuities and life insurance, for example, while other states protect them with limits. To be sure, you or a lawyer needs to check the local law.

Asset protection should not be done in a vacuum. Asset protection should be considered as part of estate, tax, and investment planning. This has several benefits.

Asset protection is only one of your goals. Making it part of your other planning ensures that you don't sacrifice other goals to asset protection. Integrating the process also makes an asset protection plan more viable. A court is less likely to protect an asset if it appears a move was taken solely to thwart creditors. The plan would be viewed as a fraud on creditors. When you show tax, investment, or business reasons for the plan, a court is more likely to uphold it.

It is vital that asset protection planning be done before you have a real problem. Once there is a problem with creditors, a court is likely to view any action you take as a fraudulent transfer. Take action before there is a court decision or creditors are beating on the door, and a court is more likely to support your actions.

Finally, don't look for a magic bullet. It is better to rely on a collection of asset protection strategies than to have your wealth depend solely on one method.

Here is the toolbox from which to select asset protection strategies that will work for you.

Insurance. Now that insurers have recovered from the financial crisis, many types of insurance are fairly inexpensive for most people. Asset protection planning should supplement insurance, not replace it. An insurer will help defend you from claims and usually suggests ways to protect yourself. You should have significant liability

coverage in your auto, homeowners', and other property coverage. Also, don't forget to have an umbrella liability insurance policy. This insurance still is inexpensive and covers you for liabilities not covered under other personal policies. It is well worth the cost. You also need insurance to cover your business or professional activities.

Spousal shield. Unless your spouse also signed on to a debt or is a co-defendant in a lawsuit, his or her property cannot be reached by your creditors. There are several ways to use this shield.

A simple transfer of title to your spouse works. There won't be any gift taxes, because of the unlimited marital gift tax deduction. Of course, you cannot get the property back, and your spouse is free to do whatever he or she wants with it.

You also want to be sure that the property doesn't come directly back to you if the spouse dies first. Instead, your spouse's will should provide that the property will be transferred to a trust for your benefit that has a spendthrift clause, so that your creditors cannot reach the trust.

Another strategy is property held jointly as tenants by the entirety. Not all states recognize this type of title. In those states that do recognize it, creditors of one spouse cannot force the property to be sold. Only creditors of a joint debt can get the property. To get protection, the title must be tenancy by the entirety. Jointly held property and property held jointly with right of survivorship do not get this protection.

Estate planning vehicles. Family limited partnerships and limited liability companies can be excellent parts of estate plans. They reduce gift taxes, get assets out of your estate, and still allow you a lot of control over the assets, as explained later in this report. In addition, in most states the assets in the entity are protected from the creditors of the partners. Distributions from the entity could be claimed by creditors, but the creditors cannot force distributions, seize assets from the entity or seize a partner's ownership interest.

Annuities and life insurance. This protection varies from state to state, as mentioned earlier. Some states fully protect annuities or the cash value in life insurance policies. Creditors might be able to get distributions as they are made, but they cannot seize the assets or force distributions.

You might need to file for bankruptcy to trigger the protection. Check state law before making a purchase.

Prepay for college. Section 529 college savings plans are protected to some extent from creditors in more than half of the states. The protection varies, and you might need to be a resident of the state sponsoring the plan to get the protection. Another protection is to name the student as the owner of the account, but then you wouldn't be able to control the account or get the money back if needed. A good strategy might be to name your spouse as owner of the account.

Create trusts. Irrevocable trusts usually protect assets from creditors of either the grantor or the beneficiaries of the trust. They also ensure that the assets are out of your estate for tax purposes. A good asset protection trust should have a spendthrift clause, which shields assets from creditor claims. Spendthrift clause protection differs from state to state. Some provide unlimited protection; others limit the protection. Also, an independent party should be trustee.

Many asset protection planners recommend carefully choosing the location of the trust and its trustee. The most aggressive strategy is to locate the trust in a foreign country, especially one with strong asset protection laws, though those are rapidly diminishing. Courts, however, have found ways to break down the effectiveness of these trusts. Most asset protection planners acknowledge that the real benefit of an offshore trust is that many creditors will be discouraged by the time and expense involved in breaking the trust and will write off the debt instead of pursuing the claim.

A number of states now are offering asset protection trusts similar to those found offshore. The trust laws are relatively new, and there tend to be restrictions such as that assets have to be in the trust for at least four years to be protected. It isn't clear how U.S. courts, especially those in a state different from the trust's location, will respect and interpret the law. Yet, they are a less expensive alternative to an offshore trust.

You could set up a simple irrevocable trust for the benefit of your children. Or you could have multiple layers. For example, a trust can serve as a partner of a family limited partnership. Or you can name someone as a trust protector, and the protector directs a trust that owns most of a family limited partnership. These multiple layered plans are expensive to create and maintain.

Bankruptcy exemptions. Ideally you want to protect your assets without filing for bankruptcy. As a fallback, however, you should examine the bankruptcy exemptions in your state and consider arranging asset ownership to maximize protected assets.

Most states protect a home of up to some value from creditors in bankruptcy. In some states there is an unlimited homestead exemption. You can own a home of any value and have it protected from bankruptcy creditors. There might be minimum residency periods or other requirements to receive maximum protection. Some bankrupts have protected assets by purchasing expensive homes in one of these states even after losing court cases.

Retirement accounts. The protected amount for retirement accounts varies by state and by the type of account. In most states, IRAs receive a limited exemption while profit-sharing plans and corporate retirement plans are fully exempt. When a creditor claim seems likely, it might be possible to set up a business, create a retirement plan, and roll an IRA into the business retirement plan. Federal bankruptcy law provides full protection for IRAs and other qualified retirement plans for the original owner (but not for beneficiaries who inherit), but each state has its own law and doesn't have to follow the federal rules.

Aggressively manage assets. Some assets are difficult to protect from creditors, yet you might be able to protect equity in the asset. For example, you can borrow against the equity in real estate and put the loan proceeds in a trust, family limited partnership, or other vehicle with more protection. A variation is to identify assets that are difficult to protect and sell them for cash. Then, protect the cash.

Consider a charitable trust. The charitable remainder annuity trust can be a great estate planning tool. It works with appreciated assets such as real estate or stocks. You contribute the asset to the trust and take a tax deduction for a portion of its fair market value. No capital gains taxes are due on the appreciation. You receive a regular annuity payment for life from the trust, and the amount left in the trust at your death goes to a charity you designated.

In a state that protects annuities, the income stream from this trust is likely to be protected in bankruptcy. A variation, known as a unitrust, pays a fixed percentage of the trust instead of a fixed amount. That provides inflation protection. Unfortunately, the unitrust might not get the protection an annuity trust receives.

These are examples of simple, relatively low-cost ways to protect assets from lawsuits and creditors. Consider these before undertaking an expensive asset protection plan if you're concerned with protecting the assets from creditors.

Crafting The Perfect Will

It doesn't take much to tarnish a gem of an estate plan, and with it your legacy. A misplaced word, missing clause, or miscommunication between lawyer and client can send your ordered plan spinning into chaos. You can avoid such a fate. Follow these guidelines and you'll be well on the way to establishing the perfect will as the foundation for your estate plan.

Observe your lawyer work. A good estate planner wants to know about everything you own or have an interest in before beginning. If the lawyer doesn't ask for details, you probably need another lawyer. A good estate planner also will ask your goals and philosophy of money, show you different ways of trying to meet those goals, explain the tradeoffs in each method, and let you choose which route to take. Unless your estate is very simple, be wary of a lawyer who has only one solution or quickly determines what to propose.

Write it in English. Lawyers and clients don't always speak the same language. And too often clients aren't willing to make their lawyers explain enough. The result can be unintended consequences in the will.

You can avoid this fate by writing in your own words what you want to accomplish and what you think the estate plan accomplishes. You should do this before you talk to the lawyer and give the lawyer a copy. Then as you and the lawyer develop a plan, update your statement to include the changes you believe have been made. Show each revision to your lawyer. This method reduces the room for error, and you'll find out quickly if you and the lawyer miscommunicate in your discussions.

Get a second opinion. You do it with almost every significant thing in your life, and probably with some things that aren't very important. Spend a little extra money to get a second opinion on the will and any other estate plan documents. Take your statement of goals and the documents to another estate planning lawyer for a review and comment.

Estate planning is fairly complicated and gets more complicated each year. A small mistake can greatly change your estate plan. For example, a bypass or credit shelter trust allows your estate to take advantage of the lifetime estate and gift tax exemption. The trust can pay income to your spouse for the rest of his or her life, then pay the remaining

property to your children. But the tax exemption could be lost if the trust gives your spouse the power to change the beneficiary. Some trusts make that simple mistake and cost the estate additional taxes.

Know your children. Naming the oldest adult child as executor of an estate is very common and often works fine. It is a big problem, however, when the children have a history of animosity or there is some rivalry. It is not unusual for children who were able to behave civilly while their parents were alive to go to war after a parent's death. The results are an irreconcilable family and money wasted on attorneys' fees. If you have any doubts about your children's ability to get along after you are gone, name someone outside the family as executor.

Limit specific bequests. A specific bequest gives certain property to a certain person. Specific bequests are appropriate for valuable or unique items. But putting a lot of specific bequests in your will causes problems. You have to update your will every time you lose, sell, or give away one of the items. How are you sure that the children are getting equal shares? What happens if an item can't be located after your death? What happens to items that somehow didn't get named in your will? What happens when the market changes the total value of your estate? The specific bequests could leave your family with less than you intended.

It is better to limit specific bequests to valuable items and those you know have meaning to certain individuals. Then have all the other items disposed in the "residuary clause." This is the clause that says, "all the remainder or residue or my estate goes to..." Normally this clause divides the property among the surviving spouse or the children.

Don't divide your heirs. The residuary estate often is divided equally among the children or other loved ones. The trick is choosing a method for dividing the property that works best for your heirs. Choose the wrong method, and you'll divide the loved ones along with your property. I give specific suggestions for dealing with this issue later in the book.

Keep up with the times. Your estate planner needs to know of any changes in your family and your wealth. You need to meet with your estate planner when a child or grandchild is born, when there is a marriage or divorce, and when someone dies. Changes might need to be made if you move to another state. Also check with your estate planner when the amount of your wealth changes or when you sell a significant asset.

Establish your domicile. A state that has death taxes will tax the estate of anyone who was “domiciled” there at the time of death. Domicile is a technical legal term. In most states it means the place in which you intended to live indefinitely. The state of residence is where you actually lived.

That creates problems for those who split the year between two or more states and also for people who largely moved to a new state but did not sever all their ties with the original state of domicile. In some cases, two (or more) states each will claim the deceased was domiciled within its borders, and each will assess full taxes on the estate.

Don't leave your heirs in this position. Decide which state you want to be your domicile and find out how to legally establish that domicile. Then document those steps. States generally look at voter registration, vehicle registration, and driver's license addresses. They also will look at where you spend over half the year and a host of over factors. (There’s a checklist on the members’ section of the *Retirement Watch* web site.)

Unfortunately, a few states essentially require you to sever all ties. Some will claim you were domiciled there if you retain a property such as your old residence, even if you rent it to others or rarely visit. If you split time between two or more states and at least one has a death tax, be sure to establish a domicile and document it.

When you take the time to craft the perfect will, the administration of your estate will go smoothly and won't affect how loved ones remember you. But a mistake or poor planning could result in bad blood among your survivors and bad memories of you.

What A Will Can And Cannot Do

A will is one of the simplest yet most powerful documents you can write. A will can decide what happens to valuable property, even billions of dollars’ worth. It can decide who becomes the guardian of minor children, who controls a business or other entity, and how much of your wealth goes to the government. The will definitely is a requirement of every estate plan.

But a will cannot do everything that is essential to a good estate plan. And there are some things you just aren't allowed to do in a will. Let's take a look at some of these limits and what you can do about them.

A will has no effect over property whose ownership is controlled by law. For example, if you own property jointly with someone, the co-owner normally becomes full owner upon your death. The details vary by state and the form of ownership (joint owners with right of survivorship, tenants by the entirety, etc.) But in general, when property is jointly owned you cannot use the will to give your share to someone else. Likewise, life insurance benefits go to the beneficiaries named in the policy, and that cannot be changed in your will. The same applies to annuities and qualified retirement plans, including IRAs. You name beneficiaries in the plan documents or similar documents, and that's who inherits the account. It doesn't matter what you say about the property in your will.

If you set up a living trust, the trust documents control who receives the property and income owned by the trust. You cannot change that in your will. The only time a will overrides a trust is when the trust document gives you a "power of appointment." Normally you can exercise that power in a will to direct who inherits the trust property. But a trust with a power of appointment generally is included in your estate for tax purposes.

Here's something that few people realize, because they spend a lot of space addressing this issue in their wills. We discussed this earlier. In many states, your will cannot control what is done with your body, how your funeral is arranged, or anything of that nature. In fact, in those states you have no legal control over these matters. You can leave directions and letters covering them to your executor and relatives, but they are under no legal obligation to follow your wishes.

It also is difficult to provide for the care of a disabled person or minor in a will. It is better to set up a trust through your will or during your lifetime. The trustee has to follow the directions in the trust agreement.

You can, of course, disinherit someone through your will. The only exception in most states is your spouse. A spouse generally is entitled to a minimum share of the other spouse's estate, usually between one-third and two-thirds of the estate, unless there is a valid prenuptial or postnuptial agreement in which the spouse waives all or part of this right. But you don't have to leave your spouse more than the minimum required by the state, and you don't have to provide for anyone else unless you made a binding promise to him or her.

If you are disinheriting someone who ordinarily would be considered a loved one or a natural object of your affection, then you should state that in the will. It is best not to simply ignore the person and say nothing. If you do that, the disinherited person, usually a child, could effectively argue that you or your lawyer simply made a mistake and accidentally left out his or her name. You don't have to state a reason for disinheriting, but most lawyers believe it is wise to state a brief reason. That might prevent a lawsuit claiming that you were unduly influenced by someone or weren't mentally competent. One reason that usually is easy to defend is that you believe you amply gave to them during your lifetime or that the person has acquired adequate resources on his or her own.

A disinherited person still can challenge a will. That's why some wills leave at least something to everyone, then include a clause stating that anyone who challenges the will and loses gets nothing, known as an *in terrorem* clause. That is a deterrent from tying the estate up in the courts and siphoning the bulk of it in lawyer's fees. But it doesn't always stop lawsuits. The disgruntled heir can sue other people instead of challenging the will directly. For example, a charity that solicited your donation might be sued for interfering with a child's expected inheritance. The trick with the combination of the token inheritance and *in terrorem* clause is to determine an amount to leave the person that will be large enough to discourage him or her from risking losing it if a lawsuit fails.

What about strings or conditions on gifts? You can put any string or condition on a gift if it is not against public policy as determined by the courts. Today, that generally means most racial restrictions are eliminated as are actions that violate the law or encourage the violation of the law. For example, you probably cannot leave a scholarship fund for "whites only." It is an open question whether you can make an inheritance contingent on the beneficiary not marrying outside a race or religion.

You can place almost any other condition in the will or a trust. You can even make gifts contingent on the beneficiary's being married, staying married, or being employed. One fellow was denied membership in a club during his lifetime. He provided that his daughter could inherit as long as she did not marry a member of that club. In another case, Canadian courts upheld a will in which the deceased left his estate to the woman who had the most children in the 10 years following his death. Several women had nine children each and split the estate.

One will leave the entire estate to the only child on the condition that he be a registered Republican, a member of the Moose lodge, never change his surname, be employed in either the family business or certain specified occupations, have his wife sign a postnuptial agreement, and attend a Christian church with his family at least twice a month. None of those objectives appears to be against public policy, so the will probably is legal. The will was not challenged.

Of course, there's the question of who is going to enforce such restrictions. Suppose the son in this last instance met all these qualifications, received the inheritance, and the estate was settled and closed. Five years later, he becomes a Democrat, quits the Moose lodge, and stops going to church. Is the executor now going to hire a lawyer and ask a court to get the money back? Probably not. If not, who will complain? The state attorney general or a similar official probably has standing to sue to ensure the state's laws are respected, but it is questionable whether he or she would find out about the events and choose to spend resources on a lawsuit.

Wills are very flexible and powerful. But they do have limits. You need to determine your goals, then meet with an estate planner to decide how best to achieve your goals. Part of the solution will be a will, but other actions and tools also will be needed.

Handling The Toughest Estate Problem

The most difficult part of an estate plan can be the family home or a second home. Often the property is a large part of the estate's value. It also cannot be divided among the heirs. They either sell the property or share it. But the emotions surrounding a family property probably are the biggest reason that it can be a problem. Estate planning strategies need to be combined with an understanding of the emotions involved. Estates large and small have been dissipated by legal fights over family homes.

Don't think owning a modest house means this issue doesn't apply to you. It often is lifelong rivalries and disagreements, some of which have been under the surface because of the parents' presence, that trigger the behavior of siblings. Fights have been known to take place over trailers. It doesn't matter whether the real estate was the principal residence, a vacation home, or undeveloped land. Siblings can find reasons to fight over it.

Fortunately, there is much you can do to avoid these fights. Here are some strategies to consider.

- Sell the home while you are alive or provide in your will that it will be sold, and the cash distributed. You take a risk that it might be sold in a temporarily bad market. It also means the property won't become the equivalent of a family heirloom, which is a disappointment to some people. But it also avoids problems between siblings.
- Name someone outside the family as executor of the estate. This might avoid some battles, and it keeps one sibling from having an advantage. Appoint a child as executor only if you are confident that he or she can be fair and impartial and do what's best for the estate.
- If the children will keep and share the property, especially a vacation home or retreat, set the rules governing use and expense-sharing.
- Decide how the property will be valued. This is important whether the children will continue to own the home or plan to sell it and split the proceeds. It is essential if one child is to be the primary owner. You probably want to ensure a relatively even split of the estate between your offspring. If there's some question of how the property was valued or whether it was sold for a fair price, there could be disputes among the heirs.
- Put the property in a trust with an independent trustee. You can do this either now or in your will. You might be able to structure this with tax advantages, such as a qualified personal residence trust, which we discuss later in this book. But a trust can be valuable in itself to resolve disputes. In the trust agreement you set the rules governing the use, sharing, and sale of the property. Under the trust your children are the beneficial owners of the property, but the trustee controls things. The trustee also can decide to sell the property if that seems the best move.
- Prepare for buyouts. When the estate plan is set up so that the heirs share the property, the financial status or interests of your children might change. Some might not be able to afford the upkeep or might want to use their share of the value for other things. Provide that those who want to keep the property have first right of refusal to buy the shares of the other siblings. It is possible that those who want to keep the property cannot afford to buy out their siblings. That would create some disagreement among them. But at least you should give them the legal right to keep the property if they can afford it and set a way to value it.
- Some people buy life insurance so that those who don't want to own a share of the property (and its expenses) can be bought out by the estate and receive the fair value of their shares of the property.

There are two additional strategies that generate tax benefits while avoiding some of the disputes that arise from inherited homesteads. One option is the sale or gift of the property to your children followed by a leaseback. Another common strategy is the personal residence trust. Both of these strategies are discussed in detail later in this report.

These strategies can be very effective ways to reduce your estate and gift taxes while settling how a family home is handled in the future. Be sure to consult an experienced estate planning attorney if any interest you.

When You Need Solomon's Wisdom

Small items often cause big estate planning problems. Anyone with some experience handling estates knows that often the worst disputes among heirs are over what seem like trivial items. In a large estate, heirs might aggressively contest the disposition of a few pieces of furniture or personal mementos. Those small, personal items are most likely to stir the emotions and resentments among surviving family members.

Items that can cause emotions to run high include jewelry, dinnerware, furniture, personal collections, and frequently used items, even if they are essentially worthless and well worn. Sometimes, the relatives really don't want an item, but none wants any of the others to have it.

Part of a good estate plan establishes a system for handling the personal property in the estate. You don't want to itemize these assets in your will. The will would be too long, and it would have to be revised every time you acquire or dispose of an item. Also, it is difficult to describe some items so that the executor can identify them. Itemization also runs up the probate and administration costs. Especially valuable or unique items should be specifically designated in your will. The bulk of personal property in the estate (included in the "residuary estate") should be disposed using one of these strategies.

- The most common approach is to let the kids or the executor (usually one of the kids) decide how to divide the residuary estate. The will might direct the executor to divide the residuary in equal shares among the children. Or it might direct the children to agree on a division. Ideally, everyone will agree to be a mature adult, and this approach will work. Too often, emotions take over and things get messy. There are instances of the attorney taking possession of one or more items for years until the children could agree.
- You can decide not to bother with these issues. Direct that everything that can be sold will be sold and the cash distributed to the heirs. The executor decides on the sale process. Unsold items are given to charity. A good solution is to have an independent, qualified appraiser determine the value of items, and then have an auction. No item can sell for less than its appraised value, and family members can bid. That means heirs can buy the items that are important to them, perhaps using other wealth they inherited through the estate. This provides heirs an opportunity to buy items that have personal significance to them. Some estates initially limit the sale to family members, to ensure they have first crack at items that are important to them.
- You can label things while you are alive. Put the name of the person who should inherit items on the backs of artwork and on the bottoms of sculptures, for example. These designations are not legally binding. But usually, the executor and heirs respect the designation. Unfortunately, there probably are many items that cannot be labeled in this way, and someone always can claim that a label was switched or is not in your handwriting.
- Some advisors recommend including a separate letter in your estate plan. This document would list who should get key personal items or some other method for disposing of them. In some states this is a legally binding document if referenced in the will. In others it is not.

There can be problems with this approach. The list has to be revised each time you dispose of or acquire an asset, or even if you lose one. The list also gives the IRS a roadmap to valuing your estate and encourages it to put high values on the items named.

- You can give the heirs an incentive to agree. The will might say that if the heirs don't agree within a certain time (say, three months), everything that is not settled will be given to the Salvation Army or another charity.

When these strategies don't seem viable, it is time to consider one of several lottery systems.

- In the most common lottery, straws or names are drawn to determine the selection order. In the first round, the children each choose an item in that order. In the next round, the selection order is reversed. Then they

return to the initial order, and so on. If there are only two heirs, they can flip a coin. The winner of the flip has a choice of either going first and picking one item or going second and picking two items.

A difficulty with this approach is ensuring that the items are of relatively equal value. You might conclude that relative monetary value is not an issue. The heirs should pick the items that are most valuable to them. The real value might be in the personal meaning or usefulness of the item. Others believe the executor should assign a value to each item and keep track of the selections. If heirs end up with unequal values, the difference is made up with cash. Another approach is to allow heirs to choose only from items of relatively equal value in each round. That approach, however, is time-consuming and might not be practical with all estates. Somebody has to put a value on the items, and the executor probably will have to hire a personal property appraiser.

- Another lottery strategy is to let the heirs decide how to value items. There are a couple of ways to implement this strategy.

Each heir can assign a number of points to each item. By giving the items points, they are deciding how important each item is to them. After everything is valued, in the first round each person gets one item on which he or she placed more points than anyone else did.

The points assigned to the items awarded are not likely to be equal. The person who "spent" the most points on the item that he won doesn't select again right away. Instead, the others pick one or more items to which they assigned points until the total points of their items equal the total points the first person spent. For example, the first heir might "win" property to which he assigned 100 points, the second heir might have assigned 70 points to his item. The second heir gets to pick one or more items to which he assigned a total of 30 points.

A variation is to give each heir the same number of points. They use the points to bid for items in the estate. If an item is particularly important to an heir, he might bid all or most of his points to ensure getting it. Under this approach, the heirs might end up with items of unequal economic value. But the heirs have determined the personal value of each item. More details on these two approaches are in the book, *The Universe and The Teacup* by K.C. Cole (Harcourt Brace & Co.; $13.00 paperback).

There are a couple of issues to keep in mind whichever strategy you select. Estate planners say that in-laws should not be invited to participate in or view the selection process. They can make a messy process messier. Others disagree with this, saying that all family members should be invited. The decision largely depends on your family.

The other issue is taxes, if the estate will be taxable. The estate will pay taxes based on the appraised value of each item, and the taxes will reduce the wealth available to the heirs. You can decide that each heir's inheritance is reduced by the amount of taxes due on his or her share of the estate. Or you can decide that the taxes will be paid with the liquid assets of the estate. The heirs who are scheduled to receive those assets will receive what is left after taxes. Discuss the different options for a tax apportionment clause with your estate planner.

There is no right way to divide the personal property of an estate. You need to consider each of the options and decide which might work for your family. Otherwise, settling your estate might divide your family more than it does your property. I'll repeat this: If you think none of the strategies would avoid disputes or disappointment within your family, have the executor sell everything that can be sold and give the rest to charity. The heirs will receive only cash.

How To Secure Your Digital Legacy

Almost all of us have digital assets that should be included in our estate plans. Technology and digital assets have become major parts of most of our lives, often more than we realize. A digital asset is any account, electronic device, or portion of a website that is password protected. That covers a lot of ground. It can include your smartphone, especially its photos and text messages. Other commonly held digital assets are email accounts, financial accounts, payment accounts (such as PayPal), digital currencies and any online places (the cloud) where you store photos. You also might have digital liabilities, such as automatic payments.

Of course, various social media accounts are digital assets, such as Facebook and Instagram. A website or blog, whether as a business or hobby, is a digital asset. Your computer, if it is password-protected, also is a digital asset.

These items need to be included in your estate plan to ensure someone can access and manage them after you are unable to do so. That is particularly important for online financial accounts and automatic bill payments, but it is also true for the other assets.

The law lagged behind the real world until very recently. Many attorneys argue that federal anti-hacking law makes it illegal for anyone, even your executor, to access these accounts after your death. In some cases, heirs or executors had to sue to gain access to email and other important accounts.

Fortunately, most states now have adopted versions of the Fiduciary Access to Digital Assets Act. This is a model law developed by the Uniform Law Commission for the states to use to develop their own laws.

By 2021, 47 states had enacted versions of the law.

The law intends to give fiduciaries the same rights to access and manage digital assets that they have for tangible properties.

The details of the law differ a bit from state to state. In general, the law gives executors, trustees and agents the automatic right to manage a person's computer files, web domains and virtual currencies. But for an executor, agent, or trustee to have access to electronic communications, such as email, text messages and social media accounts, the original owner must have consented specifically in a will, trust or power of attorney.

Some online service providers also established their own ways for an owner to consent to access. Some providers have written policies regarding ownership succession, to which users consent when they agree to the terms of service agreement. Others have a process by which the owner appoints one or more people to have access to the accounts upon their death or incapacity.

While the law finally has caught up with the real world, it has little effect unless you take action. You need to compile an inventory of all your digital accounts and assets. The inventory should include the name of the asset or service, the website address, app, or other means used to access it, and the password and username or other access information. If you completed security questions or provided other information that could also be used to identify an authorized user, be sure to include the questions and answers in the inventory.

Don't forget to include digital liabilities in the inventory. These are automatic payment plans, automatic renewal programs and other arrangements under which your bank account or credit card is automatically charged on a regular basis.

The inventory is vital. Without it, the fiduciary has to search through your records to discover what your digital inventory is and how to access everything. If that information isn't apparent from your records, a digital asset or liability might not be located.

Next, you need to authorize access to the accounts. The access authorization should be included in your power of attorney, so that your agent or agents can manage the accounts in case you become disabled. Of course, you can designate different people to access different types of accounts.

Authorizations also should be clear in your will and any trusts you have. You should be broad in defining the types of assets to which access is authorized, because the definition of digital assets is fluid.

You also should check the rights you have in certain digital assets. For example, if you downloaded digital books, music, movies and other products from an online seller, you generally don't own the books and don't have the right to designate heirs to inherit them. You only purchased a license to use them during your lifetime and sometimes for a shorter period. Check the user agreements for details.

Remember, you don't have to authorize the same person access to all your different digital assets. You might want your trustee or executor to manage financial accounts along with your tangible estate. But you might want a different person or persons managing emails, photos, social media and other more personal assets.

In states that haven't enacted FADA or a similar law, many issues still are up in the air. You still should take the steps outlined above. But some commentators say a person violates federal anti-hacking law by accessing a deceased person's digital assets, even when permission is provided in a will or other document. Also, digital service providers can ignore a document and rely on their own policies or attorneys' advice.

Understanding and Using Trusts

You probably need at least one trust in your estate plan. It seems almost all estate plans do these days. Many problems can be solved, and goals achieved with the right trust. Trusts no longer are restricted to the very wealthy.

Too many people are intimidated by talk of trusts. You don't learn much about trusts in daily life, and estate planners often don't do a good job explaining trusts and making people feel comfortable with them.

In this visit we have a quick course in trusts. You won't know everything about trusts after this, but you'll know the basics. You should be comfortable and have a working knowledge of trusts that will enable you to work better with an estate planner to develop an effective estate plan in which you have confidence.

Stripped to their basics, trusts are fairly simple. A trust is simply a contract between three parties.

One party is the grantor, or creator, who, of course, is the person who originated the trust, sets its terms, and usually puts all the assets in the trust. Putting assets in the trust is known as funding the trust.

Another party is the trustee, who agrees to manage and make distributions of the assets according to the terms of the trust agreement and the law. Technically the trustee is the legal owner of the trust property, but he is a fiduciary. He owns the property as trustee for the benefit of others and can't treat it as his own property.

The third party is the beneficiary. A beneficiary has the right to receive income or principal or both from the trust but only according to the terms of the trust agreement. Trust assets are managed for the benefit of the beneficiaries. Sometimes beneficiaries have other rights, such as the ability to change trustees or name who receives their interests after they pass away. The grantor usually names beneficiaries when the trust is created.

A beneficiary can be primary or contingent. A contingent beneficiary is one who doesn't have any rights to income or property until after a primary beneficiary. For example, a trust might name the grantor's adult child as primary beneficiary and a grandchild as contingent beneficiary who has rights to distributions only after the primary beneficiary passes away.

The beneficiary can have a life, term, or remainder interest. A life interest is, as the name implies, for the life of the beneficiary. A term interest is for a fixed period of years. A remainder interest is of trust property that remains after all the life or term interests have expired. The life and term interests can be of income, principal, or both. That means a person with a remainder interest isn't guaranteed to receive anything if distributions to the income or term beneficiaries drain the trust.

The beneficiary also might be entitled to income, principal, or both. An income interest means the beneficiary can receive distributions only from income earned by the trust. Income usually is defined as interest, dividends, rent, and royalties. Anything else is principal and can't be distributed to an income beneficiary.

Either the beneficiaries or grantor normally can sue the trustee for violating the trust agreement or mismanaging the assets.

Each of the roles can be filled by more than one person at the same time. For example, a husband and wife might be joint grantors. There can be co-trustees, and it is very common for a trust to have more than one beneficiary.

In addition, the same person can be in more than one of these roles at the same time. For example, the grantor of the trust also might serve as primary beneficiary.

Trusts are very flexible. There are few limits to the terms that can be put in the trust agreement. Lawyers have shorthand names for trusts designed to achieve specific goals, and the tax law also gives names to trusts with certain provisions. All those names can make trusts seem confusing, but they all fall into a few categories.

In general, it is easiest to divide trusts in four functional categories with two types of trusts in each category. Many trusts have features from more than one category. Once you learn these categories, you'll be able to talk trusts with an estate planner.

Living vs. testamentary. A living trust simply is a trust created during the grantor's lifetime. A testamentary trust is created in the will. A living trust often is given the Latin name *inter vivos* trust, and a testamentary trust is called *postmortem*.

Keep in mind a trust can be created but not funded. For example, a grantor and trustee can sign the trust agreement. That creates the trust. But the trust has no effect and there is no business for it to do until money or property is transferred to it, until it is funded. It is not unusual for grantors to create trusts then fail to transfer title of assets to them. Also, a trust can be created during life but funded only by the grantor's will.

When most people hear the phrase "living trust" they usually are thinking of a revocable living trust, which is discussed in the next category.

Revocable vs. irrevocable. A living trust can be revocable or irrevocable. In a revocable trust, the grantor reserves the right to revoke the trust or change some or all of its terms. An irrevocable trust is what the name says. The grantor can't revoke it and retrieve any property that was transferred to it. A revocable trust might not be fully revocable. A grantor might reserve only the right to change certain terms, such as the beneficiary.

A frequently used trust is the revocable living trust. It primarily is used to avoid probate in states with high probate costs or long probate procedures, especially California and Florida. It also is an aid in disability planning, because a substitute trustee takes over management of the assets when the initial trustee is disabled.

Under the revocable living trust the grantor transfers title to almost all his or her property to the trust, including homes, cars, financial accounts, and household furnishings. The grantor and grantor's spouse are both the initial trustees and beneficiaries. They generally treat the property as they did before the trust, except everything is owned by the trust instead of them as individuals, and they manage it as trustees instead of individuals. The trust agreement spells out who succeeds them as trustees and beneficiaries.

After the grantors pass away, property is managed and distributed to the next generation under the terms of the trust agreement. A will has no effect on property owned by the trust, and property owned by a trust avoids probate. There is no public recording of the trust, and the trustees do not have to ask a court to transfer title to heirs.

Significant tax differences exist between revocable and irrevocable trusts. When a grantor creates a revocable trust, the grantor usually is treated as the owner of the property for income and estate tax purposes. The trust assets are included in the grantor's estate. Income and gains of the trust generally are taxed to the grantor as though the assets were owned in his or her own name.

Irrevocable trusts can reduce income or estate taxes. When properly structured, trust property is not included in the grantor's estate, and income and capital gains are taxed to either the trust or the beneficiary. To reduce taxes, irrevocable trusts really must be irrevocable; the grantor can't have the right to retrieve the property or receive distributions.

Income vs. total return. This category refers to how distributions to the primary beneficiary are determined. Remember there can be income beneficiaries and remainder beneficiaries, though one person can be both. Traditionally, income beneficiaries receive only income earned by the trust's assets. A standard arrangement is for all income to be paid to the grantor's spouse for life with possible payments of principal as needed or for specific purposes. After the spouse's demise, the children receive the trust remainder.

An income interest can be insufficient when interest rates are relatively low and the cost-of-living increases. The trustee could try to increase income by investing in riskier, higher-yielding income vehicles, but that puts the principal at risk. Also, the remainder beneficiaries want some of the trust invested for growth. Otherwise, the purchasing power of their remainder interest declines because of inflation. But the needs of the income beneficiary discourage growth investing.

A total return trust solves these problems. The "income beneficiary" is paid a percentage of the trust assets, a fixed amount, or an amount determined by a formula. The trustee does not worry about restricting payouts only to income or what the definition of income is. Instead, the trustee invests for long-term growth with a diversified portfolio and makes annual distributions from income, capital gains, or principal. The total return trust is better today than a traditional trust that pays only income to the primary beneficiary.

Of course, the distributions to the income beneficiary can decline under the total return trust if the trust's investments decline or the returns are less than the distributions.

Discretionary vs. nondiscretionary. This category refers to the trustee's ability to vary distributions or payouts. In a nondiscretionary trust, the trustee is told in the trust agreement how much to distribute to beneficiaries or how to calculate the distributions and when to make distributions. For example, the trustee might be told to distribute all income to the primary beneficiary annually and distribute one third of the principal to the beneficiary upon turning age 21 and the remainder at age 35.

A discretionary trust allows the trustee to exercise judgment at least some of the time. The trustee might have discretion to distribute to the surviving spouse all income earned by the trust plus principal or capital gains as needed to maintain the spouse's standard of living in the trustee's judgment. Or the trustee might be able to withhold distributions

when the trustee believes it is in a beneficiary's best interest, such as when the beneficiary has a substance abuse or gambling problem. Some trusts are completely discretionary, allowing the trustee to distribute income and principal whenever and in whatever amounts are deemed in the best interests of the beneficiary. The grantor might have provided some guidelines for the trustee to consult. The trustee might have discretion to increase distributions when the beneficiary has an unexpected need, such as medical expenses.

These are the broad categories of trusts. Within these categories are many specific or specialized trusts. There are charitable trusts (several types of them), dynasty trusts, grantor retained annuity trusts, grantor retained income trusts, and many more. We've discussed these in the past and will discuss them in the future. Taxes and the tax law usually drive specialized trusts but so do particular goals or interests. But each of the specialized trusts can be fit within the broad categories. Now, you know the basics of trusts. You can intelligently review and discuss estate plan options, know the key questions to ask about a trust and the consequences of the answers. You are ready to put together a more effective estate plan and to avoid having a trust you don't need or that does not meet your goals.

Best Gift to Leave Your Heirs

One essential element of an estate plan that too many people overlook is known as the instruction letter. This is a letter, often accompanied by copies of key documents, that tells your survivors everything they need to know to administer your estate quickly and efficiently. Without the instruction letter, your survivors could spend weeks or months pulling together the records needed to settle your estate. It is not unusual for a surviving spouse to be unable to pay bills because of a lack of basic information, such as where the accounts are, what their numbers are, etc. Heirs also might argue over what you really wanted to be done with certain assets. You can avoid this situation by leaving an instruction letter.

The simplest instruction letter gives your spouse specific information about whom to contact upon your death, the location of your will and other important documents, and might describe any funeral preferences.

Other forms of the letter provide more details, sometimes significantly more. The letter might provide background on special assets or your plans for some of the assets. If you have debts, those also should be discussed in detail. The composition of the estate usually dictates the length and details of the letter.

Ideally the letter is accompanied by a number of other documents. The letter and documents should all be included in a notebook.

Included in the package should be a list of your legal and financial advisors. These include your attorney, executor, life insurance agent, bank, and other financial institutions. Any other individuals who deal with aspects of your financial situation should be included.

An inventory of your assets should be attached. An inventory has to be done as part of the probate process and also must be done to complete a federal estate tax return. The process is much easier for the executor and less expensive if you do the inventory and revise it as necessary. You should list what you own and where it or your account statements are located.

Other helpful documents include recent income tax returns, personal financial statements, a list of debts, and an obituary and a list of where you would like it published. The executor would be aided by draft calculations of estate taxes and cash flow.

Another useful set of items would be details about your financial accounts: Social Security, life insurance, pensions, bank accounts, brokerage accounts, mutual funds, and any other assets you own. You could either include the information in the notebook or tell where a file containing the information for each account is located.

If you own special assets, detailed information about those should be provided. This is especially important if you own a small business, collection, or investment real estate. Often heirs and executors know very little about these items, or at least substantially less than you. Failure to leave some detailed instructions and information about the items could mean that your heirs will not get maximum value out of them. Ideally you should leave instructions about when and how to sell them or how to manage them.

This compilation would make a great difference to your survivors. It will save time and money, avoid a lot of trouble, and probably increase the value your heirs get from the estate. The best of estate plans can be negated or diminished if this information is not readily available.

The notebook should be updated at least annually. In addition, you should discuss the contents with your spouse or executor to ensure that everything is clear.

Preserving The Family Business

When owners think about preserving the family business for the next generation, they think about estate taxes. You can do a lot to continue the family firm through tax strategies such as annual gifts, family limited partnerships, dynasty trusts, and the like. But tax planning is at most only half the job.

Half of all family business founders expect that two or more offspring will jointly manage the family enterprise. But reality is much different. About 70% of family businesses are sold before reaching the second generation. Only 15% last to the third generation. And 97% of inheritors blame neglect of the founders for the problems encountered in trying to continue the business. Business reasons usually are at the bottom of the list of why family enterprises don't survive through the generations. Too often the founders have not carefully planned a succession. Lines of authority aren't clear. Lifelong rivalries and disputes among siblings carry over into the business. There isn't a clear line between business affairs and family affairs. Some view the business as a welfare program for the family, making it difficult to manage it properly.

The list goes on. Whatever the cause, the problems with family business succession can be solved. Here's a checklist to making the family business survive and succeed.

- You need a comprehensive plan, and you need to start working on it early. The point of the plan is to anticipate the difficulties within your family and business and set up mechanisms ahead of time to deal with the potential problems. Most business successions fail because these issues are avoided until it is too late. Structuring the business for tax savings should be the last concern of this plan. The plan must provide for compensation, division of authority, transfers of ownership, and other key issues.
- Outside advisors are needed. A good family succession counselor will talk with each affected family member separately then lead group meetings at which potential problems are discussed and solutions proposed and hashed out. This expert might be an attorney, CPA, or a specialist in succession planning, and you might need more than one advisor.

There are many issues that aren't always discussed among family members, especially while the parents are alive, that the outside advisors can address. For example, children who don't work in the business often are resentful of the decisions, priorities, and compensation of those who do. Some of those who don’t work in the business might believe they deserve equal treatment with others who work at the firm, while those who work in the business believe the other children have a free ride. Children might feel entitled to walk through the business and issue orders or make decisions simply because they are family members. Often a family business mixes both business and non-business goals, such as providing income to members regardless of their workload or quality. There also might be troubled family members, and the family has to decide what role they can play in the firm. The advisor should uncover these issues and help create solutions.

- Decision structures must be created, and authority established. For example, you might set up a board of non-family members to set compensation and hiring policies for family members. A board of directors that excludes family members who do not work in the business might be created as final authority on business decisions, including distributions of net income. A family advisory council (which could include all adult family members) might be created to keep the family informed about the business and to get feedback from family members who are not in the business. Whatever structure is settled upon, you do need to establish a governing structure that will deal with potential conflicts and problems.
- Communication is a key. While you are alive and establishing the succession plan, your vision of the company, including its history and philosophy, should be communicated to all family members. You might want to do this in a way that can be referred back to or passed to new family members, such as a video or writing.

Regular communication about the business also should occur. All family members who own an interest need to know what is happening in the business and why decisions are being made. You don't want members who don't work in the business to start rumors or misinformation that eventually build resentments and confusion. Monthly or quarterly meetings with two-way communication are important. Non-family members who are important to the business might make presentations at these meetings.

For example, the outside CPA or chief financial officer might present the financial situation.

- A successor as leader of the business should be appointed. In some cases, rule-by-committee works. But most often, a business needs one individual who has unquestioned authority to make final decisions. Long-term decisions can be deferred to a committee. But day-to-day operating decisions need a clear final authority. You should decide who this will be and communicate that to everyone.
- Some advisors believe strongly that family members who don't work in the business should not be owners or that siblings should be asked to run a business together. In either situation, they believe a better solution might be to split the business. The enterprise might be divisible into two or more separate entities. Each sibling could run his or her own business. Or, when there are family members who won't work in the business, you might spin off the real estate the business occupies and give it to the members who don't work in the business. They collect rent on the real estate and don't interfere in the underlying business. There are many possibilities and options, often limited only by the creativity of you and your advisors. Don't believe you are constrained by the present structure of the business and have to force siblings to work together.
- Each child who is given an ownership interest in a business or other common assets should have an opportunity to get out. A buy-sell agreement with clear, objective terms needs to be established. Then, if a family member wants to cash out, an independent source or formula will decide the price and terms well ahead of time. The trick here is ensuring that the business or the other owners can come up with the cash to buy out one or more other owners.

There is no single formula for a successful succession plan. The details depend on the interaction of the members. In some cases, non-working and working family members harmoniously share ownership. In other cases, joint ownership leads to increasing acrimony. The only way to find the best plan is to start early, bring in outside help, and work to avoid potential problems.

The Foundations Of A Great Estate Plan

As we've discussed, you need an estate plan even if you don't expect to owe taxes. When you expect to owe taxes, tax planning still should not be the focus of your planning. It is more important to decide who should receive the wealth, how much each should receive, when the wealth should be transferred, and how the wealth should be transferred.

Here is a look at some of the more important but often overlooked issues in estate planning and how to resolve them.

Who's in charge? Every estate needs at least one executor or administrator (the term used depends on your state). Every trust needs one or more trustees.

Most people appoint the oldest adult child to these positions, even if the spouse still is alive. Keep in mind that this puts that child in charge of everything. Depending on family dynamics, that move could trigger or aggravate family jealousy and rivalries. Appointing all the children as coexecutors on the other hand could slow down the process and invite disputes and disagreements over even the most minor items. If the executor does not live near you, the distance could make the estate settling process more difficult.

Appointing the family lawyer or other professional always is an option. Unfortunately, that might increase costs and drag out the process of settling the estate.

The right choice for executor depends on your family. For some, the best compromise is to name both a family member and a lawyer or other professional as co-executors. A good suggestion is to make your choice known to family members. Early notice gives them an opportunity to get used to the decision and gives you an idea of whether or not it will work.

The same considerations go into naming a trustee, but bear in mind that a trustee likely will be managing the property longer than the executor.

That's why when drafting a trust, you should include a clause that allows the family to change trustees. This is discussed in more detail elsewhere in this book.

How much should I give now? If you are confident that your lifetime needs are taken care of, consider giving some wealth to the loved ones now. The tax law certainly encourages this by allowing tax-free gifts. Also, the lifetime

estate and gift tax exemption is more valuable if used now rather than later. When charity is part of your wealth distribution plan, the tax law also encourages lifetime gifts with income tax deductions.

Some people make lifetime gifts to enjoy seeing how the gifts benefit others. Others use lifetime giving as a trial run to how the wealth is used and affects people. Sometimes the observations cause changes in the estate plan, such as putting money in a trust for an heir instead of giving it directly.

Lifetime gifts don't have to be straight transfers of money or property. You can pay tuition or medical expenses. You might provide the down payment for a house or the start-up capital for a business. A popular gift in recent years is to foot the bill for family vacations that the loved ones could not afford on their own.

Be conservative when setting up a lifetime giving strategy. More and more people live into their 80s and 90s. Unless you have health problems, include that possibility when deciding how much to give.

Should there be controls and incentives? In the 1990s people became more concerned that leaving simple gifts would make heirs lazy, spoiled, or worse. In addition, those who consider giving wealth always are concerned about mismanagement of the wealth and substance abuse and other problems by heirs.

One longstanding solution is to leave money in a trust that has controls. Heirs won’t receive the bulk of the money until reaching a certain age or other milestone. The trustee can have discretion over how much to distribute each year until then and could withheld all money in circumstances such as substance abuse. In the 1990s many people went a step further and used "incentive trusts." Heirs would receive money only after achieving something, such as attaining a certain academic degree, holding a job for a minimum time, reaching a certain income level, attending church, getting married, or whatever other goal the parents wanted to establish. More details about these different trusts are presented later in this book.

Some people believe incentive inheritances resolve the dilemma of how to leave wealth to heirs but in a healthy way. The heirs have to earn their inheritances and be productive citizens. Others are against the trusts, and some lawyers won't draft them. The trusts can be viewed as an attempt to control loved ones from beyond the grave. The incentives in the trusts can be too detailed and restrictive. Some require children to attend certain colleges, for example. The trusts also can have the effect of channeling heirs into occupations for which they are unsuited or less interested in than other fields.

If you leave an incentive trust, try to keep it flexible. The trust might be in effect decades from now. You might end up penalizing a loved one whose interests change or who discovers a talent later in life. The heirs also might generally resent the restrictions and goals. A better approach might be to give the trustee discretion on distributions and leave a letter of instructions outlining your goals and intentions.

Should heirs get equal shares? Parents have different reasons for considering leaving unequal shares of their estates to children.

Some parents are tempted to leave a child less money because they believe he or she will waste it. A better approach in that case might be to leave that wealth in a trust with restrictions or with discretion by the trustee. There should be a contingent beneficiary in case the money is not distributed to the initial heir.

When children have unequal financial success in life, parents are tempted to factor this into their inheritances. Unfortunately, a financially successful child is likely to consider the inheritance to be a measure of your affection or will believe he or she is being punished for success if less affluent children receive greater inheritances.

Equal inheritances can be a major problem when a family business or other asset is involved, which we discussed earlier. Many advisors believe children who aren't involved in the business probably shouldn't have voting ownership in it, at least not equal to that of the child actually running the business. Regardless of how you structure things, there almost always is going to be tension between siblings who jointly inherit a business or similar property. A good solution might be to leave the business only to children who will be active in it and use life insurance to equalize the inheritances. There are other options that were discussed earlier, and you and your advisors might develop others that are unique for your situation.

Don't forget to count lifetime gifts and assistance when dividing up the estate. One child might have received substantial assistance over the years that the other children didn’t. If you really want things to be equal, these lifetime gifts should be subtracted from their inheritances.

An alternative to equal inheritances is a reserve trust. Have about 80% of the estate distributed equally among the heirs. The other 20% is placed in a trust where it can be tapped for emergencies by any of the heirs at the trustee's

discretion. This can create its own set of problems, or it can provide valuable assistance to the least financially successful heirs or those who encounter unexpected problems.

Should someone be excluded from the will? Many families have at least one child who is estranged or has troubles. The temptation can be to write the child out of the will, especially if the child is well into adulthood and shows no signs of changing.

Completely excluding a likely heir from a will is legal but rarely is a good idea. The child could challenge the will or demand money from the others in return for not challenging the will. Instead, leave the child an amount that is meaningful to him or her. Then state that the inheritance is forfeited if the will is unsuccessfully contested. The key is to find an amount that the child won't want to risk losing.

Think long term. It is fairly common these days for families to have second spouses, stepchildren, and other complications. Additional complications might arise after your death, for example if your spouse remarries. Without careful planning for these situations, the final destination of your wealth is in doubt.

Ideally, you leave wealth to the beneficiary of choice, usually your spouse. You also agree how the wealth will be bequeathed in his or her will. Unfortunately, things could change after your death. The wealth could end up in the hands of a second spouse or beneficiaries other than your children. There are a number of ways to deal with these situations, and these are discussed in this book. The key is to decide what you want to do, implement a plan that will achieve the goals, then communicate it to everyone involved.

Leave only money? You might have valuable or sentimental assets other than money and investments. These could include papers, photos, collections or art you created. These items might even have value outside the family, such as to a library or museum. Unfortunately, it could be that no one knows these items as well as you do. Do what you can to get the items catalogued, organized, and described now. Ask around, both inside and outside the family, to see if anyone has an interest in them after you. Then decide who will be the caretaker. Don't leave the items disorganized with the thought that somebody might become interested someday.

Personal and household items also can cause big controversies in estate. These are covered in other sections of this book.

All in the family? You might consider leaving part of the estate to a charity or other outside organization because you generally are interested in the cause and perhaps don't want to spoil your heirs too much.

There is no reason wealth should cause individuals not to be productive members of society. You simply have to get them involved early doing productive things and keep them at it. Involve the children in managing assets, running the business, or doing other productive activities. Often, a family limited partnership is a good way to do that. If you want to give a lot to charity, consider a family foundation and have the kids help manage that.

When a cause is important to you, the important step again is communication. Explain to the children your interest and that the charity will get part of the estate. Don't let the kids think they are going to inherit something, only to have them learn after you're gone that it never was going to happen.

Give something of yourself. There is an old tradition known as the ethical will. This is a non-legal document in which the deceased makes a personal statement. The statement can be an individual or family history, lessons learned, principles, or guidelines for living. Some even leave humorous statements to establish the kind of memory they want people to retain. The ethical will is making something of a comeback and can be enhanced now with videotape and other technology. Consider developing your own ethical will as a special gift for loved ones.

Tips for Surviving Spouses

Life can be difficult and complicated for surviving spouses. Contending with some financial rules and procedures in addition to everything else can amount to piling on. Yet, widows and widowers need to make key decisions about their finances, and some decisions need to be made within deadlines. Social Security, IRAs, employer retirement plans, and investments are the major areas with deadlines or some urgency.

<u>The best advice for a surviving spouse is not to make financial decisions in a hurry</u>. There’s enough time to seek advice and collect information, review the options, and make the best decision. As with other financial issues, you shouldn’t rely on a rule of thumb or copy what someone else did. Your situation could be different, or things might have changed, making a different action the better one.

The other option is to follow the rules for IRAs inherited by nonspouses. This would require the IRA to be fully distributed within 10 years after it was inherited. Also, if the previous owner had begun taking required minimum distributions from the IRA, the spouse inheriting it using this option would have to continue the annual required minimum distribution for years one through nine.

But the survivor's benefit has the same timing rule as retirement benefits. When you take the benefit before normal retirement age the amount you receive is reduced. So, a surviving spouse who wasn't already receiving Social Security retirement benefits or wasn't planning to begin them soon shouldn't automatically claim survivor's benefits even if he or she is age 60 or older. You want to think long term. Delaying benefits can increase them substantially, so you might not want to begin benefits just because you're eligible. When you don't need the income right away, you could be better off long term by waiting and letting the benefits increase.

For more details about the Social Security benefits for survivors, check out the Social Security web site. You can obtain their booklet, *What Every Woman Should Know*. You also should go to www.socialsecurity.gov and search for "surviving spouse").

Individual Retirement Accounts. Surviving spouses have three choices when they're the sole beneficiaries of a spouse's IRA. You can withdraw all the money and pay income taxes on it. You also can choose from two rollover or transfer options.

Surviving spouses have a special option to rollover the inherited IRA to an IRA in the survivor's name. This will be treated as a new IRA and sometimes is called a "fresh start IRA." The surviving spouse won't have to begin required minimum distributions until he or she is over age 70½ and then will take them based on his or her own life expectancy. A new group of beneficiaries also can be selected.

The other option is to turn the IRA into an inherited IRA the way other beneficiaries have to. The beneficiary of an inherited IRA must begin required minimum distributions by Dec. 31 of the year after the year of the owner's passing. When the deceased owner already reached age 70½, the beneficiary can continue the distribution schedule the deceased was using or can schedule the distributions over his or her own life expectancy. When the owner wasn't already age 70½, the distributions can be taken over the beneficiary's life expectancy or the IRA can be emptied by the end of the fifth year following the year of the owner's passing.

In most cases the best move for surviving spouses is to roll over the inherited IRA to a new IRA. That creates more options and flexibility. But there's a catch when the survivor is under age 59½. If distributions are taken from a rolled over IRA before age 59½ the distributions are subject to both income taxes and the 10% early distribution penalty. But when the distributions are from an inherited IRA that wasn't rolled over to a new IRA, the distributions aren't subject to the 10% penalty. A younger survivor who plans to take distributions from the IRA is better off with the transfer to an inherited IRA instead of a rollover to a new IRA.

Another consideration is the beginning date for distributions from the IRA when there is flexibility. The usual advice is to leave money in an IRA as long as possible to take advantage of tax deferral. But that's not always the best advice. When the survivor is in a low tax bracket suddenly and expects that to continue for a few years before returning to a higher bracket, it could be a good idea to take distributions from the IRA in the near term instead of in the future when it might be taxed at higher rates.

Filing estate tax returns. As you know, the federal estate tax now provides portability of lifetime estate tax exemptions for spouses. Each person has a $10 million lifetime exemption, indexed for inflation. When one spouse passes away and the estate isn't valuable enough to exhaust the exemption, the unused amount can be transferred to the surviving spouse. That gives the surviving spouse an exemption of $10 million plus whatever wasn't amount used by the other spouse. The trick is that under IRS regulations the surviving spouse can't use that surplus exemption unless the estate of the first spouse filed an estate tax return and elected to transfer the surplus to the surviving spouse. The IRS says it assumes the election to transfer is made if a return is filed and it doesn't say it is not making the election.

This means for portability to be effective, the estate of the first spouse to pass away must file an estate tax return, even if it otherwise isn't required to under the law. A surviving spouse and the executor must be aware of this rule and file a return to preserve the unused exemption. It can cost some money in professional fees to file an estate tax return, so consider whether the unused exempt amount really might be needed. If the assets are likely to grow in value over time to exceed the current $10 million limit, it's probably a good idea to file a return.

Survivors and executors also need to keep state level taxes in mind. Many states impose estate or inheritance taxes at lower levels than the federal government. A return for the state might be required even one a federal return isn't. Also, there might be elections and options that could reduce the state tax.

Investment decisions. Often a surviving spouse doesn't really know what the other spouse's portfolio strategy was. Or the two spouses have very different risk tolerances or investment ideas. Ideally, the deceased spouse either explained the details to the other spouse or was using a professional advisor or money manager who can provide continuity in portfolio management. But those things often don't happen.

A surviving spouse shouldn't make big moves with an inheritance right away, but the survivor does need to take ownership of the portfolio and adapt it to the new circumstances over time. Too often, the surviving spouse believes little or nothing should be changed in the portfolio. Sometimes the deceased spouse told the other spouse not to change the strategy or portfolio. Or the deceased spouse had said certain investments never should be sold.

At other times the survivor either believes the portfolio shouldn't be changed or isn't sure of the changes to be made.

A survivor needs to be sure the portfolio over time is adjusted to reflect his or her income needs, risk tolerance, and other circumstances. Professional help should be sought when the survivor needs guidance, and the deceased spouse didn't leave advice regarding a professional money manager.

Grandparents Stepping In as Parents

A quiet trend in the U.S. is that a growing number of people serve as the primary parents for their grandchildren. The Census Bureau started tabulating this information in 2000, and since then the numbers have grown. The 2010 census showed that 3.1 million children are living without their biological parents, and 59% of them were living with their grandparents. Some people refer to this situation as a "skip generation" while others prefer the term "grandfamilies."

In 2016 the Census Bureau reported that the percentage of adults living with grandchildren increased to 3.8% in 2014 from 3.6% in 2000. But only 36.4% of those grandparents were primary caregivers in 2014, down from 42.0% in 2000. *(Grandparents and Grandchildren (census.gov))*

There are many reasons grandparents might be parenting their grandchildren. A divorce, job loss, or military deployment might leave both parents unable or unwilling to raise their children. Other parents are absent because of death, physical or mental illness, substance abuse, or incarceration. Whatever the reason, more grandparents are stepping into the role of parents because they don't want to see their children in foster care or other parts of the social services system.

There are many challenges for grandparents becoming primary parents. I give financial advice, so I'll focus on the financial aspects. But there's a growing network of web sites, support groups, and other resources for grandparents who want help or advice with the full range of issues. You can start with the federal government's web site, http://www.usa.gov/Topics/Grand- parents.shtml (ignore the hyphen), and AARP's GrandFamilies Guide on its web site at www.aarp.org.

The first thing a grandparent needs to do is consider his or her legal status. Assuming the parental role for the long-term isn't the same as taking care of a child for the weekend. Grandparents in most states don't automatically have many legal rights, including being able to approve medical care and enroll a child in school, though several states do confer such rights.

There are several different possible legal statuses for grandparents, and the consequences vary from state to state. AARP's web site has what it calls GrandFact Sheets that indicate each state's laws on whether a grandparent can authorize medical care or schooling without special status. You really should meet with a lawyer who knows these issues before making a decision. Here's a summary:

Power of attorney. The parents sign a document giving you the power to make decisions about the child. The power could be a general power, giving you authority over everything affecting the child. Or the power could be limited to specific areas. The POA is commonly used for fixed-term situations, such as when a parent is deployed by the military or traveling, but it can be used for long-term situations. The POA is simple and easy when both parents (when both are alive and have legal custody) amicably agree to the arrangement.

Advantages of the POA for the parents are that it doesn't remove the legal rights of the biological parents and can be revoked by the parents at any time.

Custody. Legal custody usually is awarded by a court, usually a family or juvenile court, though parents can voluntarily transfer legal custody in writing. If one or both parents object to transferring custody and the grandparents want it, the grandparents have to demonstrate to the court why having the parents retain custody is not in the best interests of the child. Custody does not legally sever the other family relationships, and it can be reversed.

Legal custody gives the grandparents the legal right to make decisions affecting the child while they have custody, though the court or a parent voluntarily conferring guardianship can put conditions or limits on it.

Guardianship. The meaning of this status and the authority it confers varies by the state. It can refer to someone caring for a child under a POA, or there can be different types of guardianship ordered by a court. Generally, the parents don't lose their all their legal rights when someone becomes a guardian, but that varies by state and by the type of guardianship.

Custodians and guardians generally assume legal responsibilities to support a child and keep him or her safe. A POA generally confers rights to make decisions without imposing legal responsibilities to care for the child.

Adoption. When grandparents adopt a child, this ends the legal status of the parents regarding the child. The adoptive parents assume all legal rights and responsibilities.

Whichever status you seek, a grandparent raising a grandchild needs to acquire as many legal documents about the child as you can: birth certificate, passport, medical records, and school records.

Before deciding which legal status to seek, consider how the different choices affect financial support you might seek. Adoption by the grandparents often reduces the financial resources available to the grandchild. Here are the main sources of support you might consider with some guidelines to how your legal status affects them.

Temporary Assistance for Needy Families. This used to be called welfare. The key point for grandparents is that when they have too much income or assets to qualify for family assistance, they still can apply for a child-only grant that will be based on the child's income.

Medicaid or CHIP. The same basic rules apply here. When a child isn't living with his or her parents and isn't covered under other medical insurance, a Medicaid application based only on the child's income can be submitted and will be reviewed considering only the child's personal resources.

Social Security. When one or both of a child's parents are deceased, the child might be eligible for survivor benefits. If the child is disabled, he or she might be eligible for disability benefits regardless of the parents' status. Check with Social Security for eligibility and how to apply.

Medical insurance. When you're working, your employer-sponsored medical plan might cover a grandchild living with you. Check with your employer for details. Your Medicare won't cover a grandchild living with you. If you have other medical insurance, check with the insurer to see if it covers the grandchild or can be changed to a policy that does.

Taxes: You should be able to claim tax benefits such as a dependent exemption and deductions for medical expenses. You also might be eligible for the earned income tax credit (if you're working), a tax credit for childcare, and credits or deductions for education expenses. Check the IRS web site for free publications with details on each deduction.

Many states have additional programs that might be available to you, the child, or both. For most of the assistance programs, you don't need to be a legal custodian or guardian,

but the rules vary from state to state. If you aren't working with an attorney or other advisor who knows the details, check with the local Social Services Agency for help.

There are many more issues that grandparents serving as primary parents need assistance with, including trying to have enough life insurance in case something happens to you. For more sources of information, go to your favorite Internet search engine and search for "grandparents raising grandchildren" or something similar. The two web sites listed above are excellent starting points.

How To Use Safe Deposit Boxes And Safes

Safe deposit boxes are among the most misunderstood and improperly used tools in estate planning. The ways many people use safe deposit boxes can cause more problems than they solve. A safe deposit box usually is not the

place you want to keep a will or other valuable documents, especially those that are necessary to settling your estate. Your executor needs a copy of the will to get the estate settlement process moving. That means if you keep the will in a safe deposit box, the executor needs to know that your will is in the safe deposit box, needs the key to the box, and has to go to the bank and get the will. In some states, a bank will seal the box once notified that the owner has died. The state might prohibit opening the box without a copy of the death certificate and perhaps some other paperwork. To protect themselves, some banks create their own rules about opening the box of a deceased owner. Sometimes the bank takes a complete inventory of the box, either for its own protection or for state tax officials.

At a minimum, before leaving your will and other documents in the box, ask the bank what its procedures are upon the death of a box owner and what your executor will have to do to get the box's contents.

It is much easier to have the original will in either your personal files or with your lawyer.

Keep copies for yourself, your executor, and anyone else you think should have a copy.

What about keeping other valuables in a safe deposit box? Again, this is over-rated as a safety measure. The items probably won't be stolen, but they could be damaged in a fire or other disaster. Before leaving items in a box, ask about the bank's insurance and what you'll need to prove to recover any losses.

September 11, 2001, demonstrated why important items probably should not be kept in safe deposit boxes. There were safe deposit boxes in the buildings destroyed in New York. The documents in the boxes, of course, were obliterated. Other items—such as jewelry, heirlooms, and artifacts—either were lost, destroyed, or damaged. Rescue workers reported finding many items in various conditions and trying to determine their owners.

Taxes are another consideration. It is not true, as many people believe, that tax authorities seize the contents of safe deposit boxes when someone passes away. In an audit, the IRS and state tax authorities will want to see an inventory of the contents. If there is cash in the box, the IRS will assume that it was not reported on an income tax return unless there is some proof to the contrary. The IRS also might assume the same for any other valuables for which there is no record of the purchase.

An alternative is a fireproof home or office safe. Most owners, however, don't realize that without proper care these safes can destroy your documents or other valuables.

Fireproof safes have a great deal of insulation. Because of that, they tend to retain the moisture in the air. If you don't open the safe regularly, the moisture will seep into the documents or other contents of the safe, making them damp and musty at best. Keep the safe locked for an extended time and the contents might sprout mold. Jewelry and other metallic objects could become tarnished.

A home fireproof safe is supposed to be opened at least once a week according to most manufacturers. An office fireproof safe is supposed to be opened several times a week. You also should consider placing safe contents in sealed plastic bags with as much air as possible squeezed out of the bags. Other airtight containers also can be used. An additional step is to place a desiccant packet in the safe to absorb moisture.

Safe deposit boxes are not as secure as many people believe and are not appropriate for all the valuables left in them. Give careful thought to the items you put in a box and the location of the box you use. Consider options such as a fireproof home or office safe or your lawyer's office.

Knowing When to Update Your Plan

Having an estate plan is important, but having one means only part of your job is done. A plan has to be complete and current. Not enough people have an estate plan, but of those that do a high percentage let their plans become outdated. Sometimes having a plan that isn't current is worse than not having a plan at all.

Your estate planner probably prefers that you touch base every year or two.

There's something to be said for that guideline, but it's too much for a lot of people. They don't want to spend that much time and money on estate planning. There's a middle ground between that approach and the set-it-and-forget-it model.

There are five questions you should ask every few months. The answers tell you when it's time to visit your estate planner.

Do I still have the right people in charge? One topic addressed in this book is that the wrong executors or trustees can foil even the best estate plan. The agents who can act for you under either a financial or medical power of attorney also are critical choices.

Review the choices in your plan. Especially if your plan has been in the file a few years, the choice might not be ideal today. Perhaps the reliable relative, friend, professional, or employee you selected has different circumstances. People grow older, move, take on too many other capacities, or have other changes in their lives. Your contacts with a person might not be as frequent as they once were, so the person isn't as familiar with matters. Or perhaps your estate has changed in ways that make your original choice unsuitable. Maybe your estate is larger or more complicated than it was.

The executor, trustee, and agents are the keys to ensuring your plan is implemented as you intended. Keep in touch with them and regularly reconsider your selection of them. When you think a change might be in order, talk with your estate planner.

What's changed in your life? Major changes in your life are the most frequent reason that a visit to the estate planner is in order. Marriage and divorce are the big changes, and your state law might automatically invalidate all or part of your will if your marital status changed. But your marital status is not the only important one. A change in marital status of any beneficiary in your will should cause you to consider the consequences.

There are a host of other changes that are critical. Your plan might need to be revised if you have new children or if children grew into adulthood. The introduction of a grandchild or changes in a grandchild's life also might alter your will. Changes in your health or the health or a loved one also might require changes.

Perhaps your net worth is different than anticipated in your current plan, in either a positive or negative way. Or the structure or your assets or liabilities has changed. Maybe you started or sold a business or investment real estate. Or you own different types of investments. You could have new or different charitable interests. Over a few years, small, gradual changes that we take in stride could compound to make your situation very different from the one contemplated in your plan.

Some of these changes require only a small change, such as a codicil (amendment) to the will that includes a new grandchild. Others require you to reconsider all or significant provisions of your plan.

Where are you spending time? Each state has its own laws governing estates, trusts, property ownership, and powers of attorney. In general, the state in which you are considered to be a resident or domicile is the state where your will is probated and that governs your powers of attorney. The medical power of attorney and related documents has to be valid in the state you're physically in when medical care is needed. Of course, states have different tax laws, and a plan that made tax-sense in one state might not be wise in another.

Your estate planner needs to know if you moved or are spending more time out of state than you used to (perhaps spending winter or summer in a more hospitable climate).

Discuss your travels and residence with an estate planner. The planner will determine which state is considered your current legal residence and domicile. The planner also might recommend relatively small changes that can establish your residence in the more desirable state for your estate. You also need to avoid the very undesirable position of being considered a legal resident of two states.

Where is your property? Real estate is subject to probate and related laws in the state in which it is located, regardless of where the owner lives. Other property also might fall under the laws of another state instead of your home state.

If you bought property in another state, your estate will have to go through probate in at least two states. There are ways to avoid this expensive situation. Your planner might recommend putting the out-of-state property in a trust or limited liability company or some other strategy. Purchasing property or a business that's located in another state should trigger a visit to your planner.

How old is your plan? I've already listed life changes that should trigger a review of your estate plan. But there are other events, some of which you might not even aware of, that make your plan obsolete.

There's the federal tax law, of course. Your state law also can change. Many states have been revising their probate and trust laws in recent years. Changes in Medicare and other seemingly unrelated laws and programs could affect your estate plan.

In addition, estate planners always are refining their strategies and finding better ways to do things. An example is in the standard trust. It used to be commonplace for a surviving spouse or other primary beneficiary to receive only the income earned by the trust. Principal and capital gains were reserved for the next generation or two. But with today's low interest rates (we are currently experiencing high interest rates – either remove or reword), income doesn't amount to much. Most trusts drafted now pay the first-generation income beneficiary a fixed percentage of the trust or a dollar amount annually without regard to whether it is paid from income, capital gains, or principal.

Most laypeople aren't aware of all the changes that make revising your plan a good idea. A general rule is that if your plan is more than five years old, you probably need to touch base with your planner. When your plan is more than 10 years old, you definitely need it reviewed. If it is less than five years old, review the factors mentioned here and visit the estate planner if there is any doubt your estate plan is up to date.

The problems caused by an out-of-date estate plan all will be resolved if you don't revise the plan. But the courts will resolve them. This will cost your estate money and delay the resolution. And the resolution might not be anything like what you would have preferred.

Why Most Estate Plans Fail

A large percentage of estate plans fail to achieve one or more of their goals, and many of them fail for a surprising reason. In this book we discuss ways trustees, heirs, changed circumstances, and new laws upend estate plans. Another cause is the most surprising and perhaps most frequent reason estate plans fail: The estate owners do not implement their plans.

The failure to implement an estate plan is surprising. Having an estate plan created can be expensive and time consuming. Attorney's fees and perhaps other costs are incurred whether or not the plan is implemented. In addition, those who undertake the estate planning process presumably did so because they understood why they need a plan and the consequences of not having an estate plan. Yet, after incurring the costs and knowing the consequences of not following through, many do not implement their plans.

It is unknown how many people fail to implement their plans, but many in the business believe it is a significant percentage of the plans created. The problem is so widespread that the magazine *Private Wealth* in 2003 and again in 2008 surveyed both attorneys and high net worth individuals to study the problem from the perspective of both sides of the transaction. The magazine found consistent answers in its two surveys, and also found the situation is growing worse.

An estate plan is not implemented if the client fails to sign the wills and other documents. A failure to implement also occurs when assets are not transferred to trusts or other entities, or planned gifts are not made. Often documents are signed in the attorney's office and transfers are made with the attorney's help, but the attorney's participation is not essential to implementation of all plans. So, the attorney might leave implementation of most of the plan in the client's hands.

The interviews with attorneys revealed that most are unconcerned about their clients' failures to implement the plans, and they acknowledge the failure is not unusual. Apparently, the attorneys believe they have earned their fees from those clients, and they are generating enough new business they do not worry about unsatisfied clients and unfinished plans. In addition, pressure from their partners to be profitable discourages attorneys from taking additional time to ask clients why they have not signed their documents, transferred assets to trusts, or taken other actions.

The comments from high-net-worth clients who have not implemented plans are more interesting. These clients have net worths of at least $10 million.

<u>Over 95% of the clients who did not implement plans said that the plans did not satisfy their goals, wants, and objectives</u>. In addition, over 93% said the attorney made them "uneasy." And 55% said their estate plans were too complicated.

All these complaints probably are the result of two problems: poor communication and a poor working relationship. They also provide clues to steps you can take to ensure having a successful estate plan you will implement.

Most clients know they need an estate plan and have general ideas why a plan is important. Their goals are to avoid unnecessary taxes, high probate costs, and long delays. They also want to provide for loved ones. But they usually have only general goals. They are looking to the estate planner to help them refine their goals and define their needs. Most estate planners, on the other hand, seem to expect people to know what they want in their estate plans and to tell the

planner what they want. Or the planners have put together a lot of estate plans and assume people generally want the same things and need similar plans.

Clients generally need an estate planner who will spend some time getting to know about their families, their finances, and their general goals and values. Together they use that information to help formulate specific goals. Then, the estate plan can be developed. How much time this takes depends on how complicated a person's situation is.

The complaint that the plans are too complicated is telling. Remember these are high net worth individuals. They generally should be people who are familiar with finance and have at least dabbled in some complicated issues. They also should know that estate planning can be complicated, especially if tax reduction is important. Yet, their estate planners are unable to explain satisfactorily how the plans would achieve their goals.

My guess is that many estate planners view themselves as technicians and perhaps assume a certain level of knowledge among their clients. The planners might do a poor job of communicating how a plan achieves a client's goals because they assume knowledge by a client and use legal jargon. They also might not take the time to learn clients' true goals. It can take a while for someone to open up to a stranger about the details of his or her family, finances, goals, and aspirations, and planners might not take the time. Perhaps, too, clients are intimidated by the situation and an attorney's use of estate planning jargon. They don't ask enough questions.

You can take steps to avoid being one of those clients who spends a lot of money to have an estate plan developed, and then does not implement the plan.

- Ask your friends and colleagues for referrals. Most estate planners are recommended through other professionals. The professionals know the estate planner is competent and can communicate with him or her. But they probably do not know how the planner communicates with clients. It might be better to get a referral from a satisfied client than from a professional who works with the attorney.
- Meet with several estate planners before making a commitment. The estate planner should know more than almost anyone else about you and your finances. If you are not comfortable sharing details with an estate planner and asking questions or if you think the two of you aren't communicating, it probably will not be a successful relationship. It's better to meet with several prospective planners to develop an idea of your choices and the type of individual you want to work with.
- Do a lot of preparatory work. Gather and organize information so the attorney can be presented with a clear picture of both your finances and family. Some estate planners have questionnaires or worksheets for clients to complete. If not offered one, ask for one and complete it thoroughly as soon as possible. This reduces the time the attorney spends gathering information and increases the time that can be spent getting to know you and developing a plan.
- Do not be afraid to ask questions or for a better explanation. Part of the attorney's job is to be sure you understand the plan and are comfortable with it. You should be sure the goals are understood, and you know how the plan will meet them.
- Keep in mind that it is your plan and your responsibility. The attorney is working for you. If there are things you are unsure of or do not understand, persist until the plan is clear. The consequences of not having an estate plan in place can be disastrous for loved ones. Putting together an estate plan takes a lot of time and money. Do not waste those resources by having a plan that is not implemented.

Chapter Three

The Estate Tax Law:

How To Shelter The Wealth Of Your Lifetime

Uncertainty about the estate tax is resolved. You don't have to worry about frequent shifts anymore. Congress finally passed a new estate tax at the end of 2012 that ended the phase-ins, phase-outs, and expirations that dominated the law since 2001. In 2017 Congress enacted higher exemptions and other provisions that last at least through 2026. Those who procrastinated about estate planning because of the tax law uncertainty can begin to plan with confidence.

Those who had plans in place need to meet with their planners to discuss how the plans should be updated, if they haven't already.

This chapter explains the latest federal estate tax and how to disinherit the IRS. Most estates won't be subject to the federal estate tax. Yet, you need to ensure that your estate won't be among those that are taxed, now or in the future. If you're among those with valuable estates, you need to understand the tax and know the strategies for reducing or eliminating it. Also, a number of states have estate or inheritance taxes, and the strategies for reducing those taxes often are the same as for reducing the federal estate tax. As we discussed in Chapter One, for many people the income tax now is a more important consideration than the estate tax. But everyone should understand the federal estate tax and how it works.

Disinheriting The IRS

You will learn in this chapter how the federal estate tax works, how to avoid it, and why the estate tax still is considered a voluntary tax. I will show you how the estate tax is computed and the basic ways to reduce or eliminate it.

The Keys to Your Fortune

In a nutshell, here is the computation the IRS uses to tax your wealth: Your Gross Estate

Minus Deductions allowed (administrative expenses, funeral expenses, losses, debts, charitable contributions, marital deduction)

Equals Your Taxable Estate

Adding Lifetime Taxable Gifts You Made *Equals* Your Tentative Tax Base

Applying The Estate and Gift Tax Tables *Equals* Your Estate Tax

Subtracting Gift Taxes Paid During Your Lifetime

Equals Your Estate Tax Before Credits

Subtracting Your Unified Estate and Gift Tax Credit

Equals Your Estate Tax Payable *Adding* Any Generation Skipping Tax *Equals*

Your Total Estate Tax Due

There used to a credit for state death taxes paid, but that was phased out.

To summarize the above outline, your executor compiles a list of all your assets and their values. That is your gross estate. Then various deductions are subtracted to arrive at your taxable estate. Your lifetime taxable gifts are added to the taxable estate, because the estate and gift taxes are considered a uniform wealth transfer tax.

In other words, you should pay the same tax whether you give property away during your lifetime or after your death. Then the tentative tax on both your final estate and your lifetime gifts is computed. After computing the tentative tax, gift taxes paid during your lifetime are subtracted.

Next, the remaining tax is reduced by the amount of your estate and gift tax credit. Everyone gets an estate and gift tax credit. The amount of the credit is what changed the most from 2000-2012. The current level of the credit is what exempts most estates from the federal estate tax. Note that since the estate and gift tax are unified, you can use all or part of the credit during your lifetime to make tax-free gifts, and that reduces the amount of credit available to your estate. If you used all or part of the credit to reduce lifetime gift taxes, the amount of the credit that was used is not available to reduce estate taxes. There will be more details about the unified estate and gift tax credit later.

In the 2017 law, the lifetime estate tax credit was raised so it is worth up to $10 million per person. That amount is indexed for inflation and was set at $22.06 million for 2022. The maximum estate tax rate is 40%. The generation skipping transfer tax also is extended with the same exemption and tax rate as the estate tax. The GSTT is the tax for gifts made directly to grandchildren and subsequent generations.

Because the credit for state estate and inheritance taxes was eliminated, people in states with those taxes need to pay attention to them. Before the credit was phased out, people didn't worry about the state taxes. The state tax credit reduced the federal tax due, so the federal credit was subsidizing the states that had the taxes. The estate paid the same total tax whether the state had the taxes or not. The only difference was the amount that was paid to the federal

government. Now, in some states there are estates that owe no federal estate tax but owe the state estate or inheritance tax.

There is an additional tax that might be added to the basic estate tax. The generation skipping tax is imposed when you try to pass assets directly to your grandchildren (or later generations). Such a direct transfer would enable you to transfer wealth to your grandchildren without having it first taxed in your children's estate.

There are a couple of points about the estate tax that often confuse people. As a shorthand, most discussions of estate planning say that $12.06 million of your estate is exempt from taxes in 2022. Actually, there is no exemption. There is the unified estate and gift tax credit that has the effect of eliminating taxes on the first $12.06 million of assets. So, $12.06 million is really the "estate tax exemption equivalent." It seems like a technical point. But it has a real effect if you made taxable gifts during your lifetime, because the estate and gift tax credit is used first against lifetime taxable gifts. So, if you made $12.06 million or more of taxable gifts during your lifetime, there will be no estate tax credit left for your estate.

You can see in the outline how the estate and gift taxes are unified. Your lifetime taxable gifts are added to the gross estate to determine the estate tax. Then, the gift taxes you actually paid during your lifetime are subtracted from the tax payable. Finally, the remaining amount of your estate and gift tax credit is used to reduce the tax payable.

Understanding the Portability of Exemptions

A new feature was introduced in the estate tax in 2010 and was made permanent in the 2017 law. The wrinkle is that in married couples any unused lifetime estate and gift tax credit of the first spouse to pass away can be transferred to the surviving spouse. Estate planners call this portability or portable credits.

Previously, the lifetime estate tax exemption was available only to the individual. It had a use-it-or-lose-it feature. Any exemption amount not used by your estate and your lifetime gifts was lost. To maximize tax savings and avoid losing a credit, it was important for married couples with substantial assets to split title to their assets so that each had an estate of roughly equal value.

Under the new law, a surviving spouse may take the unused exemption amount of the first spouse that passed away and add it to his or her own.

It works like this. The estate of the first spouse to pass away is exempt from estate taxes up to $12.06 million in 2022. If that spouse's taxable estate was worth less than $12.06 million, the unused exemption amount transfers to the surviving spouse. When the survivor eventually passes away, he or she can exempt more than $12.06 million of assets by using his or her own exemption plus the unused exemption of the deceased spouse. Together they're sure of exempting up to $24.12 million in 2022.

Consider Max and Rosie Profits with a net worth of $20 million, $15 million in Max's name and $5 million in Rosie's name. Rosie passes away first. Before 2010, her estate would be exempt from taxes, but the unused exempt amount would be lost. Max and Rosie would have been advised to ensure each spouse had legal title to assets worth the same amount to avoid the lost exempt amount.

Under current law, however, Rosie's estate still is exempt, but that unused estate tax exemption can be transferred to Max. His estate will have both his own exemption of $12.06 million in 2022 plus Rosie's unused exemption. Max's exempt amount is increased for inflation each year he lives after 2022, but Rosie's unused amount that carried over to Max is fixed. It doesn't increase for inflation.

To secure the portability of the first spouse's unused exemption, the estate executor must follow IRS rules. In particular, the estate of the first spouse to pass away must file an estate tax return, even if the estate is exempt from filing a return because no tax is due. The return must be filed within nine months of the date of death, though a six-month extension is available. If the executor fails to file a return or misses the deadline, there is no portability, and the unused exemption is lost. The executor when filing the return can elect not to allow portability if for some reason you want that, or he decides that's best. If an estate tax return is filed but doesn't take a position on the transfer of the unused credit, then it is treated as though the executor elected to transfer the unused credit.

It's important that you name an executor who knows to file an estate tax return, even when one is not required, in order for your unused exemption to be portable for your surviving spouse. Filing an estate tax return should be automatic now for someone who was married, regardless of the estate's value.

When the surviving spouse had more than one deceased spouse over his or her lifetime, only the exemption of the last deceased spouse can be used. Here's how that rule works.

Example. Rosie Profits dies, leaving her surviving husband, Max. Rosie had a previous husband who passed away and his estate used only $3 million of his exemption. So, Rosie's estate can exempt $7 million (her $5 million exclusion amount plus the unused $2 million exclusion amount from her first husband). Rosie didn't make any taxable gifts during her lifetime and has a taxable estate of $3 million. Rosie's estate elects to let Max use Rosie's unused exclusion amount, which is $4 million (Rosie's $7 million exemption less her $3 million taxable estate). So, Max's exclusion is increased by $4 million and is $9 million if none of his exclusion was used by taxable gifts. (All these numbers use the basic $5 million exemption without inflation indexing, to keep the example simple.)

A price of portability is the estate of the first spouse to pass away is subject to audit until the audit period for the second spouse to pass away has closed. Also, the carried over exempt amount from the first spouse to pass away is not indexed for inflation. It's a fixed dollar amount, regardless of how long the surviving spouse lives.

It's a good idea for most estates to take the election, even when the surviving spouse's exemption seems more than sufficient, because the surviving spouse could receive a windfall at some point or could live a long time and have assets appreciate.

Eliminating Federal Estate Taxes

Now that you know how estate taxes are computed, you can quickly see how estate taxes are reduced. There are four basic strategies for beating the estate tax.

- The first strategy for estate tax reduction is to reduce your gross estate. That means either removing assets from your estate or reducing the value of the assets in your estate. There are many ways to do this, as we'll see. The real trick is to use the tactics that will get the assets out of your estate without triggering high gift taxes or hampering your lifestyle. For example, the annual gift tax exclusion allows you to give up to $16,000 per person to any number of people in 2022 without paying estate taxes or using the lifetime exemption—up from $15,000 for 2021. (The recipient typically owes no taxes and doesn't have to report the gift unless it comes from a foreign source.). (The amount is indexed for inflation.) You also can give an unlimited amount for qualified education and medical expenses. We'll discuss those strategies later.

Another trick involves control of the assets. To remove assets from an estate, you generally have to give up ownership and control. There are ways to retain some level of influence over the assets, primarily using trusts and limited partnerships.

- Second, remove appreciation from the estate. When you start estate planning early, you can use strategies that anticipate some assets will increase in value and reduce the amount of the appreciation that is in the estate. These strategies are especially important to small business owners.
- Third, make strategic use of estate tax deductions. There are several deductions, and you might be able to structure the use of deductions so that the property generates income or wealth for you or your heirs.
- A fourth strategy is not to worry about reducing estate taxes. Instead, you make sure there are sufficient liquid assets inside or outside the estate to pay the taxes and that your heirs have enough after-tax assets to meet your goals. The most common tactic for accomplishing this strategy is to buy permanent life insurance through an irrevocable life insurance trust. There are variations. In some cases, heirs are better off if you forget about estate tax reduction and simply set up life insurance properly.

You Might Be More Wealthy Than You Think

Most people believe they will not have estate tax problems when they hear how much of a person's estate will be exempt from estate taxes, and that a married couple can have twice that amount before estate taxes kick in. Unfortunately, many people don't fully understand the first step in computing the estate tax. While this isn't as acute of a problem as when the estate amount was $1,000,000, it still can surprise many people in urban and suburban areas. Many people do not realize how much property is included in the gross estate or how wealthy they are considered to be under federal estate tax law.

One common source of confusion is the difference between the federal estate tax and probate. Many assets that avoid probate are included in your estate for tax purposes. That is because probate is a state process that covers only

assets whose ownership is changed either under your will or under state law if you die without a will. If ownership transfers automatically at your death, then the property is not subject to probate. Ownership transfers automatically at death for jointly owned property, life insurance, property held in living trusts, pensions, annuities, and several other types of property, and these properties avoid probate.

The federal estate tax covers a broader range of property. The gross estate includes the value of all property in which the deceased had "an incident of ownership" on the date of death. Many properties that avoid probate are included in the estate for tax purposes.

Here are some property interests that many people do not realize will be included in their estates for tax purposes. Estate planners refer to them as "hidden assets."

Jointly owned property. Most couples own their home and a few other assets in joint title with right of survivorship. Under the estate tax, one half the value of jointly owned property will be included in the estate of the first spouse to die. The rules for jointly owned property are a little different when the joint owners are not spouses, but in those cases some value of the property often will be included in the estate of the first joint owner to die.

Pensions and annuities. While pensions and IRAs avoid probate, their values are included in your gross estate. If you are receiving a pension or insurance annuity and payments will continue to a beneficiary after your death, then the value of the annuity will be included in your estate. Some complicated rules determine the value of the annuity for estate tax purposes, but the annuity does not avoid estate taxes. The values of retirement accounts such as IRAs and 401(k)s also will be included in the estate for tax purposes.

Living trusts. Many people set up living trusts to avoid probate. There are advantages and disadvantages to this—which are discussed in this book—but avoiding estate taxes is not one of the advantages. If you have a standard living trust that has you as trustee and allows you to control the property and receive income during your lifetime, then the value of all property owned by the living trust is included in your estate for tax purposes.

Life insurance. Life insurance benefits are free of income taxes, but they are included in the gross estate for tax purposes if you exercised any incidents of ownership over the policy. To avoid estate taxes on life insurance, the policy must be owned by another family member, an irrevocable life insurance trust, a partnership, or some other entity, and you can’t benefit from the policy.

Power of appointment. Sometimes a person's will sets up a trust that allows another person to decide who ultimately will get the property or income from that trust. For example, one of your parents might have created a trust that pays you income for life and lets you decide who gets the remaining trust property after your death. This is known as a power of appointment. If you have such a power of appointment, its value will be included in your estate. The rules for this are tricky, so you will need to have an estate professional's advice.

Incomplete gifts and revocable trusts. Some people like to give children the use of property or its income while retaining the right to get the property back or divert some of the income back to themselves. Or you might put property in a trust that pays income to someone else for a period of years, then returns the property to you. These retained rights are items of value that are included in your gross estate. If you want property or income excluded from your gross estate, you must give away the entire legal right to the property. Giving away property with strings could mean the property is yours when it comes time to compute the estate tax.

Gifts within three years of death. It used to be that virtually any gift made within three years of a person's death was included in the gross estate. Now the rule is much more limited, and the type of property most likely to be included in the estate up to three years after it is given away is a life insurance policy.

These hidden assets are in addition to the assets you clearly own. Because of the way the gross estate is computed, there are a number of "modest multi-millionaires" in the country. When you add up your home, second home, personal effects, cars, pension, investments, IRA, life insurance, and any other assets, many middle-income Americans are millionaires. They do not feel like millionaires or live the way most people think millionaires should live, but to the IRS they are. In areas of the country where homes are very valuable, people are at risk of the federal estate tax based primarily on homes they owned for several decades.

Also, while the exemption for the federal estate tax is indexed for inflation, it is indexed only to the Consumer Price Index. You might own assets that increase in value at a higher rate than the CPI. That is likely if you own a successful business or real estate in an area with strong appreciation. People whose estate are well below the taxable level now could have taxable estates in 10 years or more. That’s why it is important to plan early and consider future scenarios in addition to current conditions.

Using the Estate Tax Deductions

Just as you are allowed deductions when computing your income tax, the estate gets to deduct certain payments from the gross estate. But for planning purposes, there really are only two deductions worth considering: the marital deduction and the charitable contribution deduction.

Sheltering with Your Spouse

You can leave any amount of money or property to your spouse and have that deducted from the gross estate. There used to be a limit to the marital deduction, but now it is unlimited. So, if you want an easy, surefire way to eliminate estate taxes, simply write a will that leaves your entire estate after expenses to your spouse. The new portability rules make that a better strategy than it used to be. Even so, that easy way of eliminating estate taxes might not be the best idea and can have bad long-term effects.

While portability is a great benefit, the question now is: Who should rely on it and how should estate plans be adjusted for portability?

Under the old law, married couples were encouraged to split ownership of assets so that each spouse owned at least the lifetime exemption amount. That avoided unused exempt amounts. In addition, part of the standard estate plan was to leave a portion of the estate equal to the exemption amount either directly to the children or in a bypass trust that would benefit the surviving spouse during his or her lifetime but eventually benefit the children.

Here's how the bypass trust worked absent portability. Let's say Max Profits has a $6 million estate and the estate tax exemption is $5 million. Max could leave everything to his wife, Rosie, and the estate wouldn't owe any taxes because the marital deduction would shelter the entire estate. But that would leave Rosie with the $6 million estate plus her own estate plus any future appreciation on those assets. She'd have the burden of doing all the tax planning and would have an estate exceeding her exempt amount.

Instead, Max's will transfers $5 million to the bypass trust and $1 million directly to Rosie. The bypass trust distributes income and principal to Rosie to the extent she needs it, and then any remaining amount goes to the children after Rosie's demise. The amount in the bypass trust is shielded by Max's lifetime exemption, and the $1 million to Rosie qualifies for the marital deduction, so there is no tax to Max's estate. Rosie still has her own lifetime exemption and the $5 million in the bypass trust won't be in her estate. The result is all of both estates avoid estate taxes.

Portability is a great benefit when someone whose estate was worth more than the lifetime exemption amount and who did not properly plan. With portability, the bypass trust might not be necessary to eliminate estate taxes. In the above example, Max can leave the entire estate to Rosie. She can add Max's unused exemption to her own exemption and have a $10 million exemption available for her estate.

When the joint estate is valued at less than $10 million (and likely to remain so), the bypass trust is unnecessary to eliminate taxes. The lifetime exemptions of the two spouses will shelter both estates.

The Marital Deduction Trap

While it catches fewer people now, there still is a marital deduction trap. The marital deduction is a good way for the first spouse to completely eliminate estate taxes. Unfortunately, it leaves the entire burden of avoiding estate taxes on the second spouse. When the two estates combined exceed the joint exempt amount, the surviving spouse must develop strategies to deal with the taxes on that excess. Falling into the marital deduction trap could leave your children or other heirs with less than you or your spouse had planned.

In addition, using only the marital deduction means the first spouse avoids many important decisions, such as whether to leave the children equal inheritances and leave them directly or in trust.

While the marital deduction has benefits and is a sure way to eliminate estate taxes on the first spouse to pass away, sole reliance on the marital deduction isn’t the ideal solution in all cases. It should be combined with other tools. Later, for example, we’ll see how to combine the marital deduction with a bypass trust to ensure a tax-free estate and avoid the problems of sole reliance on the marital deduction.

Save Money By Giving It Away

Another easy, surefire way to eliminate estate taxes is to leave your wealth to charity. Your estate is allowed an unlimited charitable contribution deduction, so every penny that you give to charity is deducted from your gross estate.

Of course, the money that goes to charity does not go to your spouse or children. If one of your goals is to provide for your spouse and your heirs, the outright gift to charity would not be helpful. As far as your heirs are concerned, giving the money to a charity would be no different from having the government take the whole thing in taxes.

Fortunately, the tax code provides for ways that you can use charitable contributions to reduce the estate tax while still leaving your spouse or heirs with income or property to meet their needs.

Instead of an outright gift to charity, you can use the charitable remainder trust. This trust pays income for life or a period of years to the beneficiaries of your choice, then the remaining property goes to a charity you can designate. You also can set up a charitable lead trust. This pays income to a charity for a period of years, then the property goes to the beneficiary you designate. With either type of trust, your estate gets a charitable contribution deduction for the present value of the income or property that the charity will get. The amount of the deduction varies according to current interest rates and the terms of the trust. A charitable trust is a good way to use the charitable contribution deduction to reduce estate taxes while still benefiting your heirs.

Another option is to set up a charitable foundation and have all or part of your estate contributed to the foundation. This generates a deduction for the estate. Plus, the foundation can employ your spouse or children or at least give them paid directorships. There are strict, complicated rules that must be followed if you set up a foundation. If you have a substantial estate, it can be a good way to reduce estate taxes, set up a legacy for yourself, and provide income for your heirs.

There is a great deal of flexibility in these options, and I discuss them in more detail later in this book.

The Add-on Tax — The Grandparents' Tax

Congress placed an additional tax in the estate tax calculation. The primary goal of the estate tax is to prevent one generation from giving "too much" wealth to the next generation. One way to reduce a family's estate taxes in the past was to give property to the grandchildren, either directly or through trusts. That way, the property would not be subject to an estate tax when the children died, so one generation of estate taxes would be avoided on the property.

Congress decided it didn't care for this result, so it created the generation-skipping tax. Under the GST, when property is passed so that it skips a generation, an additional tax is imposed at the top estate tax rate. This tax is in addition to any regular estate tax imposed on the property There is a lifetime exemption to this tax of $10 million (indexed for inflation).

Cutting Off the IRS

I already told you that there are four basic strategies for reducing estate taxes: reducing asset from the gross estate, removing future appreciation from the gross estate increasing deductions, and buying life insurance. Within those four strategies are many options. Not all will be appropriate for you. But in this book, I describe quite a few strategies. You can decide which might be suitable and discuss them with your estate planner. Chapter Four discusses your estate tax reduction options and other estate planning strategies in more detail.

If your estate plan was in place before 2018, and certainly if it was created before 2013, you need to revise it or at least have an estate planner review it carefully. Here are a few of the more important potential changes.

- Wills with bypass trusts need to be reconsidered. Fewer families will need them now, because of the higher estate tax exemption. There still are cases when a bypass trust should be considered as part of an estate plan, and we'll discuss them in the next chapter. But in many cases, the bypass trust could produce results you don't want under the new law.
- Formulas in wills need to be rewritten when they determine the amount of an estate transferred to a bypass trust or when for any reason, they refer to the estate tax exemption amount. Under traditional formulas, the $10 million exemption will use all or the bulk of most estates. Many surviving spouses will be impoverished under current wills. If your estate plan has a bypass trust or formula clause, you need to visit an estate planner soon.
- Don't forget state levies. About 20 states have some form of estate or inheritance tax or both. Often these have much lower exemptions than federal law and will be a more significant burden on your heirs. You might want to revise your will primarily to avoid these taxes.

- Make tax-free gifts. The wealthy or near-wealthy who have enough assets to pay for retirement should consider removing appreciating assets from their estates. You want to remove future appreciation from your estate, especially when the assets are appreciating faster than the Consumer Price Index. Otherwise, you take the risk your future estate will be taxable. You transfer more wealth tax free to heirs when you give property before it appreciates, especially when you can make those transfers free of gift taxes.

Even those with modest estates might want to make gifts when they live in states with high estate or inheritance taxes, and they have enough to maintain their standard of living.

- Income shifting is back. With the higher gift-tax exemption, you can transfer a lot of income-generating assets or property with large capital gains free of gift taxes to family members. When they family members are in a lower tax bracket than you, this keeps more after-tax wealth in the family.
- Focus on non-tax issues. For most of us, estate planning is about a lot more than tax planning. For many, taxes aren't even a significant consideration. Your plan needs powers of attorney for financial and medical decisions when you're unable to act, and perhaps a living will. Determine if you have too much or too little life insurance. Consider how your will should be worded to minimize family conflicts and prevent assets from being wasted. There are other non- tax issues to consider.

We'll discuss a number of important planning situations and strategies in detail in the next chapter.

Chapter Four

Estate Planning Strategies

In previous chapters you learned the basic principles and strategies of estate planning. You learned the details of the non-tax considerations in estate planning and received an overview the of the estate tax law. In this chapter, we'll look at specific cases and situations. We go from the general to the specific, and you'll see how different estate planning devices can be used to help preserve wealth by cutting taxes, expenses, disputes, and other cash drains. We'll start with the most basic strategies that almost everyone should be using, then build on these to demonstrate more sophisticated estate planning devices that can be used in particular situations or that are for certain types of estates.

Remember, to successfully execute some of these strategies you must clear a number of technical hurdles in the tax law or other parts of the law. This book does not cover all the details. You should use this book to get ideas for strategies and tactics that could work for your estate, then discuss them with an experienced estate planner. After deciding which strategies are for you, have the estate planner help implement them.

Let's take a look into the files.

Strategy #1

The Latest Tax Law And Your Will

Your will and estate plan need to be reviewed every year or two. It also should be reviewed after a change in the estate tax law or other laws. If you haven't already visited an estate planner for a fresh look at your estate plan since late 2017, such a visit is overdue. The law should trigger major changes in many plans.

There are no more excuses for procrastination and delay. The estate and gift tax law finally is set. There are no more temporary or expiring provisions or transition periods. People no longer can say they don't want to incur the cost of an estate plan that might have to be re-written in a few months because of tax law changes.

In the previous chapter I laid out the basics of the estate tax law. The lifetime exemptions of $10 million for an individual and $20 million for a married couple are set, as is the $5 million exemption to the generation-skipping tax. The annual gift tax exclusion remains. All are indexed for inflation. The top tax rate rises to 40%. None of the past proposals to curb or eliminate tax reduction strategies were enacted, though some of them might be in coming years.

It's time to revise or begin what I like to call your inheritance planning or legacy planning. The process is fairly straightforward when you understand the steps in advance and do some thinking and planning before meeting with an estate planner.

Remember, inheritance planning is not primarily about avoiding taxes or probate. Estate planning is deciding whom you want to own the wealth after you do, when they should receive the wealth, and whether there should be any restrictions or controls. Then, you establish the most efficient way of meeting your goals. Only after establishing how

the assets should be distributed does the focus move to considering ways to reduce taxes, avoid probate, and other goals. I prefer calling the process inheritance planning or legacy planning, because that keeps the true purpose of the process front and center.

To begin the inheritance planning process, take these steps:

- List of all your assets and liabilities. An effective inheritance plan can't be prepared without this information. And a professional, no matter how skilled, can't do anything without this starting point. Frequently overlooked assets include pension plans, life insurance policies, trusts of which you are a beneficiary, inheritances that are likely to be received, and old assets and accounts that haven't been considered recently.

Heirs will inherit only net assets, so a list of all debts needs to be compiled, including whether or not the debts are secured by certain property.

- Decide the desired future distribution. You aren't making final, fixed-in-stone decisions at this point. You might change aspects after discussions with the estate planner, but you need an initial plan.

The traditional goal is for most of the estate to be inherited first by the spouse if he or she still is alive, then whatever is left goes to the children, usually in equal shares. Smaller amounts or specific items might be designated for special friends, other relatives, and charities.

Of course, no one has to follow the traditional route. An owner might want to favor one child over others or want the bulk of the estate to go directly to the children instead of his or her spouse. Many people decide to give a portion of their estates to charity. The only major legal limit is that a spouse can't be completely disinherited in most states (unless there is a valid prenuptial or postnuptial agreement). Children can be completely disinherited if the intention is made clear in the will. In addition, an inheritance cannot violate law or public policy.

Special assets require special consideration. Small businesses, real estate, collections, and other non-standard assets need to be owned and managed by someone who knows what he's doing. Or the assets should be sold, and the proceeds distributed to heirs.

As part of this step, secondary goals also should be considered. For example, should a spouse inherit everything but only in a way that prevents the property from being subsequently inherited by a second spouse or family instead of by the couple's children? Should property be left to children and grandchildren but with strings attached for at least a while so that they don't waste the property or lose their incentive to achieve and be productive? There are ways of accomplishing both main and secondary goals, as long as the goals are clear.

- How much property should be given now, and how much later? There are several considerations at work here. Heirs might be better off receiving some of the wealth now instead of inheriting at some unknown future date. Also, some estate owners prefer to see how at least some of their legacy is used by and benefits heirs. When an estate might be subject to taxes, it's easier to reduce taxes and other costs if the owner is willing and able to part with some wealth now.
- Work with one or more estate planning professionals to develop an estate plan that achieves the goals and also takes into account estate taxes, probate, and other concerns. A typical middle-class couple might need to work only with an estate planning attorney. Wealthier individuals and those with businesses or other complicated assets might need to add an accountant, life insurance agent, business appraiser, trustee, and other professionals.
- Be sure you understand the plan and fully implement it. Many people have great estate plans designed by skilled professionals, but then they fail to implement the plans. They don't set up the trusts recommended, or they fail to transfer legal title of assets to the trusts. Maybe life insurance is not purchased as planned, annual gifts to children are not made, or business succession plans aren't pursued. The result is a lot of time and money spent on estate planning but no effective estate plan in place.
- Let heirs know in general what is decided and how things are set up. Their financial planning is more effective when they have a general idea of what might or might not be coming their way.

An estate owner also should draft a letter of instructions that lists basic information such as where copies of the will are kept, who the financial advisers are, and a summary of assets and liabilities. This document should be updated at least annually and be accompanied by recent tax returns and an outline of your estate plan, at a

minimum. Or you can use my booklet, *To My Heirs: A Book of Final Wishes and Instructions*. For details, click on the Bob's Library tab on the *Retirement Watch* website. The executor of the estate and any other key people should know where to find this information.

Strategy #2

Married Couples: Changing the Bypass Trust

When a married taxpayer passes away and his or her estate doesn't use the entire exempt amount, the unused exemption passes to the surviving spouse in most cases. Portability of the lifetime exempt amount gives a married couple a true $20 million joint exemption Unlike under the pre-2010 law, spouses don't have to worry about making sure each spouse has legal title to enough property to maximize use of his or her exemption, because the surviving spouse can take advantage of the unused exemption of the first spouse to pass away. Spouses also can make unlimited tax-free gifts and bequests to each other, as long as the receiving spouse is a U.S. citizen.

Let's consider the stereotypical married couple with children and how the standard estate planning strategies for them were affected by the introduction of portability.

Before portability, in the standard estate plan, each spouse's will left to a bypass trust an amount up to that spouse's lifetime estate and gift tax exemption. This provision (also called a credit shelter trust, A/B trust, or family trust) ensured the spouse's exemption was used and not wasted. The rest of the estate would pass directly to the surviving spouse under the will, except for any special or charitable bequests. The trust would pay income and principal as needed to the surviving spouse, and after that spouse passed away the children or other objects of affection would receive the trust remainder.

This ensured the estate of the first spouse to pass away avoided all estate taxes. The transfer to the bypass trust took advantage of the full estate tax exemption, while the transfer to the surviving spouse avoided all taxes under the marital deduction.

Do you still need a bypass trust under the current law? The main reason to use the trust under the old law was to take full advantage of the lifetime exemption while providing for your surviving spouse. Unless your estate is likely to be more than the exempt amount, you don't need a bypass trust for that reason. <u>But there are other reasons a bypass trust still can be an important part of an estate plan.</u>

Creditor protection. Leaving assets in a trust often protects them from the creditors of your loved ones. Creditors can include ex-spouses, winners of lawsuits, accident victims, and business partners or creditors. It also includes lenders and credit card companies of those who have trouble controlling their spending or who make bad decisions or suffer economic misfortune. If your spouse or one or more of your other loved ones might be in one of these situations, consider leaving at least part of your estate in a bypass trust that eventually benefits them.

Preserving your intentions. You want to provide for your spouse for the rest of his or her life, but you also might want to ensure whatever is left of the estate goes to those you want eventually to receive it. Some people are concerned a spouse might remarry and leave the money to the new spouse and perhaps a new family. Others already are in second marriages and aren't confident the surviving spouse will leave any of the estate to the children of their first marriage. There might be other reasons your spouse might not carry through on your intentions, and those are reasons to consider using a bypass trust.

Preparing for growth. Remember the estate tax is imposed on the value of assets at the time of the owner's death. Perhaps your joint estate is worth less than $10+ million today. But what might it be worth after five, 10, or 20 years? Yes, the exempt amount will increase over time, but only at the rate of the Consumer Price Index. Good investments, a small business, or real estate could grow at a higher rate over time. Beware of leaving your spouse to deal with that future growth and its tax problems. You can shift future growth out of your spouse's estate, and still allow him or her to benefit from the assets, by leaving some of it to a bypass trust.

The grandparents' tax. The generation-skipping transfer tax still is imposed when assets skip a generation by a grandparent leaving assets directly to the grandchildren. There's a $10 million exemption to the GSTT, but there's no portability to that exemption. If you don't leave the assets to a bypass trust that eventually benefits your children, your $10 million exemption to the GSTT is lost. Your estate might not be valuable enough for this to be an issue, but for some of you it is something to consider.

State taxes. About 20 states plus the District of Columbia have estate or inheritance taxes or both. Most of them have exemptions far lower than the federal exemption, and none has a portability provision. If your state isn't one that's abolished death taxes, you might want a bypass trust to avoid the state taxes.

The remarriage glitch. When the surviving spouse remarries, the portability of the first spouse's unused exemption becomes uncertain. A person who has had more than one spouse takes the exemption of only one deceased spouse, and he or she doesn't get to choose which exemption to use. Only the exemption of the latest spouse to die is available.

Consider Max and Rosie Profits. Max has a $5 million estate and leaves all his money and his unused estate tax exemption to Rosie. After a while Rosie remarries to Sy. A few years later Sy dies and leaves an unused exemption of only $1 million. Max's exemption is lost. Rosie can add only Sy's $1 million exemption to hers. Max could have used his exemption and still provided for Rosie by leaving part of his estate to a bypass trust.

Suppose Rosie doesn't remarry. When Max did his estate plan, it looked like two $10 million exemptions would leave Rosie with an estate that is clear of estate taxes by a wide margin. But suppose Rosie lives a couple more decades and the assets Rosie owns appreciate strongly. We could have another bull market like 1982-2000. Rosie will be rich with an estate exceeding the $20 million of exemptions she has. Her estate will be partly depleted by estate taxes. If Max had put his $10 million in a bypass trust, it and all its future appreciation would be out of Rosie's estate and would pass tax free to their children after Rosie is provided for.

Avoiding administrative errors. Portability of the unused exemption is not automatic, as we discussed in Chapter Three. Using a bypass trust ensures the exemption is used and not lost due to errors or oversights.

<u>There's a potential downside to using a bypass trust</u>. When your spouse inherits assets from you, he or she increases the tax basis to their current fair market value. When he or she pass- es away, whoever inherits the assets increases the basis again to their current fair market value. But when you leave the assets to a bypass trust, there's only one increase in the basis. When assets are distributed from the trust to the beneficiaries, they'll take the same basis the trust had, no matter how much time has passed. This could be a reason to bypass the bypass trust at least with high growth assets.

There's another source of some confusion. The lifetime estate and gift tax exemption is indexed for inflation. But once a spouse dies, the amount of the unused exemption transferred to the surviving spouse is fixed. It no longer is indexed for inflation. The surviving spouse's lifetime exemption is indexed until he or she passes away.

The law makes the choice of a bypass trust less automatic than in the past and requires you to consider factors other than taxes.

<u>There's another way the 2012 and 2017 law requires you to view bypass trusts differently</u>. You need to carefully consider the wording used in the will that determines how much of the estate passes to a bypass trust.

Before the 2001 tax law began increasing the exempt amount, the standard will stated that a portion of the estate equal to the exempt amount would go into the bypass trust. There still are many wills out there with this or similar provisions.

Except for the very wealthy, you don't want this provision now, because it could mean that all or most of your estate is put into the trust. Your surviving spouse will have few or no assets in his or her own name. Most people want their spouses to own some assets outright without having to go through a trust or worry about other trust beneficiaries challenging spending and other decisions.

<u>That's why the standard today is to use a formula to fund the bypass trust</u>. You decide the maximum percentage of your estate, or a maximum dollar amount you want to go into the trust. Or alternatively determine the minimum you want going directly to your spouse. Your will then has a formula reflecting that. For example: "The bypass trust shall be funded up to either the maximum federal tax-exempt amount or 40% of the gross estate, whichever is less."

There are other formulas to consider. The limit on the assets transferred to the bypass trust can be a dollar amount. Or the clause can be phrased to ensure your surviving spouse is left with a minimum amount of assets and the bypass gets the remainder up to the exempt amount. Talk with your estate planner to derive the formula that meets your goals, but be sure your will doesn't have the old funding clause. Otherwise, your spouse might be left with no assets in his or her name.

There's a clause you can put in the trust to ensure that if the trust is overfunded your surviving spouse isn't always accounting to the trustee for spending needs. Write the trust to say that your spouse annually can have the trustee

distribute to him or her up to 5% of the trust value for any reason. This is in addition to being able to get additional amounts for needs such as support, health care, and education.

Another approach is to create a bypass trust in your will but leave all or most of the estate to your spouse. Nothing or only a relatively small amount is designated for the bypass trust. Your will provides that any amounts your spouse disclaims or can't otherwise inherit go into the bypass trust. After you pass, your spouse works with the estate planner to disclaim, or renounce, the inheritance of all or a portion of the estate. The disclaimed amount goes into the bypass trust. This lets your spouse and the estate planner fine tune your plan based on asset values and the estate tax at the time. You don't have to guess or plan for every contingency. But you do have to rely on your estate planner and spouse to implement the plan.

This approach is only advisable for a first marriage that is very stable and in which both spouses agree over who ultimately should inherit.

Strategy #3

Adjusting Estate Values of Spouses

Under the old law, before there was portability of the exempt amount between spouses, it was important that each spouse have legal title to assets at least equally the individual exempt amount. This avoided losing all or part of one spouse's exemption. Couples often would be advised to change legal title to assets to ensure neither spouse's exemption was lost.

With portability of the exemption, it isn't as important for spouses to change the title to property, even when their combined net worth exceeds the $20+ million joint exemption.

There might be situations in which it makes sense to equalize estates or to shift some assets from one spouse's name to another, but it no longer is essential to equalize estates in order to avoid losing all or part of one spouse's exempt amount.

Strategy #4

Protecting Assets and Heirs With A QTIP Trust: There's New Value In QTIP Trusts

As we've seen, it is easy to cut your estate taxes to zero, especially if you're married. All

you have to do is leave everything to your spouse. Your estate gets an unlimited marital deduction for all property left to your spouse. So having your spouse inherit everything eliminates taxes on your estate.

Despite the tax savings, there might be good reasons not to leave everything to your spouse. One reason is that the spouse might not be able to manage the assets effectively and might be overwhelmed by the responsibility. Another reason is that you lose control over how the assets eventually are distributed. For example, a common fear is that the surviving spouse eventually will remarry and leave the estate to the new spouse and other members of the new family. Or, if the spouse has children from a prior marriage, the spouse could favor those children over those from the current marriage. Another possibility is that if you have children from a prior marriage your spouse might not be inclined to leave them much of the estate.

All of these potential problems are avoided, and taxes are reduced with the QTIP trust. The tax law establishes a special type of property known as Qualified Terminal Interest Property, or QTIP. The person who inherits it is entitled to all the income from QTIP property, but all his or her rights to the property terminate at his or her death. After that, the property goes to whomever the first owner designated to receive it. Normally, QTIP property does not qualify for the marital deduction. But if you attach the right conditions, all the QTIP property qualifies for the marital deduction. That means it is passed on from your estate free of estate taxes, yet you control who eventually inherits it.

For QTIP property to qualify for the marital deduction, your spouse (and only your spouse) must be entitled to <u>all</u> the income from the property for life, payable at least annually. In addition, your spouse cannot have the right to designate who ultimately gets any part of the property. Finally, you or your executor must elect to have the property treated as QTIP. Any portion or all of your estate can be treated as QTIP. And you can have your executor decide after your death how much of the property to designate as QTIP.

QTIP property doesn't have to be left in a trust, but it is easier to qualify for QTIP status with a properly set up trust.

The price for the QTIP trust is that whatever is left in the trust on the death of the second spouse is included in his or her estate. This is the same tax result as if you had left the property to your spouse directly. With the QTIP trust, however, you retain some control and ensure that the property eventually is distributed as you want.

The QTIP trust should not be your only estate planning tool and is not for everyone. A QTIP trust is ideal in the following situations:

- At least one spouse has children from a prior marriage, and that spouse wants to ensure that those children get at least a minimum amount of property after both spouses are gone.
- You are concerned that your spouse might remarry after your death and leave the estate to the new family.
- You want some of your property to go to someone other than your children (brothers, sisters, other relatives, friends) after your spouse's passing and are not confident your spouse would make the same choice.
- You want to ensure that the property eventually is inherited by members of your immediate family and not by relatives or friends of your spouse.

The QTIP trust should supplement other strategies since your spouse will be receiving only income from the trust. You can set things up so that the trustee can use some of the principal to meet emergencies of your spouse, but then you have to define the emergencies or hope that the trustee won't use the property in ways you wouldn't want. So, the best approach is to ensure that your spouse has other assets or sources of income in addition to the QTIP trust, then set up the QTIP so that your spouse will get all the income and your children (or others you favor) will inherit its principal.

A QTIP trust should be drafted by an experienced estate planner. The tax law has very precise requirements for QTIP status. Many estates had to pay unexpected taxes over the years because of stray words or phrases in wills or QTIP trusts. Also, not all types of assets are appropriate for QTIP trusts. For example, the IRS argues that it is virtually impossible for a trust to qualify as a QTIP if it owns an IRA or other pension plan. Of course, the trust won't do your spouse any good if the trust property does not produce income, so it should hold income-producing property.

A QTIP trust is an estate planning mainstay. It could take burdens away from your spouse, ensure that your children or other loved ones eventually are cared for, and also provide for your spouse. And it can defer estate taxes. That's why it should be considered for your estate plan.

There are several potential disadvantages to the QTIP. If too much wealth is put into the QTIP trust, the income payments to the surviving spouse could cause his or her estate to continue increasing, triggering higher estate taxes down the road. Fully funding the QTIP trust also means no one other than the surprising spouse benefits from the estate of the first spouse to pass away.

Another potential disadvantage for a very valuable estate is that the trust might grow in value to exceed the surviving spouse's exempt amount and the unused exempt amount of the first spouse to pass, triggering substantial estate taxes on the surviving spouse's death. This problem could be reduced by giving the spouse and trustee the discretion to take principal out of the trust, even for the purpose of giving it to others.

Strategy #5

The Essential Family Estate Planning Package

We've looked at some basic estate planning strategies and tactics. Now let's look at how they all can come together. For most married couples, there are two tools that are part of almost every estate plan and three trusts from which to choose one or more. These strategies are the foundation of most estate plans. No matter how large or complicated your estate is or how many other tools you add to it, the foundation of your estate plan likely still will be these two tools and one or more of these three trusts. Let's review them and see how combining them can benefit your loved ones.

Marital deduction. You know all taxes on your estate can be avoided by leaving everything to your spouse. You also know about the dangers of overusing the marital deduction. It is a key feature of most estate plans, because it lets you ensure that your spouse will be able to maintain his or her lifestyle without your estate paying taxes.

Exempt amount and portability. You also know that each spouse has an estate tax exemption equivalent of more than $10 million that allows him or her to pass assets tax free to heirs other than the surviving spouse. Unlike the old law, the new law allows the surviving spouse to use any exempt amount that wasn't used by the first spouse to pass

away. The surviving spouse adds that unused amount to his or her own exempt amount. Spouses no longer have to worry about each spouse having legal title to enough assets to exhaust his or her exemption.

Now let's look at how these two tools can be combined with trusts to meet your estate planning goals.

The bypass trust. The assets that are transferred to this trust by your will be sheltered from tax by the estate tax exemption equivalent. It is called the bypass trust because the assets bypass the surviving spouse's estate. Other names are the credit shelter trust (because it uses the estate tax credit) and the A-B trust or family trust. You can eliminate taxes on your estate by leaving an amount to the bypass trust that doesn't exceed your estate amount and leaving the rest of the estate to your spouse.

The bypass trust need not leave your spouse in the cold. If your spouse needs the assets to maintain his or her lifestyle, you can provide that income and even principal from the trust will be paid to your spouse, either in specified amounts or as needed. It also can pay income to your children or other heirs as needed while your spouse is alive. Then your heirs inherit the remainder after your spouse has passed away or under other conditions you set.

The bypass trust maximizes use of the estate tax exemption equivalent, ensures that your spouse is provided for, and also ensures that what is left of the trust after your spouse's passing will go to your children or other heirs you designate. The trust limits the possibility that your wealth might go, for example, to the spouse or children of a second marriage.

Marital deduction trust. As the name implies, this trust qualifies for the marital deduction. The spouse receives income from the trust as needed, and the spouse also can get the trust principal under conditions you specify, even to the point of being paid the entire trust. Your spouse also can appoint who will eventually inherit what is left in the trust. Whatever is left in the trust is included in your spouse's estate.

The real advantage of the marital deduction trust is that it takes management of the trust property out of the spouse's hands and gives it to the trustee. The trustee can have discretion to pay or retain income and principal according to the guidelines you provide in the trust agreement or can pay as requested by the surviving spouse.

Qualified Terminable Interest Property (QTIP) trust. As we discussed earlier, in a QTIP trust, your spouse must receive all the income from the trust, paid at least annually. The trustee can dip into trust principal for your spouse under guidelines established by you, but your spouse has no right to decide who gets the property after his or her death. You decide how any remainder will be distributed to your other heirs. The remaining value of the trust is included in your spouse's estate when he or she dies.

The QTIP has several advantages. It ensures your spouse will be cared for and the amount in the trust qualifies for the marital deduction for your estate. Yet your spouse does not have full control of the property. You are ensured the trust principal will go to your children or whomever else you designate after your spouse passes away. It often is used when one or more of the spouses is in a second marriage or is young enough that re-marriage for the other spouse is a real possibility.

Here's a classic example of how these strategies can come together in one plan.

Max Profits has a $4 million estate and wants to ensure that his wife, Rosie, is provided for. He also wants to ensure that his children eventually receive the bulk of his assets after Rosie is gone. Max's will leaves Rosie $2 million in her name and puts $2 million in a bypass trust. Rosie can receive income from the bypass trust and also some of its principal if needed. If any property is left in the bypass trust after Rosie's passing, it goes to their children. The remaining $1 million in the estate goes into a QTIP trust that will pay Rosie all its income for the rest of her life. The remaining property in the QTIP will go to their children after Rosie's death.

The result is that there are no estate taxes on Max's death because of the estate tax exemption and the marital deduction. On Rosie's death, she will have her own estate tax exemption and the unused amount of Max's exemption to avoid taxes on all the property she receives outright and the QTIP trust. The bypass trust isn't included in Rosie's estate. She even has enough of an exemption available in case the property appreciates. Max is assured that Rosie is taken care of and that most of his estate eventually will go to his children.

Those are your basic clean, simple estate planning options. Everything else in estate planning builds on these. You might need more than this if your estate might exceed the taxable amount or if you have special assets such as a business or real estate. Some people have special needs or interests that require different treatment. But these are the basics, and you should set up a basic plan if it will take a while to decide which other strategies to add.

Strategy #6 Maximizing Tax-Free Gifts

For many years a staple of most estate plans, even those solidly middle-class estates, was

gift giving. The estate tax exemption was so low that many estates were potentially subject to taxes. An easy way to reduce or eliminate estate taxes was to give property to loved ones. It could be removed from the estate at little or no tax cost, and future appreciation also would be out of the estate.

People whose estate still might be subject to federal estate taxes (or its state equivalent) need to consider gift giving as part of their plans. Other people still might want to make gifts from time to time for non-tax reasons.

In either case, you should know how gifts are taxed and how taxes on gifts can be minimized or eliminated.

A key tool in every giving plan is the annual gift tax exclusion. You can give each person cash or property up to the annual exemption without incurring gift taxes or using up part of your lifetime estate and gift tax credit. In 2022, the exclusion limit is $16,000 per recipient. It is $32,000 if a married couple give jointly. That means each person can give up to $16,000 of cash or property to anyone he or she chooses without owing gift taxes or using up the estate and gift tax exclusion. This amount can be given to as many different people as you want and can afford to. (The amount is indexed for inflation.) There is no limit to the number of people to whom you can make tax free gifts each year.

Using the annual gift tax exclusion is the quickest, cheapest, and easiest way to give wealth, whether you are doing it for tax or non-tax reasons. It is especially useful if your estate might be taxable. If your estate might not be taxable, you still should keep the annual exclusion and gift taxes in mind. If you give someone more than the annual exclusion, you'll have to file a gift tax return (more on this later) and use part of your lifetime estate and gift tax exclusion amount.

Consider a couple with two children. They can give away up to $32,000 annually to each child, or a total of $64,000 annually, without worrying about gift taxes. If they have grandchildren, each of them also can be given $32,000 annually tax free. The gifts can be of cash or property. The more offspring or other beneficiaries involved; the more property that can be given tax free each year.

Naturally, you do not want to let taxes dictate entirely what you do with assets. When the estate tax exemption was lower it was important to caution every couple to retain enough assets to maintain their standard of living and provide for emergencies, even if that might result in estate taxes down the road. But when a couple has more than enough assets and knows who it wants to eventually receive those assets, an annual gifting program is an excellent way to transfer the property now at zero tax cost.

Important note: To qualify for the gift tax exclusion, there must be a gift of a "present interest" in the property. In most cases that means you must actually make a definite, permanent gift of the property to the individual. You can have no legal right to get the property back or oblige the individual to use the property for certain purposes.

Naturally, many people are wary of giving substantial, unrestricted assets to some of their children or grandchildren. They want to protect the assets from waste and don't want to spoil the recipient. One way to make protect the assets and still reduce estate and gift taxes is to put the property in an irrevocable trust and give the trust a *Crummey* power. This power allows the beneficiary to withdraw the gift from the trust if the request for withdrawal is made during a certain time period during the year, usually within 30 days after the beneficiary is notified of the gift to the trust. If the beneficiary does not request a withdrawal, the property stays in the trust under the terms of the trust agreement.

The courts have held that when a trust includes a *Crummey* power, a gift to the trust qualifies for the annual gift tax exclusion. But you must be sure to notify the beneficiary each year of the gift and the right to withdraw it within the time period. Since the IRS doesn't like this rule and tries to crack down on it, be sure to actually mail a letter and keep a copy in your files. Also, you and your estate planner need to stay updated on the law, because there frequently are proposals to repeal the *Crummey* power rule. We'll discuss other ways to give money away safely in the next few strategies.

Strategy #7

More Ways To Maximize Tax-Free Gifts

Annual gifts are a powerful way to establish your legacy. Whether you make gifts to reduce taxes or for nontax reasons, you might as well maximize the tax and financial benefits from them. You also should avoid some mistakes a number of gift givers make.

Estate and gift tax reduction was the major motivation behind giving programs in the past. For most people, those aren't the main considerations. Instead, income and capital gains taxes should be the major factors in determining what to give, when to give, and how to structure gifts.

Two points should be kept in mind when planning gifts. One point is that estate and gift taxes are based on the value of property at the time the gift is made. The other point is that the recipient of a gift has a tax basis in the property. That basis determines the taxable gain or loss when the recipient eventually sells the property. You need to consider what the recipient's basis will be when you give property. Keeping those principles in mind will lead to a few shrewd gift giving practices. Consider these tips when planning gifts.

Give early in the year. Most people make their estate planning gifts around the end of the year, partly because they want to wrap up their plans before the year closes and partly because it is the holiday gift giving season. But gifts early in the year can make much more financial sense. A gift early in the year removes from your income tax return any income produced by that property during the year. If you don't need that income, you might as well give the property and the tax burden away instead of waiting for December. Giving income-producing property early in the year is especially smart if the gift is to someone in a lower tax bracket, so the family will pay lower taxes on that income.

In addition, giving early in the year might allow you to make a larger gift. Remember the tax-free exclusion and any gift taxes are based on the property's value at the time of the gift. Suppose you want to give away mutual fund shares but wait until the end of the year to make the gift. If those shares appreciate 10% during the year, you can give tax free 10% fewer shares at the end of the year than you could have at the beginning of the year. Early giving also avoids having that 10% appreciation in your estate. If your estate might be taxable, you want to remove that extra value from your estate as soon as possible, instead of waiting for the end of the year to make gifts. Giving later in the year, after appreciation has occurred, reduces the rate at which you can reduce the estate.

Giving early in the year also ensures that your tax-free gift exclusion for the year is used. Something could happen to you during the year that keeps you from making the gifts and keeps the property in your estate.

Maximize your tax-free gifts. In addition to the annual gift tax exclusion, there are a couple of opportunities to make unlimited tax-free gifts.

Education gifts are allowed tax free in unlimited amounts if they pay for direct tuition costs and not for items such as books, supplies, board, lodging, or other fees. To qualify, the gifts must be made directly to an education institution. The gifts can be made on behalf of any individual, regardless of his or her relationship to you, and for any level of education.

Medical gifts are payments made directly to a medical care provider and are for items that would qualify as deductible itemized medical expenses on Schedule A of the income tax return. When these conditions are met, unlimited tax-free gifts are allowed.

Remember that these two types of tax-free gifts are in addition to the annual gift tax exclusion amount.

Give more than the tax-free amount. Many people limit their generosity to the annual tax-free exclusion. Yet, there are good reasons to give more than that, especially when your estate is valuable enough that it might be taxable.

Remember again that estate and gift taxes are based on the value of property at the time the gift is made. That means if property is appreciating, the sooner you remove it from your estate, the lower the taxes will be or the lower the amount of your lifetime tax-free exemption that you'll use. If you wait to give the property until it is more valuable, then giving the same amount of the property (such as shares of a stock or mutual fund) will use more of your lifetime exclusion or cost more in gift or estate tax. If you don't need the property to maintain your lifestyle, seriously consider giving more than the annual tax-free amount now to get appreciating property out of your estate.

Another reason to give more now is the lifetime credit. The credit can be used against either estate or gift taxes. Many people save the credit to reduce estate taxes. But your life- time exempt amount increases only with the rate of the Consumer Price Index. If your estate is increasing at a faster rate, your heirs probably would be much better off if you used the lifetime credit early and removed some property and future appreciation from your estate now. Also, any unused estate exempt amount you received under the portability rule isn't indexed for inflation at all. You'd be better off using that now to remove appreciating property from your estate.

The bottom line is that if you don't need property to maintain your standard of living, consider giving it away early instead of in your will.

Factor in potential capital gains and losses. After deciding how much you want to give, consider what you want to give. Too many people simply write a check for the amount and give cash. It might be better to give property, and you should look at more than the value of property when deciding what to give. You have to look at the capital gain or loss in the property, who might pay it, and when it might be paid. When property is given away, the recipient takes as his or tax basis the lower of your tax basis and current market value. That means any gain during your ownership is deferred until the recipient sells the property and any loss during your ownership could be lost. Here are some ideas to keep in mind.

- It generally is a bad idea to give property in which you have a paper loss. Instead, sell the property, deduct the loss on your own tax return, and give away the cash proceeds.

A possible exception to this rule is when you already have more capital losses than you can use.

- Suppose the property will be sold at a gain right after the gift, so that the recipient can spend the cash. If the recipient is in the same tax bracket as you, consider selling the property, paying the capital gains taxes yourself, and giving away the after-tax proceeds. Otherwise, you'll be paying gift taxes or using your gift tax exclusion on the part of the property's value that is ear- marked for capital gains taxes. You'll essentially be paying a tax on a tax.

But if the recipient is in a lower capital gains tax bracket than you, give the property. That way, capital gains taxes will be paid at a lower rate, and the family will have lower taxes and more after-tax cash.

Giving to someone in a lower tax bracket is especially valuable when the property has appreciated. If your plan was to sell the property anyway, more money stays in the family if you give the property and have the lower tax-bracket recipient sell it.

- You want to hold some property and have it transferred through your estate. When you give property that has appreciated a lot, the recipient takes the same tax basis you had. That means the gain in the property eventually will be taxed when it is sold by the recipient. When appreciated property is inherited through an estate, however, the beneficiary increases the tax basis to its fair market value at your death. All the appreciation that occurred during your lifetime avoids capital gains taxes. In most cases, it is better to give other property or cash than to give property that has appreciated a lot.

Give appreciating property for long-term holding. Sometimes gifts are made with the expectation that the recipient will use the wealth to pay current expenses, whether the gift is cash or is property that will be sold. Often, however, gifts are made to help build long-term financial security. The best way to accomplish this is to give property that you anticipate will appreciate over the years. When you do that, not only is the property's current value out of your estate, but so is the future appreciation. In addition, you'll be shifting the future capital gains taxes off your tax return and onto someone else's.

One caveat to this strategy is that the recipient ultimately will owe capital gains taxes when the property is sold, unless he or she holds it for life and transfers it through his or her estate. So, you might not be giving the recipient as much after-tax wealth as you might think. The best way to avoid this problem is to select property that has not appreciated much but is likely to in the future, if you own such property.

Planned gift-giving is one of the best ways to slash your estate and gift taxes, leaving your heirs better off. But the IRS knows this is the case and is stepping up its review in these areas. The biggest issue to the IRS is the valuation of gifts of property. Because of this you should get help from an attorney or accountant when planning non-cash gifts, especially those that do not have a published market value.

Strategy #8

Boosting the Annual Gift Tax Exclusion

As an estate grows, the annual gift tax exclusion seems too small to substantially reduce the value of an estate. One way that you can increase the amount you give away tax free each year is to give money to a trust with a number of beneficiaries, including contingent beneficiaries. In the trust world, the primary beneficiary or beneficiaries are those who first receive income or property from the trust. The contingent beneficiary or beneficiaries are those who receive the income or property after the primary beneficiaries. Usually, contingent beneficiaries receive distributions only after one or more primary beneficiaries have passed away.

You can use contingent beneficiaries to increase the amount you transfer tax-free to a trust. The IRS has fought this strategy over the years, but the courts so far consistently have sup- ported it. You boost the exclusion by giving money to an irrevocable trust that has a number of primary and contingent beneficiaries.

In the classic case, an individual set up a trust that benefited her children for their lifetimes, and then the grandchildren if certain events occurred. In all, there were a couple dozen potential beneficiaries of the trust, allowing annual tax-free gifts to the trust of over $200,000, based on the annual gift tax exclusion level at the time. The IRS challenged the taxpayer’s treatment, contending that the grandchildren would only receive the property or income under certain circumstances that might never occur, so they should not be counted in determining the annual gift tax exclusion. The courts disagreed, and the substantial gift and estate tax savings were allowed.

You'll want to set up a trust like this only with the benefit of an experienced estate planner. There are a number of technical details that must be filed to make it work, and of course the IRS does not like it.

Strategy #9

Don’t Forget Gift Tax Returns

Failing to file a gift tax return is a common mistake that fouls up many estate plans and can make life difficult for heirs. The gift tax return rules are not what most people think, and that leads to many mistakes and penalties.

A gift tax return (Form 709) might be due even if no gift taxes are owed. Gifts are tax free up to $16,000 per recipient in 2022. Gifts above that amount also are tax free to the extent your lifetime estate and gift tax credit is available. Yet, you still must file the return to report gifts over $16,000 per recipient, even when no gift tax is owed. The IRS wants a record of how much of the lifetime credit is used.

Married couples can give tax free jointly owned property as a "split gift" of up to $32,000 to each recipient. Yet, a return reporting this tax-free gift must be filed by each spouse, because each spouse must consent on the other spouse’s return to the split gift. When making cash gifts, this return requirement is avoided if each spouse writes a separate check and no gifts for the year are above $16,000.

A gift worth less than $16,000 also might have to be reported. To be tax free, a gift must be of a "present interest." Gifts to trusts or that have restrictions might not be of present interests, making them ineligible for the annual exclusion. That means a return is due, no matter how small the gift. Check with an estate planner or tax accountant if in doubt about your gift tax return requirements.

Payments to or on behalf of minors that are for legal support obligations of the donor aren’t considered gifts. They aren’t applied against the annual gift tax exclusion and aren’t reportable. Support obligations of parents include housing, food, clothing, and medical care. Items that aren't legally required support or those that are paid after the child reaches majority are considered gifts that use the annual exclusion or might be subject to tax.

Most importantly, filing a gift tax return is the only way to start the statute of limitations running. With a gift of property, the IRS could challenge the value you placed on the property any time before the statute of limitations expires. If you file a return, even when you aren’t required to, the IRS has six years to challenge the value if it believes you understated the value by 25% or more. Otherwise, is has three years to challenge your treatment. If no gift tax return is filed, there is no statute of limitations. The gift’s value can be challenged any time, even after your death.

That’s why you might want to file a gift tax return even when one isn’t required. It starts the statute of limitations running. Filing a return and starting the statute of limitations is especially important when the value of the property is hard to determine. Valuation isn’t much of a problem when you give publicly traded securities such as stocks, bonds, and mutual funds. But when you give shares in a private business, real estate, collectibles, or other property without a readily determinable market value, there’s a risk the IRS will challenge the value you put on the property. The IRS loves to challenge the valuations placed on those gifts. Document how you determined the value of the property and file a gift tax return to get the statute of limitations running.

Once a gift tax return is filed, keep a copy for life. The information on the returns can affect the estate tax. If the gift tax returns aren't available, your heirs could end up paying taxes they don’t really owe.

Strategy #10

Simple, Low-Cost Ways To Help

You don't need to be a multi-millionaire to help your children or grandchildren. You don't even need to be rich. There are many simple, low-cost ways to help, and they are tax-free. With many of these strategies, you see the benefits now instead of imaging how the wealth will be used after you are gone.

The use of your property is a great way to help future generations. For example, you might have a vacation property or recreational vehicle. You can let your adult children use the property for family vacations and save them a significant expense. That savings can be used to help pay for the grandchildren's education or other future needs. Letting others use property costs you very little, and it usually has no tax consequences.

If you don't have property, you can let the family use, family loans with little or no interest are an option. Borrowers will have use of the money, and they can use it to earn more money or buy property for themselves. A loan can be used for anything from investing conservatively for extra income to starting a business. If you don't need the money back for many years, you could write a mortgage to help buy a house.

Your only cost of the loan is the earnings you could have received from the money. And you lose that only if it is a no-interest loan. You could charge a below-market interest rate. The family gets the benefit of a lower interest rate than commercial lenders charge, no credit check, and minimal costs of setting up the loan.

There are some potential tax factors to family loans. The basic rules are that you have to charge a minimum interest rate announced monthly by the IRS and that is based on treasury rates. It's known as the "adjusted federal rate" and is available on the IRS web site. If the minimum interest rate isn't charged, it will be imputed and the parties to the loan will be taxed as though the interest was charged. But there are exceptions, when no interest need be charged.

Interest is not required on a gift loan between individuals when total loans between the individuals do not exceed $10,000, and the loan is not used to purchase or carry income-producing investments. In addition, there is no imputed interest on gift loans between individuals when the total loans do not exceed $100,000 and the borrower's investment income does not exceed $1,000. If the borrower's net investment income does exceed $1,000, imputed interest on the loan will not exceed the amount of the borrower's net investment income for the year.

If you do not fall under these exceptions and still do not charge the minimum interest, the penalty is not severe. The tax law will impose "imputed interest" on the transaction. Here is one way it would work. Suppose you lend $20,000 to an adult child who has investment income for the year exceeding $1,000. You do not charge the minimum required interest rate. You are treated as though you actually received cash interest payments at the minimum rate from your adult child. That amount is included in income on your tax return. You also are treated as making a gift to the child equal to that interest. If you haven't already used the annual gift tax exclusion, the interest will be free of gift taxes under the exclusion. The imputed payment also will be free of taxes to your adult child, because gifts are not taxable. The only costs, then, are your income taxes on the imputed interest amount and any cost of having the imputed interest computed by your accountant or other professional.

The required interest is based on U.S. Treasury rates, so even when interest is required, your children and grandchildren essentially can borrow from you at the same rate the federal government pays on its debt.

When making a loan to family members be sure to have all the legal paperwork in order. Treat the transaction as a real loan to an unrelated person. That protects you in case there is some dispute as to whether you intended a gift or a loan. It helps you collect from a borrower who doesn't want to pay and helps if the IRS tries to say you made a gift. You want to show that this clearly was intended as a loan which was to be repaid. Proper documentation and a payment schedule that was followed prove you really made a loan, not a gift.

More ideas for loan strategies are in the next Strategy.

An increasingly popular strategy is to pay for family vacations. Travel can be fairly expensive, and many families with children have to stretch for or cannot afford a nice trip. A trip paid by the grandparents can give the family an experience they never would have had or save them thousands of dollars. Also, families tend to be spread across the country these days. A family trip or reunion encourages everyone to get together at least once in a while and perhaps prevents the family from disintegrating.

If you cannot afford to pay for the entire trip, pay for a portion. Sometimes grandparents will pay for a cruise or a stay at a resort. All the children and grandchildren have to do is get to and from the location and perhaps pay for some of their meals and activities at the location.

Technically, paying a share of someone's vacation costs is a gift to them and counts against the annual tax-free gift amount. But the IRS in the past has looked only at gifts of money and property. I've not seen a case or ruling in which it tried to count up holiday gifts, meals, and travel. You'll have to take these factors into account when deciding how to report these payments.

Another way to help your loved ones is to have your financial advisers help them. Suppose you get professional advice for your estate, financial plan, or investments. You can make sure that the needs of your children and grandchildren are considered in the plan. Then pass on to them any advice you receive.

You can go a step further and offer to pay for your advisers to work with your children or grandchildren. The loved ones would meet with the advisers, and all the information would be confidential between them. You will have rendered a valuable benefit, and the advisers can ensure that what the children are doing is consistent with what you are doing and that the plans are coordinated.

You should get a break on fees, or if you don't pay for everything, the family should get a break by using your advisers. A family buying as a group probably can negotiate a lower fee than could each family member buying separately.

Another benefit is that everyone in the family learns more and sees how things work together. That's a big improvement over leaving loved ones' assets and expecting them to know how to manage them. Often, being unprepared to handle the family's assets can do more damage to family wealth than taxes or probate costs.

If you are in business or are an investor, you can help family members by letting them benefit from opportunities that come your way. Instead of investing in a new business or project yourself, be sure that your family members know about it and get the opportunity to invest. Or when a family member is in the same business as you, consider sending some potential business or clients to him or her instead of keeping them for yourself.

You don't need a fortune to help your children and grandchildren. A few relatively low cost, simple strategies such as these can provide meaningful benefits. They also might give you inspiration to come up with your own ideas.

Strategy #11

No-Tax, Low-Cost Way To Help

You don't need to give away money or property to help the children or grandchildren. You can lend to them and let them build something with the loan.

Here's one plan. Lend $50,000 to your grandchild for five years.

Suppose the grandchild invests the money and earns 10% annually. At the end of five years, the grandchild has accumulated over $80,000 before taxes. The grandchild can repay your $50,000 and still have over $30,000, minus taxes, left as a nest egg. Taxes should be quite low, since the grandchild should be in the lowest tax bracket and the gains should be long-term capital gains. Your cost is the earnings you could have had from the $50,000 for five years, and your grandchild has accumulated a nice starter fund after only five years.

This is such an attractive deal for taxpayers at any income level that the tax code puts up a number of hurdles you have to clear.

As you know from the previous strategy, you are required to charge a minimum interest rate on most loans. If you don't charge the minimum, then you have a "below market loan" on which a minimum interest rate based on current market rates is imputed.

You might be able to avoid imputed interest rates, because there are several key exceptions. A gift loan between individuals, which is what we have here, does not have interest imputed when loans between the individuals do not exceed $10,000, and the loan is not used to purchase or carry income-producing investments.

Another important exception says there is no imputed interest on gift loans when loans between the individuals do not exceed $100,000 and when the borrower's investment income does not exceed $1,000. If the borrower's net investment income does exceed $1,000, imputed interest does not exceed the amount of the borrower's net investment income.

This obviously is an important exception for loans to grandchildren. You can lend up to

$100,000 to a grandchild interest free, and make sure it is invested primarily for long-term capital gains so that there is little or no annual income. If there is annual investment income, be sure to keep track of investment expenses such as broker's commissions. Those expenses are subtracted to determine net investment income. After five years, the grandchild sells enough of the investments to pay you back. There are no tax consequences to anyone, except taxes when the grandchild sells the investment.

Suppose your loan doesn't meet one of the exceptions and has interest imputed. Even then, the results aren't bad.

When interest is imputed, you will be treated as having made a gift to the grandchild equal to the interest that should have been charged but wasn't. Then you will be treated as though the grandchild turned around and paid you that amount of interest. Since you can give the grandchild up to the annual gift tax exclusion amount free of gift taxes, you aren't concerned about gift taxes until the imputed interest and any other gifts are over the annual exclusion amount of $14,000 in 2015.

You'll then have income equal to the amount of the imputed interest, though you won't receive cash. Suppose the imputed interest is $2,000 and you are in the 35% tax bracket. Your cost of making the loan will be $700 in taxes on phantom income each year, plus the earnings you could have earned on the loan amount.

If you decide to make a gift loan to a grandchild (or any other relative), you'll have to handle things properly. The IRS doesn't like loans between related parties and tries to treat them as gifts. Two Tax Court cases show how to avoid this problem.

You must show that the transfer was intended as a loan with a real expectation of repayment and an intent to enforce collection. Be sure that a note is signed by the borrower or an adult guardian. The note should spell out an interest rate and repayment schedule and contain an unconditional promise to repay. The repayment schedule, which can be a balloon payment at the end, must be followed as much as the borrower's finances permit. There also must be a reasonable expectation at the outset that the loan could be repaid. For example, a transfer to a relative with a failing business that is unlikely to recover might be treated as a gift rather than a loan.

In one case, a family construction business was experiencing hard times.

The company made a loan to the owner's son, an experienced foreman, as an inducement to be available to work for the company when new contracts were won. The son made some payments on the loans. But after a few years the son was unemployed with a lot of debts and declared bankruptcy. The Tax Court found that the transactions were loans. The corporation had a reasonable expectation of repayment when the loans were made because the son seemed likely to have employment sufficient to make the payments. (*Mann Construction, Inc.*, T.C. Memo 1999-183)

The other case involved a man who lent money to his brother. The brother's business was in financial difficulty, but that was expected to be resolved after life insurance on the brother's late partner was paid. The lending brother sold the loan to their father. Unfortunately, the borrowing brother was indicted for killing the partner and, though the indictment was dismissed, the insurance company refused to pay benefits on the life policy. The borrowing brother slid deeply into debt and said he was unlikely to ever repay the loan.

The Tax Court treated the transaction as a loan. There was a signed note requiring interest, and both parties treated the transaction as a loan. Also, there was a formal demand for payment after payments on the loan were missed. (*Barr*, TC Memo 1999-40)

If you eventually do not need the loan to be repaid, you can forgive it. That would be treated as a gift to the borrower at that time, with gift taxes on the forgiveness. Sometimes a forgiven loan is treated as income to the borrower, but that usually occurs when there is a business relationship between the parties. When the lender and borrower are relatives, forgiveness of a loan usually is treated as a gift.

One word of caution on family loans is that the assets your grandchild or other lender purchases with the loan proceeds might decline in value. I know one wealthy individual who was optimistic about a stock he thought he knew well. He decided to do an adult child a favor and lent her money with the suggestion that she purchase the stock. Unfortunately, the market did not agree with his assessment of the stock. The stock declined, and the daughter ended up owning a stock worth half its previous value and still owed her father the loan amount. He had to decide whether to forgive all or part of the loan, renegotiate payment terms, or take other action.

No-interest loans are one of the estate planning classics, used by individuals of every net worth. Consider making no-interest loans part of your plan to create a legacy.

Strategy #12

Protecting Heirs From Themselves

"Great Fortunes Lost" was an article in *Fortune* magazine years ago. It described how various individuals, usually heirs, lost or squandered very large fortunes. Some of the individuals lost more than money. They lost their health or wasted their lives because of the effects wealth had on them.

It's nice to leave enough to make the children and grandchildren comfortable. Yet, you don't want to leave them more money than they can responsibly handle or make them idle or wasteful. You also probably don't want to risk having your money end up with ex-spouses, creditors, or drug dealers.

Fortunately, you can leave enough to make your children and grandchildren comfortable and leave it in ways that avoid most of these problems. You generally want to leave money and property in a trust or trusts, with a reliable friend, family member, or professional as trustee or co-trustees. Then include some key provisions in the trust. Here are the provisions to consider.

- **Spendthrift clause:** This is the standard for all trusts and generally provides that creditors of the beneficiary cannot force payouts from the trust or be paid directly from the trust. That means that even if the beneficiary is bankrupt, the creditors still cannot invade the trust.

The creditors can lay claim to any money or property paid to the beneficiary from the trust. In addition, some states don't allow the spendthrift clause while others limit it to the first $500,000 or so of the trust. So, while you should have the spendthrift clause when it is available in your state, it is not the only trust control you need.

- **Discretionary clause:** Under this clause, the trustee has discretion to pay or not pay income and principal to the beneficiary and can decide how much to pay. This provision can work when the trustee knows your wishes well and you have left written guidelines for the trustee to follow. In these circumstances, you might not need any other protection or incentive clause in the trust. You can leave distributions to the trustee's discretion.

The discretionary clause can leave the trustee and beneficiary as adversaries, and you can't anticipate all possible situations ahead of time and give the trustee guidance on each possibility. So, it is a clause to be used carefully. A corporate trustee who is not familiar with your family also might not be able or willing to use the discretion effectively. It's likely you would need an individual who knows the family to serve as trustee.

- **Milestone or steppingstone trust:** This provision avoids giving money to an heir before he or she can handle it. Instead of leaving money outright, you leave it in a trust that will pay out only the income or will pay only for specified expenses such as education and medical care for a period of time.

The beneficiary receives principal distributions when certain milestones are met. The milestones can be reaching a certain age, graduating from college, being employed for a certain number of years, or virtually any milestone you want to set. The entire trust might be distributed upon reaching one milestone or in stages as different milestones are reached.

The steppingstone trust allows the beneficiary to learn how to handle the money and encourages the beneficiary to be useful and productive. For example, a trust could provide that one third of the principal is paid when the beneficiary reaches age 25, one third at age 30, and the rest at age 35. Or you could have smaller percentages or specific dollar amounts paid in the early years and large percentage or amounts for the later dates.

- **Matching trust:** This is another clause designed to pay out trust principal only when the beneficiary has some maturity and responsibility. The trustee makes payments to match income earned by the beneficiary. The payments can be for exactly the beneficiary's salary or be a multiple of it, such as three times the salary. You might set up the trust so that these are the only distributions, or they are supplements to basic distributions.

The matching trust can be a bit unfair if there are several heirs, or it might give the beneficiary the wrong incentives or values. An heir who is attracted to a relatively low-paying occupation will receive less than a sibling who is drawn to a higher-paying profession. The trust might cause the heir to seek employment in a high-paying field rather than one which he or she enjoys the most or is most suitable. So, the matching trust must be used carefully.

- **Escape clause:** This clause is called by a number of different names, but the meaning always is the same. No matter how carefully you choose from and draft the provisions already mentioned, the beneficiary still might not be ready to handle a large sum of money at the time it is scheduled to be distributed. Perhaps the grandchild drifted into substance abuse, gambling, or high- risk business ventures or is going through a nasty divorce.

If you don't want your wealth distributed under those circumstances, the escape clause makes that happen. The clause allows the trustee to withhold payments when it is in the best interests of the beneficiary. Some people spell out the circumstances under which payments should be withheld. Others realize that they cannot anticipate every circumstance, so they give the trustee a broad, general power to determine when withholding payments is in the beneficiary's best interests. Payments to the beneficiary resume when the situation that caused suspension of the payments is resolved and the trustee concludes a distribution is in the beneficiary's best interests.

- **Emergency clause:** Some of the saddest estate planning stories are those in which the trust creator concentrated on situations in which money was not to be distributed and ignored special circumstances under which payments should be increased. For example, you probably would want the trust to be used if your grandchild developed special medical needs or wanted extended education. It is a good idea to leave the trustee the power to increase payments in these and other special situations.
- **Marital agreements:** Would you like a big part of your estate to end up in the hands of someone you never knew? The wealth could end up with a second spouse or the children of a second marriage of one of your current in-laws or a future spouse of one of your offspring. Once someone inherits part of your estate or receives a gift from you, that wealth typically is part of the person's marital estate. If there's a divorce, the other spouse could receive all or part of the wealth. You can avoid this situation by telling your children that they won't get anything, other than income payments from a trust, unless they have valid premarital or post marital agreements.

These agreements are very flexible, and the couple can put in whatever terms they like. But the basic clause you want is that any gifts or inheritances from you or trusts you create are not considered marital property to be divided in the case of a divorce. They are the separate property of the beneficiary.

For a marital agreement to be valid, each party should have separate legal counsel, there must be full financial disclosure from each party, and there must be enough time taken to contemplate the agreement.

You can't plan for all contingencies. But you can plan for the ones that have caused problems for people in the past. By inserting a few carefully chosen words into a will or trust you can ensure that your children and grandchildren are cared for and reduce the probability that your estate will be squandered or wasted.

Strategy #13

The Advantages of Giving Now Instead of Later

Many people fall into the trap of believing that, since the estate and gift tax rates and credits are the same, it doesn't matter whether you give property away during your lifetime or under your will. The fact is, if property is going to be subject to the federal wealth transfer taxes or you are going to use your lifetime credit, you often are better to give and pay taxes now rather than later.

The key to remember once again is that estate and gift taxes are based on the value of assets. If you have assets that appreciate or produce income, the odds are that they are going to be worth more in a few years than they are now. If you wait to give the property away, the estate taxes in the future will be higher than gift taxes today, or you will use more of your lifetime credit later than you would today. If you do not need an asset to maintain your standard of living and you know who eventually want to own it, the family probably will realize a net tax saving if you give the property away sooner rather than later.

Take the case of a successful professional with a net worth of $10 million. He owns a second home worth $750,000 in a popular resort area. The home has appreciated, and all indications are that it will continue to appreciate for years. The professional has no plans to sell the property and plans to leave it to his children.

An estate planner shows the professional that his estate is likely to increase in value faster than the estate tax exempt amount and be taxable. Since he has not made any taxable gifts in his lifetime, if he gives the home to his children now, he will use up $750,000 of his lifetime estate and gift tax exemption equivalent. The future appreciation of the house also will be out of his estate. He still will have the rest of his credit to shelter other gifts either during his lifetime or in his will. The home can be removed from the estate without giving it directly to his children. It can be put in an irrevocable trust for the benefit of the children. Other structures also are possible.

Suppose the professional doesn't give away the property now, he has a life expectancy of 15 years, and the home appreciates 5% annually. At the professional's death, the home will be worth more than $1.5 million. The home will use more of his lifetime credit than before, reducing the amount of other wealth that can be sheltered from taxes.

This analysis holds for any appreciating asset—real estate, stocks, and collectables, for example. If your estate is above the exemption equivalent amount, you should seriously consider giving away appreciating assets now rather than holding them until your death. You want to keep enough assets and liquidity to provide for your foreseeable needs but consider giving away other assets now.

Strategy #14

Avoiding Probate To Save Time and Money For Your Heirs

Virtually every family has a horror story of how, after a relative died, the estate was tied up in probate for a considerable time and was substantially reduced by lawyers' fees and other costs. For that reason, many people have an estate planning goal of avoiding probate.

The most common ways of avoiding probate are to transfer assets to a revocable living trust and to hold property in joint title. The pros and cons of using these and other methods to avoid probate are discussed in Chapter Two.

Strategy #15

Deciding to Let Uncle Sam Get His Share

Sometimes the traditional strategies to reduce estate taxes are not practical or appealing. It might be difficult to give away an asset in increments over the years to make tax-free gifts. Or you might want to retain control of your assets for life. There are a lot of reasons why someone might not want to reduce the value of an estate enough to avoid estate taxes. In these and other cases, you might decide not to look for ways to reduce gift and estate taxes. Instead, you decide to let life insurance pay the taxes.

Let's use the case of Max and Rosie Profits. Max is a successful business owner. His business is worth $20 million. Giving away shares of the business now is not acceptable to Max.

So, instead of planning to remove the business from his estate, Max decides to retain ownership of the business and estimates the maximum tax the estate will have to pay. Max must be sure to estimate the growth in value of the business over his life expectancy or at least the period he is likely to retain full ownership. Max decides to buy permanent life insurance to cover this tax bill. He doesn't want to buy term insurance, because that eventually will expire. The estate tax isn't likely to expire, so Max needs insurance that will be in effect indefinitely. A permanent life insurance policy with a cash value is required to meet Max's goals.

There is an additional step Max must take to get the maximum benefit of this strategy.

Recall from Chapter Three that life insurance is included in Max's estate when he has any "incidents of ownership" over the policy. If Max buys and holds a policy and names his estate or children as beneficiaries, then the insurance proceeds will be part of his estate and subject to estate taxes. Max will have to buy even more life insurance to pay the additional estate taxes on the life insurance.

A better solution is for Max to set up an irrevocable life insurance trust. The trust has an independent trustee who is empowered, but not required, to buy permanent insurance on Max's life. The trust agreement provides that any insurance benefits will be distributed to Max's estate to pay the taxes and other expenses. Any additional amounts will be paid to other beneficiaries designated by Max.

To pay for the policy, Max transfers money to the trust equal to the premium payments.

The trustee uses the money to buy insurance on Max's life. The trust must have a Crummey provision to ensure that the annual gifts to it are tax free (see Strategy #6.) Max either can give a lump sum so the trustee can buy the policy with a lump sum premium, or he can make annual gifts sufficient to pay annual premiums on the policy. Max should have an annual gift tax exclusion ($16,000 per person per year) for each beneficiary of the trust. If the trust has three beneficiaries, Max can give $48,000 annually without worrying about gift taxes. If Max is married, he and his wife jointly can give up to $96,000 annually free of gift taxes.

The results are that Max's business and other assets stay intact and the estate taxes are fully paid.

A life insurance policy can meet estate planning needs whenever an estate is composed of assets that cannot be divided through gifts or other means over the years, or when the assets are illiquid, and you do not want to risk having

them sold at fire sale prices after your death. Ideal users of this strategy are owners of businesses, real estate, collectables, or investments that are illiquid or highly volatile.

Instead of reducing the estate tax bill, you are deciding to pay the tax but are looking for a way to pay it at a discount. You have to be medically qualified to buy the life insurance. Many people are able to buy, say, a million dollars' worth of life insurance by paying much less than a million dollars in premiums over their lifetimes. If that is your case, you can use life insurance to pay estate taxes in advance at a discount. When you can reduce estate taxes through the other methods discussed in this book, they usually are cheaper than life insurance. But in other cases, life insurance is the most efficient way to handle estate taxes.

There are a couple of alternatives to an irrevocable life insurance trust. One method is simply to have individuals other than you own the insurance policy. A policy could be owned by one or more of your children or your spouse. You make annual gifts directly to them, and they pay the premiums. This avoids the cost and hassle of setting up the trust and also avoids having to qualify for the *Crummey* provision. There are two potential disadvantages. One risk is your annual gifts might not be used to pay policy premiums. There is no legal requirement that the gifts be used that way (or they wouldn't be gifts). A second risk is that the policy beneficiaries might pocket the insurance proceeds after you die instead of using them to pay estate taxes.

Another alternative for owning the policy is a partnership or limited liability company. The principles here are essentially the same as for a trust. Using a partnership to own life insurance still is a fairly new strategy and the tax rules are not always as clear cut as for the trusts.

Strategy #16

Getting Maximum Life Insurance Benefits for the Dollar

Permanent life insurance can be expensive. One way for a married couple to drive down the cost of using insurance to pay estate taxes is to use a type of life insurance known as second- to-die, joint life, or survivorship life insurance.

The policy is taken out jointly by a husband and wife and pays the death benefit only after both spouses have died. Since two lives are being insured rather than one, the insurance is cheaper per dollar of benefits than a single life policy or two single life policies.

Max and Rosie Profits could use a survivorship policy instead of a policy on only Max's life. Their wills could make full use of the marital deduction by leaving their entire estates to each other. When the second spouse dies, all the property would be in that estate. Then the trust would receive the insurance benefits and give them to the estate to pay the taxes.

Survivorship life insurance can be easier to obtain than a policy covering a single life. Since it is covering two lives, insurers often will issue a policy when one of the spouses is insurable, even when the other spouse isn't insurable or would be charged a high premium.

Survivorship life also usually doesn't have a cash value account, though it is permanent life insurance. The lack of cash value and the coverage of two lives instead of one means the premiums usually are lower than for alternative insurance.

There are different versions, such as permanent universal survivorship life, that have different terms and can become complicated. There also are policies that allow the insurer to raise the premiums after a period of time. It also is possible to buy a policy that allows the spouses to split the policy into two separate policies, one for each spouse without evidence of insurability in case of a divorce. Another good feature allows you to increase the death benefit without additional evidence of insurability. This is protection against your estate growing faster than you anticipate or you're living much longer than expected. You want to work with an estate planner and a sophisticated insurance broker to select the survivorship life policy that might be best for you.

It is especially important that you compare survivorship policies from different insurers. Premiums vary considerably for essentially the same policy. It is not unusual for one insurer to offer the best premiums for policyholders of one age but relatively high premiums for policyholders of another age.

Strategy #17

Estate Planning with Roth IRAs

An IRA, especially a Roth IRA, is valuable for more than your retirement planning. Your estate plan can be much better when a Roth IRA is shrewdly used.

Instead of looking at the front-end tax benefits and costs, take the long-term view. While converting a traditional IRA to a Roth can save estate taxes, Roth IRA can leave your heirs better off even when your estate won't owe federal estate taxes.

An IRA, whether traditional or Roth, is included in the owner's gross estate. After a traditional IRA is inherited, the beneficiary must include all distributions in gross income just as the original owner would have.

Distributions from an inherited IRA are known as income in respect of a decedent, which could give the beneficiary a tax deduction for the share of estate taxes attributable to the IRA. The deduction shelters a portion of the IRA distributions from taxes. See IRS Publication 559 and Strategy #40 for details about the write off.

Suppose instead of maintaining a traditional IRA for life you convert it to a Roth. In a conversion, you treat the converted amount as though it were taken as a distribution. So, you pay income taxes on the converted amount.

Most people don't want to pay taxes before they have to, but this tax bill has several long- term benefits.

First, you're in effect paying income taxes for your heirs. They would have owed the taxes in the future when taking distributions from the IRA. Instead, you pay them now, and avoid estate and gift taxes on that gift. In the future when your beneficiary takes distributions from the Roth IRA, those distributions are tax free. In addition, you and your heirs avoid any taxes on future growth of the IRA.

Second, paying the taxes now reduces the size of your estate and any taxes on it. This is key for taxable estates and also is important when you live in a state with an estate or inheritance tax. Remember, the traditional IRA has an embedded income tax bill. Your beneficiary enjoys only the after-tax amount, not the market value of the IRA. But federal and state death taxes will be imposed on the market value. So, your estate would be paying estate taxes on the embedded income taxes.

Third, the conversion provides lifetime income tax benefits to you. When you maintain a traditional IRA, after age 72 you're required to take minimum annual distributions. When you don't need this money for spending, it simply increases your taxes. It could increase your income enough to push you into a higher tax bracket, reduce itemized deductions, increase taxes on Social Security benefits, and have other effects. The older you are, the higher the required distributions and taxes on them.

RMDs and all the stealth taxes turn tax planning on its head. You and your beneficiary are likely to be better off when you pay the taxes early, such as in a conversion. After that, there are no RMDs and the IRA compounds tax free.

The benefits of paying income taxes now instead of later are reduced when you are in a higher tax bracket than your beneficiary is likely to be when he or she takes distributions from the inherited IRA. But that doesn't eliminate the benefits of conversion, and it's difficult to forecast the tax bracket your beneficiary will be in over the rest of his or her life.

When you have a Roth IRA, you want to plan who the beneficiaries are and how they will receive the IRA. If your children are mature adults, you won't need to do more than name them as beneficiaries. They'll inherit the IRA and manage it as they wish. You decide the percentage each will receive and put that in the beneficiary designation form.

As with traditional IRAs, when a Roth IRA has multiple beneficiaries, they can decide to split the IRA into separate individual IRAs for each beneficiary. You may want to do that yourself now. Split the IRA and name one primary beneficiary for each. Or you can continue having one IRA and be sure the beneficiaries know they can split it.

More thought is required when beneficiaries are young. IRA custodians report that most IRA beneficiaries take a distribution of the entire IRA and spend it soon after inheriting it. You might want to prevent that. You also might want to take precautions when a beneficiary is not likely to manage the investments well.

In those cases, consider naming one or more trusts as beneficiary of the IRA.

Suppose Max Profits has a large IRA and names his adult children and his grandchildren as beneficiaries. He leaves 30% to each of his two children and 10% to each of the four grandchildren. The grandchildren are young. Max doesn't want them making decisions about the money until they are mature adults. If they want to spend the money then, it's up to them. But until then he wants the Roth IRA to compound and be a "stretch IRA" for them.

The most likely solution is to name trusts as the beneficiaries instead of the grandchildren individually. A trust is set up for the benefit of each grandchild. After the IRA is inherited, the trustee takes required minimum distributions using the life expectancy of the trust beneficiary. The distributions go to the trust. While the grandchild is young, the

distributions can be paid from the trust to the parent or custodian of the grandchild. After the grandchild turns 21 or so, the trust agreement can provide the distributions are paid directly to the grandchild.

The grandchild is not able to compel distributions greater than the required minimum, though the trustee can make larger distributions when he or she deems it in the best interests of the grandchild.

When a trust is an IRA beneficiary the trust agreement must be carefully drafted. The tax code requires certain language for it to qualify as a "see through" trust and allow the stretch out IRA. Should the trust be done incorrectly, the ability to take only the required minimum distributions is lost. The entire IRA would have to be distributed within five years of the original owner's death. You need an experienced attorney to draft the trust agreement, and the IRA usually must be worth $100,000 or more for the cost to be worthwhile. The attorney also should be able to tell you if the trust provides some asset protection in the beneficiary's state.

Under the SECURE Act enacted in 2019, beneficiaries of inherited IRA no longer can use the full Stretch IRA strategy. Beneficiaries younger than 21 can take annual required minimum distributions based on their life expectancies and let the rest of the IRA compound. But once they turn 21, the beneficiaries must distribute the entire IRA within 10 years. If a beneficiary is 21 or older when inheriting, the IRA must be distributed within 10 years.

Be sure to consider the estate planning benefits before deciding which type of IRA you want.

Strategy #18

The New Era Of Dynasty Trusts

Dynasty trusts have been a mainstay of estate planning for a long time. They are a standard way to ensure family wealth is preserved and grows through several generations. Avoiding taxes has been a strong incentive to create a dynasty trust since the beginning of estate and inheritance taxes. Given that background, it would be logical for dynasty trusts to decline in use now that fewer estates are subject to the estate tax. In fact, dynasty trusts still are useful to many families. With few families needing to worry about the estate tax, more families can emphasize the non-tax goals of estate planning. These goals include wealth preservation, creditor protection, multi-generation investment management, and value-based distributions. The dynasty trust is the ideal vehicle to achieve many of these goals.

A dynasty trust is very flexible. Its terms can be set to meet the goals of an individual estate owner. The trick these days is to shift gears from emphasizing tax savings to considering broader goals for the family and the wealth.

The trust can be set up during the creator's lifetime or in the will. Most often it is started while the creator is living. With the high lifetime estate and gift tax exemption, a large tax-free dynasty trust can be started early. A married couple can jointly start one using their lifetime exemptions. The high limit on the generation-skipping tax also makes dynasty trusts more feasible and useful. Before the 2001 tax law began increasing the exemption, dynasty trusts of any value generally could be created only with life insurance or with property that was not worth much at the time but seemed likely to appreciate. Now, with the higher exemption, other assets can be used to fund a dynasty trust.

Those with very valuable estates can increase the tax-free funding of the trusts during their lifetime with sophisticated tax-slashing strategies such as intentionally defective trusts, installment sales, shifting economic opportunities to the trust, and other shrewd moves.

Typically, just one trust is created during the creator's lifetime. After that, the trust often is split into different trusts for each child of the family. Other options are to maintain one trust with subtrusts for accounting purposes. After a child dies, that trust or subtrust often is split into separate trusts or subtrusts for each of his or her children. Or there can be one trust all family members share. As I said, the dynasty trust is very flexible. When you work with an estate planner who is experienced with the trusts, you can find the structure that best meets your needs.

When created, the trust is irrevocable, which produces the estate and gift tax savings. Many states also allow the trust to be written in a way that the wealth is protected from creditors of the creator and of the children.

The amount of wealth that can be added to the trust after the creator's death depends on the size of the estate and the tax law in effect at the time. Your will should have several contingency clauses, so that additional wealth will be added only if the tax cost is reasonable. Whatever happens with the tax law, once the trust is created during your lifetime it stands as a pool of assets exempt from further estate and gift taxes.

After the trust is created, there are many options for its operation. You determine the operating rules when the trust is written, so give the options a lot of thought.

The classic operation is for the trustee, or a group of trustees, to have discretion to invest the principal and make distributions of income and principal to family members. The creator might leave a statement of principles that would guide the decisions. But the actual decisions would depend on a vote of the trustees.

An option that became more popular in recent years is to have distributions based on goals or values, or a combination of the two. These were covered earlier when we discussed trusts that protect heirs from themselves in strategy #12. For example, distributions might be made for a beneficiary's education and living expenses until age 21. Subsequent distributions might depend on the beneficiary's graduating from college or staying employed. One-time distributions of principal might be made when other milestones are met, such as reaching a certain age. Some trusts increase distributions upon marriage. The distribution formula might make adjustments for those who do charitable work or enter lower-paying, service-based occupations. The amount of the distributions might be based on the income or value of the trust, ensuring that the trust will last beyond the next generation. The choices are limited primarily by your goals and imagination.

A more recent, creative approach is to have the trust make few formal distributions.

Instead, the trust will buy items or make investments for the use of the beneficiaries.

In this variation, the beneficiaries are expected to pay for their basic living expenses with earnings from their jobs or businesses. These expenses would include food, schooling, clothing, cars, vacations, and other consumable items. The trust would acquire assets for the beneficiaries to use that also are expected to increase in value. Such assets could include houses, artwork, jewelry, businesses, and vacation homes. If a beneficiary wants to start or buy a business, the trust could make the investment and let the beneficiary operate it.

A potential disadvantage is that the dynasty trust is irrevocable. The family would be locked into an arrangement until the trust expires. One way to avoid that is to give the oldest beneficiary of each line a broad power of appointment that essentially would allow him or her to rewrite the trust. You might not believe this is necessary, because once the trust is created the wealth should avoid future taxes even if the law changes.

The new tax law gives families an opportunity to safeguard assets for several generations instead of looking for the lowest tax way to pass assets to the next generation. You can broaden your focus to providing for generations after the next one and use a trust to protect the wealth from creditors and waste. It's worth taking a fresh look at the dynasty trust.

Many states are making it easier to set up a dynasty trust. Traditionally a trust's existence was limited to roughly 100 years by a complicated law known as the Rule Against Perpetuities. More and more states have repealed or substantially changed the Rule Against Perpetuities. Perpetual planning is easier and more effective when a trust is based in one of these states.

Don't automatically conclude that this strategy is not for you. Trusts aren't just for the super wealthy anymore. IRS statistics show that the average trust has about $250,000 in it, not exactly Buffett-Gates territory. That's because many people have learned that trusts can be useful for even middle-class families.

Strategy #19

Passing On a Home For Maximum Tax Advantage

One of the most difficult problems in an estate plan often is the family home or vacation home. It is an especially significant problem for estates that are likely to be taxable. A principal residence or vacation home is likely to have significant value. The key to reducing estate taxes is to remove property from the estate. Yet, you probably want to retain use of your home or vacation house.

A vacation home also can create probate problems. It is going to be in a different area than your principal residence. That likely means the vacation house will require a probate process that is separate from the rest of the estate. Multiple probate processes increase the cost of settling the estate and could result in delays.

One solution is the qualified personal residence trust. It is a classic estate planning tool that still works. IRS regulations on the QPRT are detailed, making it easy for the estate planner to avoid traps and mistakes.

Suppose Max Profits has a $1,000,000 vacation home and is age 60. He wants his children to inherit it, but he wants to continue using the home. To meet his goals, Max creates an irrevocable trust and transfers the house to the trust. Under the trust terms, Max has use of the home as his own for 20 years.

If Max is still alive after 20 years, the home is out of his estate. It likely has appreciated and is worth significantly more than $1 million, but Max removed it from his estate and incurred any gift taxes when it was worth only $1 million. When he drafts the trust, Max has some options for how the house will be treated after 20 years. Title to the house can be transferred directly to Max's children or other beneficiaries he named for the trust. Or the house can remain in the trust and be available for the use of the beneficiaries under terms established in the trust. If Max wants to continue to use the home after the 20 years, he'll need the permission of the trustee or the children. He should pay rent for any use of the house.

When Max transferred title of the house to the trust, he made a taxable gift. The annual gift tax exclusion couldn't be used, because the gift to his children was not of a present interest. The children had no rights to the property for 20 years. He had to use part of his lifetime exemption or, if that already was used, pay gift taxes.

The value of the gift wouldn't be the market value of $1 million. The gift tax computation is in IRS regulations, and the value of the gift is its present value calculated using current interest rates and the length of the trust. Each month the IRS publishes the interest rates to be used for these and other computations, known as the adjusted federal rates or the section 7520 rates.

If the applicable interest rate for the month the property is transferred to the trust is 2.2% and the trust term is 20 years, the taxable gift is $375,430 of the $1 million value. If the trust term were less than 20 years, the taxable gift would be higher. If the interest rate were higher, the value of the gift would be lower.

Note: If Max doesn't survive more than 20 years, the full value of the house is included in his estate as though the trust never were established. When creating a QPRT it is important to set the trust term for a period that is less than the life expectancy of the property owner.

The QPRT can be used with a principal residence. If Max used the QPRT with his main home and survived 20 years, he would have several options. He could move into a different home. He might have been planning to downsize at that point in his life anyway. He also could remain in the home but pay his children or the trust fair market rent. That would be another way to benefit his children, by paying them rent on the home. The rent would avoid any gift tax consequences. Most QPRTs, however, are done with homes other than the principal residence.

The grantor of the trust (Max in the example) and his or her spouse are not permitted to purchase the home from the trust as any point.

During the trust term, Max is treated as owner of the property for federal income tax purposes. He pays and deducts the real estate taxes and any mortgage interest. If the home is sold during the trust term, the qualifications for tax-free treatment are determined by looking at Max's ownership and residence of the property. After a sale of the property during the trust term, the proceeds must be reinvested in a new residence within two years. If they proceeds aren't reinvested, the trust must either terminate and distribute the proceeds to the grantor or convert to a grantor retained annuity trust (GRAT).

There are tax complications if the home has a mortgage. The mortgage balance is subtracted when computing gift taxes. Future mortgage payments by the grantor are considered to be additional gifts. If the beneficiary or trust takes over the mortgage payments, then the trust grantor is treated as selling the property and receiving the amount of the outstanding mortgage balance in return. Because of these complications, it is best to transfer a property that doesn't have a mortgage.

Only a personal residence, either primary or secondary, is eligible for a QPRT. Commercial properties and other types of real estate don't qualify. A single person can have no more than two QPRTs, and a married couple can have up to three QPRTs. The trust is allowed to receive only a personal residence and a limited amount of cash. The cash allowed is only enough to cover the cost of purchasing a home (if one isn't transferred to the trust), improvements, and mortgage payments for the next six months.

Since you are making a gift, your children or other beneficiaries of the trust will take a tax basis in the home equal to your tax basis. That means if you have a low basis in the property, your children eventually will pay taxes on any capital gains when they sell the property. You have to consider the tradeoff between the capital gains taxes and the estate tax savings and other advantages when deciding whether or not to create a QPRT.

Additional property related to the house, such as household furnishings, does not qualify for the tax breaks of the QPRT. If you transfer these items in trust along with the house, then you will owe gift taxes on 100% of the value of the furnishings and other personal property.

To get the maximum benefits at the lowest cost from a QPRT, you should be young enough to reasonably expect to live more than 10 years. If you are older, then a QPRT still might work if you can justify a relatively low appraisal on the home. But older clients who have high-priced homes probably won't get much savings from using a QPRT and should consider other options.

When the QPRT doesn't appeal to you, there's another creative strategy to consider based on an IRS ruling.

The couple sold their home to their children and excluded all the gain from income using the $125,000 exclusion that then was available to homeowners who were age 55 or older. The children had a choice of either getting a traditional mortgage from a lender or having the parents finance the sale through a private annuity. Under a private annuity, the children promise to make regular payments to the parents based on the value of the home, prevailing interest rates, and age of the parents. Either choice would work.

After the sale, the couple continued to live in the home. Again, there was a choice. One option was to pay rent to the children. The rent is another way to get money out of the parents' estates and into the children's hands without incurring gift taxes. Renting also gives the children a tax shelter. Since they now own the home, they can deduct depreciation and other expenses from the rent.

The second option was for the parents to live in the home rent free. The rental value of the home would be a gift from the children to the parents. If the value of the gift exceeds the annual gift tax exclusion, the children must pay gift taxes or use part of their lifetime estate and gift tax credits. (IRS Letter Ruling 8502027) The results of this strategy are that the home is out of both parents' estates, is in the children's hands, and the parents continue to live in the home.

Strategy #20

Profit By Giving Your Home Away

Suppose you want to live in your home for the rest of your life. You don't feel a need to leave the home to your children, because there are other assets to provide for them. But you want to reduce overall estate taxes and getting the house out of your estate would be a good way to do that. Even if you don't have an estate tax problem, this strategy is worth considering for its income tax benefits.

The strategy for you might be the charitable remainder interest. Under this strategy, you change the deed on your property so that you retain the right to live in the home for the rest of your life (known as a life estate), but a charity gets ownership of the home automatically upon your death. The property interest you give to the charity is known as a "remainder interest" or "charitable remainder."

The result is that you get a current income tax deduction in the year you set up the remain- der interest for the charity. The deduction is based on your age, prevailing interest rates, and the current value of your home. The older you are, the greater the percentage of the home's current value you are allowed to deduct. If you sell the home during your lifetime, the charity will get part of the sale proceeds, and you will get part.

Suppose Max Profits at age 60 determined his house was worth $300,000 and the land on which it sits was worth $100,000. He decides to give a remainder interest in the home and land to a charity, reserving to himself the right to live in the home for the rest of his life. After going through computations required by the IRS regulations, Max's estate planner determines that the value of the remainder interest given to the charity is $165,622. That is Max's current income tax deduction, and all future appreciation of the home is out of his estate. The older Max is when set- ting up the charitable remainder, the greater the percentage of the home's value the tax deduction will be.

This strategy is not reversible, so you should not set up a charitable remainder in your property unless you definitely do not want to leave it to your children or any other heir.

Strategy #21

Investing The Family Way

Family limited partnerships are evolving, and people are finding more uses for them.

Until recently, family limited partnerships (FLPs) were considered primarily vehicles for reducing estate and gift taxes. But these vehicles are so flexible that families are finding many practical uses for them, even when taxes aren't an issue. You might find that they can keep your family together and help its wealth grow faster.

Estate planners first became attracted to FLPs because they could generate estate and gift tax discounts. In the standard strategy, a couple forms an FLP, naming themselves as general partners. Property—such as cash, a business, or real estate—is transferred to the FLP in exchange for the limited partnership interests. The couple then can transfer the limited partnership interests to their children and grandchildren, either all at once or over the years.

As general partners, the parents control how the assets are managed. Because of that, and because none of the limited partners will have more than 50% of the vote, the limited partnership interests are valued at a discount. This "control discount" means the limited partnership interests are worth less than a pro rata share of the FLP's underlying asset value. Since the FLP interests are not publicly traded and could take years to sell, a "liquidity discount" also is applied.

Together the discounts could reduce the value of the limited partnership interests by 20% to 40%—sometimes more. That means the parents can give a child a 20% interest in an FLP interest that has $1,000,000 in assets but make a taxable gift of only $160,000 to $120,000 of value instead of $200,000.

FLPs have more than these tax advantages. You might even want to use them when there are no tax advantages.

The greatest risk to family wealth, especially these days, probably is not taxes. More often, family wealth is lost because those who inherit it don't know how to manage it or because of family rancor. Forming an FLP now is a way for all the family members to learn how to manage wealth and to work together.

The grandparents can put in all the money to start, or each child and grandchild can contribute cash to the FLP. As general partners the parents can set the agenda and have ultimate control over what is done with the assets. The FLP can be used as a great way to educate the younger generations and encourage them to think more about investing and managing wealth. They can learn how different investments fit together, how assets are selected, and how to make decisions regarding the assets. Eventually, the younger generations should be able to make good decisions on their own.

The FLP also gives the family a reason to come together regularly and ensures they have something in common. This can be important when family members develop different interests and live in different parts of the country.

You can get other benefits from an FLP. By pooling a family's wealth, or at least a portion of it, you might pay lower investment fees. Most investment managers reduce the percentage fee they charge for larger accounts. Many investment accounts also have high minimum investment requirements. By pooling funds, the family might qualify in ways that not all members could individually.

An FLP is more flexible than a trust. As general partners, the parents control which assets are bought and sold, when cash is distributed, and other key issues. The family can manage the assets themselves or hire outside managers who are supervised by the partners. Limited partners can leave and go their own way by selling their interests to the partnership. Or the whole operation can be liquidated by a vote of the partners.

If you decide to set up an FLP, carefully think through the operation. When one of your goals is for the younger generations to learn about wealth, be sure that partner meetings are educational. Set learning goals for each meeting. It is a good idea to have an outside adviser at each meeting to discuss some aspect of the partnership assets. Or you can prepare your own presentation on one or more topics. Set a goal of having the younger generations make presentations and recommendations over time. Many advisors believe an outside person, such as an attorney or investment adviser, should lead discussions so that there is more of a feeling of equality among the partners.

You'll also want some key provisions in the FLP agreement and in the operations.

- Goals and communication are important. The family should draft an investment plan or policy statement together. Key features include goals and parameters for the portfolio, voting rights, how differences will be handled, and rules on how decisions will be made. If the partners cannot agree on these basic procedures, then the family probably cannot invest together.
- Partners should receive regular reports on how the investments are doing. There also should be regular meetings, probably quarterly if that is feasible, with specific agendas.
- The FLP should have a way for partners to leave. You don't want to make it too easy for a partner to exit. Otherwise, someone will want to exit after every disagreement. But you don't want to lock in a partner who cannot work with the others or who is unhappy with the direction of the FLP. For example, you might want to require notice of six months to one year before a partner can withdraw and set the terms of how the partnership or other partners will buy out the interest.

- The partners should have adequate assets outside the FLP. The FLP is supposed to be for long-term investing of family wealth. You'll want a provision that lets partners get some cash for emergencies or special situations. But generally, income for basic living expenses should come from outside the FLP. The only exception should be for taxes owed on partnership income and gains. These pass through to partners whether or not the cash is distributed. So, the partnership should distribute enough cash to pay the taxes.
- Set a distribution policy. Often family wealth dissipates because one group of the family decides it wants or needs cash now to spend. They aren't content to have wealth on paper. Sometimes the members who want cash simply want a higher standard of living now. Other times they are struggling to pay for things such as their children's education. Determining a distribution policy might be the hardest part of a family investment pool such as this.
- Since the GPs have final control, it is important to have a succession plan in place. The plan should name the actual successors, so everyone knows who they will be. That usually is better than a provision that requires the partners to agree on new general partners shortly after one or both parents have passed away. Or you might conclude that the FLP won't be sustainable after the first generation is gone and so plan for a liquidation after that.
- Don't try to set up an FLP on your own. An attorney should draft the documents and lead discussions to ensure all issues are being explored. It also is a good idea to have an investment adviser assist in the discussions about how the money will be invested.

Properly set up and managed, an FLP can teach the whole family more about money and make the whole family's wealth last considerably longer.

Strategy #22

Fixing What's Wrong With Many Trusts

Many families needlessly have several generations at war with each other over trusts. Low interest rates make the situation even worse than in the past. Yet the situation could be fixed easily and leave everyone better off.

The problem starts with good intentions. The individual setting up the trust wants to provide income to support one generation, usually the grantor's surviving spouse. After that generation has passed on, the grantor wants the trust principal to go to the next generation.

The problem is caused by the focus on providing the "income" of the trust to the first generation. To provide enough income to meet the first generation's needs, the trustee must invest for income. When interest rates are very low, that is very difficult. It means investing most of the trust in income-generating securities just to generate enough income to distribute a meaningful amount to the beneficiary. It also can mean taking risk to earn a desirable yield.

This is where the war begins. The second generation sees the appreciation that is possible in stocks or real estate and computes what the trust would compound to over time if it were fully invested for growth. Not only is the value of the trust stagnant, because it all is invested for income, but the purchasing power of the principal after inflation actually is declining. The second generation accuses the first generation of benefiting at the expense of the second generation. Meanwhile, the first generation believes it isn't receiving enough income and sees its standard of living being reduced by inflation and low income.

This situation could be avoided with a simple change in the mindset of the trust grantor, a different wording in the trust, and a shift in the investment and distribution strategy of the trust. Instead of paying the first generation "income" and having the trust invested to generate sufficient income for the first generation, the trust should pay the first generation either a fixed amount or a fixed percentage of the trust principal. The trust could be invested in whatever way the trustee believes will generate the best total return. That benefits both generations.

This type of trust, which usually leaves everyone better off, is called a "unitrust." It pays either a fixed annual amount each year (which can be adjusted for inflation) or a fixed percentage of the assets. The trust then invests for both growth and income—for total return, in other words.

In practice, the trust periodically will sell assets to make the annual payouts instead of relying on bonds and similar investments to generate enough "income." If the stock market rises at its historic rate (or any rate that beats the distribution rate plus inflation), both the first and second generation will be better off. Income distributions will increase, because the value of the trust will increase. And even after the payouts and expenses, the value of the trust

principal will increase, probably much faster than the rate of inflation. Another benefit is that taxes on the trust and its beneficiaries should be less, since long-term capital gains are taxed at a lower rate than income.

More trusts aren't set up this way because trust lawyers and clients on the whole haven't kept up with changes in the investment landscape and with the fact that people live longer. There was a time in the 1960s when unitrusts were catching on. But the essentially flat stock market from 1966 to 1982 (with several large declines in that period) plus high inflation stifled interest in unitrusts.

That highlights the biggest risk of unitrusts. In a long bear market or even a flat market, the trust's total return could be less than what would be earned from safe income investments. The trust could lose value. When payouts are based on a percentage of the trust's value, annual payouts actually might decrease, and remainder beneficiaries would wonder if there will be any principal left for them. The same could happen if the trustee makes bad investments.

This doesn't happen very often in financial history. But with a traditional trust, the risk of falling income payments and a war between generations is almost a certainty. And the adverse effects of a flat market can be reduced by the selection of a quality trustee or money manager to invest the trust principal.

A unitrust often will have a provision that prevents distributions to the income beneficiary from falling too much after a bad investment year. The trust might say that the beneficiary is to be paid 4% of the trust’s value at the end of the previous year or at least 90% of what was paid the previous year, whichever is greater.

Setting up a unitrust instead of an income trust is easy. Any estate planning lawyer should have access to the appropriate trust language.

What if you already are stuck with an income trust and a generational war? One option is for all the parties (income beneficiary, remainder beneficiaries, and trustee) to petition a court to switch the trust to a unitrust. That will cost some money, and even then, there is no assurance the court will agree.

Another option is for the trustee to read the trust agreement carefully. Most trusts give the trustee some investment discretion and the ability to make distributions to the income beneficiary out of more than the income of the trust. If the trust agreement doesn't require the annual payouts to be from non-capital gains income, then the beneficiaries and trustee might agree that the investment policy can and should be changed for the benefit of everyone.

Strategy #23

Escape Hatches For Trusts

It doesn't take much to ruin a great estate plan. Many great plans, completed with careful

work and good intentions, turn to disasters because of one simple decision—the wrong trustee was selected. Instead of being grateful that their parents and grandparents worked hard to provide for them, heirs become bitter and even resentful

Selecting a trustee often is an afterthought when a trust is created. The tax benefits and trust terms seem more important. Or the trustee might be suggested by the lawyer, who has a referral relationship with a bank. But you need to give this decision as much thought as any other part of the plan.

It used to be that only the super-rich worried about trusts and trustees. But many estate plans now have some kind of trust. The average trust in the U.S. contains only about $250,000.

Often a local bank trustee is selected because of a personal relationship with the trust grantor and is fully briefed on the creator's wishes. But that trustee might die, change banks, or take a different job at the bank. Or a local bank might be merged into ever larger banks until the trustee becomes someone in a large trust department in another city who has 250 or so trusts to manage. A "revolving door trustee" can't be expected to know you, your heirs, or your intentions very well.

Perhaps more significant problems with trustees are investment performance and fees. Bank trust departments historically overinvested in bonds or put together stock portfolios that generated below-average returns. These days, the trust department is more likely to channel the trust into mutual funds maintained by the bank. That gives the bank one fee for managing the trust and another for managing the mutual funds. Banks also are raising their trust fees and adding new fees all the time. Those fees eat into income and principal.

Before giving you some ideas about preventing these problems, let me say a few kind words about bank trustees. Many banks have improved their investment performance over the years. More importantly, administering a trust can

be difficult. The tax and accounting rules are not easy, even in the simplest trusts. If you have some complicated trust provisions, simply complying with the rules can be a chore. A good bank trust department can be worth its fees because it has the experience and systems to handle those issues.

A bank or corporate trustee also will always be around. An individual trustee can die, become disabled, or simply quit. A bank always has other people ready to step in. And if the trustee does something really wrong with the trust, the bank usually has enough resources behind it to make the trust whole. Experience, continuity, technology, and financial stability all count when you want a trust to last for a generation or more after you.

Also, trustees are not always the real problem. There is a natural tension in a trust set up to last several generations. The current generation of income beneficiaries (your spouse or children) wants to maximize income payouts, while the trustee also is charged to protect principal for the following generation (your children or grandchildren). The trustee cannot make everyone happy in that situation. Also, beneficiaries complain that they are treated like children long into adulthood. But that's not the trustee's fault; the trustee might be simply following the terms of the trust.

To avoid all these problems, you have to set things up right, because trust beneficiaries don't have much power under state law. Courts are hesitant to remove a trustee that you appointed, except for gross negligence. Your beneficiaries can sue, but they won't have as much money as the bank. Also, the trustee can use trust funds to pay its legal fees unless it loses the case.

Just as it doesn't take much for a trustee to ruin a good estate plan, it doesn't take much to put in some safeguards. Consider these tools as ways to make your trust last for a long time while meeting your goals.

Separate tasks. A bank trustee naturally wants to sell you the whole package of its trust services. But you can unbundle the package. You can select the bank to handle the custody, administration, recordkeeping, and tax reporting for the trust. Then you can have a separate provision in the trust that selects the investment manager or managers. You might name specific investment managers or select a firm or individual that will oversee the investments and decide who will man- age the money. You also can have a separate trustee or committee of trustees decide on the distributions. A related option is to name a person as trustee but specifically empower and encourage him or her to hire professionals to perform most of the tasks.

Multiple trustees. Many corporate trust officers cannot know your family and your wishes for them. A family member, adviser, or close friend can. You can name such an individual (or several individuals) as co-trustees. Again, you'll have the bank to handle all the technical matters. Then the bank will have to consult with or take direction from the co-trustee(s) when deciding how to invest the trust and how much money to pay to beneficiaries. The co-trustees also can have a hand in negotiating fees. This arrangement is, in principle, the same as separating tasks, but legally is a bit different. In this arrangement, each person or entity is a trustee, and the trustees have to work together.

Limit the fees. Too often the standard trusts prepared by lawyers, at least in the past, allowed the trustee to charge basically whatever it wanted for its services. The standard trust agreement said the trustee was entitled to charge its published fees. You can and should be more sophisticated than that. You might state the maximum fees clearly in the trust agreement. You could have a co-trustee or someone other than the bank trustee who has to approve fees and fee increases.

Remove the trustee. Many trusts don't allow the trustee to be removed. For years, the IRS said allowing the beneficiaries to remove the trustee voided all the tax benefits of many trusts. But the IRS reversed itself, and state laws are becoming more beneficiary friendly. Beneficiaries can change the trustee without losing the tax benefits as long as the beneficiaries also cannot direct the trustee to change the trust payout. Many states now have provisions for the beneficiaries change trustees. You should provide circumstances in the trust agreement under which the beneficiaries can change a trustee.

Even so, you might not want to let your beneficiaries go "trustee shopping." Presumably you have a reason for putting the property in a trust instead of giving it outright to the beneficiaries, and trustee shopping could subvert that purpose. One option is to limit the number of times that a trustee can be changed (say, once in five years), and also not allow the beneficiaries to change trustees until they reach a mature age.

Another option is to allow the beneficiaries to change trustees but limit the choice to a list of trustees selected by you. Still another route is to appoint co-trustees to serve with the bank and allow those co-trustees to change the bank trustee. Or you can essentially allow the beneficiaries to fire a trustee but give power to select the new trustee to a committee of non-beneficiaries in whom you have confidence.

Another option that is becoming more popular is to borrow a concept from international trusts and have a trust protector. This is discussed in the next strategy.

Don't make your choice of trustee an afterthought; that could leave your beneficiaries prisoners of high fees, bad investments, or uncaring management. Give a lot of thought to the initial trustee, the level of fees, and the ability to change the trustee. Your wishes are more likely to be followed.

Strategy #24

The Flexible Irrevocable Trust

Irrevocable trusts are important elements of many estates and are among the most useful estate planning tools. An irrevocable trust can reduce estate and income taxes, avoid probate, and add creditor protection. The trusts also provide many more options than simply leaving property outright to beneficiaries. The trusts can have limits, controls, timetables, and other features, as we've seen in this book.

Yet, irrevocable trusts have disadvantages. Once established, they are fairly inflexible, as implied by the name. Situations can change; the tax law can change; and a trustee might prove to be a bad fit. Since the trust is irrevocable, it generally can't be changed.

There is a potential solution to these problems, including those already discussed. An irrevocable trust can be set up so that it can be changed by borrowing a feature that's been used for a long time in offshore and foreign trusts.

Offshore trusts always needed extra flexibility. The grantors creating the trusts often were worried that the overseas trust companies would turn out to be crooked or that there would be political or legal changes in the country in which the trust was located.

To combat such problems, offshore trusts long have had "trust protectors." These are individuals empowered to take certain actions when in their judgment it seemed in the best interests of the trust and its beneficiaries. The standard protector clause allowed the protector to either change the trustee or move the trust to another country. The protector is one or more people who are independent of the trustee and the grantor.

The protector is needed because the grantor of the trust cannot retain the power to make these changes if the trust is to fulfill its tax reduction and other goals. If the grantor could take these actions, the grantor would be considered owner of the trust. All income would be taxed to the grantor, and the property would be included in the grantor's estate.

Because of the success of trust protectors with offshore trusts, estate planners are starting to include protectors in irrevocable trusts based in the U.S. Other names used for the position are special trustees and trust advisors.

A protector can have either broad or limited powers, and the actions the protector can take are limited largely by the grantor's imagination and desire.

A protector might be empowered to add or delete beneficiaries. This can be helpful if additional births in the family are likely. The protector might be allowed to change the age at which distributions will be made, the amounts of the distributions, or other terms of trust distributions. These powers can be helpful when a beneficiary develops a problem such as debt, substance abuse, or gambling. There also might be a need to accelerate distributions for a medical emergency or disability. Of course, the protector can be empowered to change the trustee or location of the trust.

When a dynasty trust to last for several generations is contemplated, a protector might be a good idea to adapt to new circumstances. This could become more important since a number of states are dropping the old rule against perpetuities that limited the life of a trust.

There are two ideal circumstances in which to consider using a trust protector.

One circumstance is when a trust is created during your lifetime. The trust has to be irrevocable to generate tax and other benefits. Yet, there could be new family members, existing members might pass away, or relationships could change. The grantor is powerless to alter the trust, and the trustee only administers a trust. A protector can add or delete beneficiaries and make other changes, if given such powers in the trust agreement.

The other circumstance is when the trust won't be funded until the grantor's death. At that time, of course, the grantor won't be able to change the trust for new circumstances.

The prospect of changing tax laws is another good reason to consider a protector. A protector also can be a good idea when the trust holds shares of a family business or significant real estate. Family members usually don't want a professional trustee voting business shares or deciding how the property is to be managed or developed, and a trust protector is a good alternative to having a corporate trustee doing the voting.

A trustee, of course, could be empowered to make some of these changes, though not all of them. And a trustee is not likely to decide to change trustees. In addition, many professional trust companies refuse to accept such powers. They don't want to be choosing between beneficiaries or making other decisions. They want to invest the trust, prepare tax returns, and make distributions according to instructions.

The decisions a protector make depend on knowledge of the family and its circumstances. So, you should prefer a family member, friend, or professional advisor rather than a professional trustee to be the protector.

The choice is a tough one. The protector must be someone you trust for honesty, judgment, and knowledge of the family and your wishes. You also need to decide if there should be a process for selecting a successor protector if the first one becomes not capable of continuing. You could either have the protector name the successor or set up a committee to name the protector. Some lawyers say there should not be a successor protector, because the initial protector was selected for unique qualities.

Some estate planning lawyers won't use protectors on U.S.-based trusts because there isn't a lot of law to give them guidance. Only a few states have statutes officially recognizing protectors, and these statutes were enacted recently. Of course, that means there are few court cases testing the powers and legitimacy of a trust protector in the U.S.

A potential protector should know that there could be legal liability attached to the position. Many estate planners who normally agree to serve as trustees or estate administrators will not serve as protectors. They fear any changes they make would be legally challenged and result in time-consuming and expensive court action. That possibility should be considered when deciding which powers to give a protector.

The potential for changing circumstances leads estate planners to seek new tools to give estate plans flexibility, and the trust protector is a tool to consider.

Strategy #25

A 'Defective' Trust That Saves You Money

Sometimes when Congress closes one tax loophole it creates another. This is especially likely when Congress doesn't coordinate the income and estate tax sections of the law. That's how complicated the tax law is. And it opens up an opportunity for you with "grantor trusts."

A grantor trust in the income tax law is one in which the grantor, or creator, of the trust retains enough powers over it to be considered the owner. The owner of the trust is taxed on its income, regardless of who receives it. The grantor trust rules were set up to end an income tax strategy in which a high tax bracket person shifted income to someone in a lower bracket but still managed to retain control over, and most of the benefits from, the trust and its property.

Under the estate tax, if you set up a trust and retain too much control over or benefit from it, then all the property in the trust is included in your estate.

But here's the little glitch. "Control" is defined differently in the estate tax law than it is in the income tax law. That means you can set up a grantor trust in which you are taxed on the income from the trust, but the property in the trust is not included in your estate. Believe it or not, when your estate is valuable enough to be taxable that can create benefits, saving your family a lot of money.

Here's how it works. You set up an irrevocable trust that qualifies as a grantor trust under the income tax and transfer property to it. Since it is a grantor trust, you pay taxes on the income and capital gains. But the trust is written so that you don't have enough control for the property to be included in your estate.

What kind of provision makes you taxable on the income without including the property in your estate? A number of simple provisions work. The trust can provide that your spouse is eligible at some future time to receive income or principal, even if that never happens. Or you can borrow $1 from the trust each year. Those simple "defects" make you taxable on the trust income but keep the property and its future appreciation out of your estate. Meet with a tax advisor to determine the best current strategy that works for you.

Having the income taxed to you allows the income and gains to accumulate and compound in the trust without being diluted by taxes. In effect you are able to make an additional gift to the trust's beneficiaries equal to the amount of

the income taxes. Since the taxes are your legal obligation, paying them is not considered a gift under the tax law. That means no gift taxes, and the payment of the taxes doesn't count against your annual gift tax exclusion or lifetime credit. You have found another way to make a tax-free gift to the trust.

If you are considering such a trust, you want to give appreciating assets or those that pay fairly high income, because the real benefit is to remove the future appreciation and income from your estate and have them compound in the trust.

When you transfer assets to the trust, the transfer is subject to gift taxes under the rules already discussed in this book. You can make the trust even better by giving assets that qualify for gift tax discounts. For example, you can put shares of a family business or real estate into a family limited partnership. If you set up the partnership properly, you can take a discount of 20% or more when you make gifts of the partnership interests to the trust. This is explained elsewhere in this book.

A way to really enhance the trust is to sell assets to the trust.

You start by giving money or property to the trust equal to about 10% of the value of the property that you intend to sell to the trust. This is a gift.

Later, the trust buys property from you by issuing a promissory note. The cash or property you initially put into the trust and income that is generated by the purchased property are used to make the note payments. The note often requires interest-only payments for five years or more, with a balloon payment at the end.

Because you effectively are dealing with yourself when selling property to a grantor trust, there are no capital gains taxes to pay on the sale. You also don't pay taxes on the interest payments received.

The note and any payments on it eventually are included in your estate. The appreciation of the property transferred to the trust is out of your estate. If for some reason the trust doesn't generate enough income to make the balloon payment, it can return assets to you equal to the unpaid balance.

You can increase tax benefits further by naming your grandchildren, instead of your children, as beneficiaries of the trust. Skipping a generation like that saves a layer of estate taxes. Be sure your estate planner structures things to avoid the generation skipping tax.

The main drawback to the defective grantor trust is that the trust and its beneficiaries get the same tax basis in the asset that you had. There is no step-up in basis because it was not included in your estate.

The intentionally defective trust is a great way to increase the after-tax amount of assets left to your heirs. It won't do anything to enhance your current standard of living. It is for assets you no longer need to maintain your standard of living and that you eventually want to benefit your loved ones.

Intentionally defective grantor trusts are very flexible. You can combine them with other strategies, such as a family limited partnership. But you do need to get all the details right. You need to work closely with an estate planner who knows the law in this area well and who will help get the results you want. You and your estate planner also need to be on top of changes in the law. The IRS and many members of Congress don't like the strategy and regularly propose changes that would eliminate or curb it.

Strategy #26

When Assets Have Significant Taxable Gains, Get Triple Tax Benefits While Retaining Income

A common problem for those with valuable estates is how to manage assets that have significant capital gains. This is especially important to people who bought investment real estate or stocks a decade or more ago and have not sold them. The potential capital gains taxes are a significant portion of the value of the assets.

Take the case of a couple who bought investment real estate some years ago. The property now is worth about $750,000 and after depreciation has a tax basis of about $75,000. If sold, the property would generate a taxable gain of $675,000. The couple faces a joint federal-state capital gains tax rate of 25%, which means the tax liability from the sale would be $168,750. This leaves after-tax cash of $581,250 from the $750,000 property. If the cash is invested to produce a 5% annual payout to the couple, they will have $29,063 in annual income, before taxes.

A better strategy might be for the couple to put the property in a charitable remainder trust. The trust will pay income to the couple for the rest of their lives, then the remaining property will be given to a charity or charities determined by the couple.

Here are the benefits. The couple takes an immediate tax deduction for the present value of the charity's remainder interest in the trust. The exact amount of the deduction is determined by IRS regulations and depends on their ages or the term of the trust, current interest rates, and the value of the property. The trust property also is excluded from their estates.

After the property is transferred to the trust, the trust can sell the property. Since the trust is charitable, there are no capital gains on the sale. The trust receives the entire $750,000 in sale proceeds and reinvests it. This produces more income than if the couple had sold the property themselves, paid the capital gains taxes, and reinvested the net proceeds.

If each spouse is age 70 and the IRS interest rate at the time they set up the trust is 6.6%, then the results look like this. The couple gets a tax deduction of $322,387.50 in the year the property is contributed to the trust. That is the present value of the charity's remainder interest in the trust. If the trust is set up to make a 5% annual payout to the couple, their first pretax payout is $37,500. That is about an $8,000 increase in their annual income compared to selling the property and investing the after-tax proceeds. Plus, they get the tax deduction for setting up the trust. Since the payout is based on the value of the trust, it should increase each year if the trust's value increases.

This result is possible, because there are no taxes when the property is sold. The entire sale proceeds can be invested to generate income for the couple. The shorter the income payout period (meaning the older the couple is, the greater the income tax deduction.

When creating the trust, the couple essentially sets the amount of income it wants to receive each year, within limits set by IRS regulations. The regulations try to ensure that a minimum percentage of the original value of the property goes to the charity. The payment formula can be set so that the payments increase each year to keep up with inflation or fluctuate with the trust’s value. Most CRTs set a payout rate between 3% and 6% these days. Instead of paying capital gains taxes on the sale of the property and having the remaining proceeds subject to estate taxes, the couple received a current tax deduction, avoided capital gains taxes on the property, and avoided estate taxes, all while getting income from the trust for the rest of their lives. That’s how the charitable remainder trust provides triple tax benefits.

The CRT also can be set up in your will. The results are very similar. The property is included in your gross estate, but the estate gets a deduction for the value of the remainder interest that the charity will receive. The charitable trust can pay income to your surviving spouse, children, or other heirs for either the rest of their lives or for a period of years determined by you. So, your estate taxes are minimized, yet your survivors get income from the property for either their lives or a period of years.

Your charitable contribution income tax deductions generally are limited to no more than 50% of your adjusted gross income, and you must itemize expenses on your tax return. But any contributions you aren't allowed to deduct because of the limit can be deducted in future years. Also, remember that at higher incomes you lose a portion of your itemized deductions, including charitable contributions.

The standard CRT requires the trust to make a distribution to the income beneficiary each year. What happens if the trust doesn't have any income? This can happen when the trust owns assets that don't pay income and doesn't sell any assets. You are allowed to provide in the trust agreement that the trust doesn’t have to make an income distribution in a year when it doesn’t have income. The trust doesn’t have to sell assets make an income distribution.

This can be a useful planning tool. Suppose you aren't retired or don't need the income for a few years. Or you want the growth in the assets to compound for a few years before they are sold. Yet, you’d like the income tax deduction this year and also want the property out of your estate. You can put a provision in the trust which says that if it doesn't have income, nothing has to be distributed. This is known as a no-income CRT. At a later point the trust can convert to a unitrust that is required to make annual distributions, known as a net income CRT or NI-CRT. This "flip trust" lets the gains in assets compound for years, and then it pays you an annual income when you want it or decide it is time for the assets to be sold.

The IRS didn't like this variation of the CRT, but finally in late 1998 decided it would not challenge flip trusts as long as the flip was caused by a specific triggering event, such as the sale of assets or the beneficiary reaching a certain age. That means it is safe to use a flip CRT.

Who would want to use a CRT? Anyone with highly appreciated assets is a good candidate. You might have a valuable home, second home, farm or other real estate. Stocks or mutual funds that you've held for a long time also are good assets for funding a CRT.

You also don't need to set up the CRT for yourself or your spouse. Suppose you have a grandchild who will be going to college in 10 years. Transfer $100,000 of appreciated assets to a CRT. The CRT holds the assets and doesn't pay income until the child turns 18. After 10 years of 10% growth, when the assets are worth $260,000, the assets are sold. A 10% payout will give the grandchild $26,000 annually. After four years (or longer if you want to help pay for graduate school), the payments stop, and the remainder of the trust goes to charity. (This is likely to incur some gift tax liability when the trust is created, since the income beneficiary isn't you or your spouse and the gift probably exceeds the annual exclusion.)

You might consider a CRT even when your estate won't be taxable. The capital gains tax savings, the income tax deduction, and the higher income for life could be sufficient reasons to create the CRT.

Charitable remainder trusts are remarkably flexible tools that the IRS made more flexible. They should be considered by anyone who has highly appreciated assets and any charitable inclination. In some cases, the tax benefits are so great that you are better off with a CRT than selling the assets. The benefits of a CRT need to be carefully estimated before a plan is made. You need to consider the potential capital gains taxes on the sale of the assets, the benefits of the charitable contribution income tax deduction, the exclusion of the assets from your estate, and how the CRT will be invested.

Strategy #26

Building Family Wealth While Earning Triple Tax Benefits

The couple in Strategy #27 had other assets to provide for their children, so they were not concerned that their children received no benefits from the property put in the charitable remainder trust.

Suppose the couple had the same problem of highly appreciated assets, but the assets were a major part of their net worth. There aren't sufficient other assets to allow them to provide for the children to the extent they want to and still create the charitable trust.

A solution for them is to use the charitable remainder trust and combine it with an irrevocable life insurance trust. At the same time that the charitable trust is created, the couple set up an irrevocable life insurance trust. The couple takes some of the income tax savings or additional income they receive from creating the charitable remainder trust and gives that cash to the insurance trust to buy an insurance policy.

The result is that their heirs get the proceeds of the insurance policy through the insurance trust, and the insurance is out of the estate for tax purposes. In addition, the couple might find that the benefits of creating the charitable trust are so great they can buy a large enough insurance policy that they leave their children more money than if they had either held onto the property until their deaths or sold it without the charitable trust.

Strategy #28

Letting A Charity Get Paid First, But Providing Benefits for Heirs

The opposite of the charitable remainder trust is the charitable lead trust. Under this trust, the charity gets paid first. After the trust is created and property is transferred to it, the charity gets income from the trust annually for a period of years stated by you. After the charity's income period ends, the property remaining in the trust belongs to your children or to other beneficiaries you designated. It could return to you. If the trust is set up in your will, your estate gets a charitable contribution deduction for part of the value of the property that is put in the trust. The amount of the deduction depends on the period of years that the charity will receive payments from the trust.

Here's how the deal works for the same couple as in Strategy #26. Giving the trust $750,000 and having the trust pay the charity 5% of its value annually means the charity gets $37,500 the first year. That amount will increase each year if the trust value increases. If the payout continues until both spouses have died, the couple will get a charitable contribution deduction of $427,612.50 in the year the trust is created. After the parents die, the children receive the property remaining in the trust. The property's estimated remaining value of $322,387.50 is a gift to their children at the time the trust is created that will either reduce their lifetime estate and gift tax credits by the taxes on that amount, or they will owe gift taxes. In the 40% gift tax bracket, that is a maximum gift tax of $128,387.50. Since the property eventually goes to their children, the property and its future appreciation of the property are out of the parents' estates. If the trust is invested for a return that exceeds the 5% payout to the charity, the children actually will receive more than $750,000 when the trust ends. That magnifies the tax discount of the charitable lead trust.

Suppose the couple doesn't want their children to wait a long time to get the property. The charitable lead trust can be set up for a 10-year term (or any other term). The charitable deduction will fall to $299,658.75, and the taxable gift

will increase to $450,341.25. (The exact values will depend on interest rates in the month the property is contributed to the trust and the term of the trust.) Again, the children should end up with more than $750,000 after 10 years if the trust is invested to return more than the 5% payout to the charity.

The exact amount of the tax deduction and other figures will depend on the interest rates prevailing at the time the trust is created.

The charitable lead trust can be created either during your life or in your will.

An important difference between the charitable lead trust and the charitable remainder trust is that the charitable lead trust is not tax exempt since its property doesn't eventually go to a charity. The trust must pay income taxes on its income and gains.

You also can set up a CLT so that after the charity receives income for a period of years the property is returned to you. In that situation, the assets aren't excluded from your estate.

There are several situations in which a charitable lead trust might be appropriate in your will. You might want to benefit a charity for a period of years, such as when it has a particular funding need, and your survivors might be adequately provided for during that period from other sources. Or you might feel that the survivors will not need the property for a period of years, so you give a charity the property's income for that period. This gives you or your estate some tax benefits while eventually transferring the property to your heirs. There are several varieties of charitable lead trust. If the concept appeals to you, discuss the possibilities with an estate planner.

Because of some quirks in the tax law, a CLT can be structured so that the donor retains some control over the trust, but not enough to have the trust assets included in his estate. It will take an experienced estate planner to draft the trust properly. Bu if you want to retain some control over the trust, or have the income taxed to you instead, of the trust, the strategy is available.

A CLT is not used as often as a CRT and is beneficial in fewer situations. It is for someone who is charitably inclined and looking for ways to help the charity.

Strategy #29

Cutting Taxes While Preserving Wealth and Creating A Legacy

There is one surefire way to cut your estate taxes, provide for your survivors, and ensure that your principles and name will live on. That way is the private charitable foundation.

This previously was the province of only the very wealthy, but in the last few decades many moderately wealthy people decided the private foundation is the best way to accomplish their estate planning goals.

A private foundation generally is a nonprofit corporation or trust that receives an IRS tax- exemption. Contributions to the foundation usually are tax deductible, and income earned by the foundation is tax-exempt. The foundation uses its resources for charitable activities. It can undertake its own activities or make contributions to charities that already exist.

You can create the details of the foundation during your lifetime. You define the goals and activities of the foundation and, most importantly, can appoint the initial directors of the foundation and set the procedure for selecting future directors.

Your will can state how much of your estate will be given to the foundation. You can appoint your spouse and children to the board of directors, and they can draw salaries for their duties. Or you can set up the foundation, give it initial funding, and have it operating during your lifetime.

When set up properly, you and your estate should receive charitable contribution deductions for cash and property transferred to the foundation. The limit for contributions to a private foundation is less than for contributions to public charities, also known as 501(c)(3) organizations. Private foundations are subject to a number of very complicated rules, so you will need excellent legal advice. But you might find that creating a private foundation is a good way to reduce estate taxes, perpetuate a legacy, and provide income for your survivors. Some people believe foundations stray from their founders' original goals after the founders have been gone for a while, and they recommend that when the foundation is created you require it to spend down its assets and go out of business by a certain date.

Strategy #30

The Donor-Advised Fund

Suppose you like the idea of a private foundation, but you don't want the cost and hassle of setting up your own foundation or don’t have enough money to justify the cost. There is an alternative that is less expensive and takes the administrative burdens off you and your heirs. It also gives you a number of choices concerning the use of your money.

Consider a donor-advised fund. These foundations take charitable contributions and disburse them over time to charities recommended by the givers. You can leave the money in the fund for years, where it is invested and grows in value. Technically, you don't have the right to determine who gets the money. For you to get the deduction at the time of your donation, you have to give up control and make a request that the fund donate a certain amount to a particular charity. But it is rare that a donor-advised fund doesn't honor a donor's request.

Traditionally, community foundations in most localities were the prime donor-advised funds. There probably is at least one in your area, and many universities and other institutions have their own donor-advised funds. In addition, financial services firms are setting up the funds so that they can reap management fees before the money is given away. The biggest such fund probably is the Fidelity Charitable Gift Fund. The one with the lowest expenses is sponsored by Vanguard. Many other brokers and mutual funds have their own versions. The funds established by financial services firms generally require minimum initial contributions of at least $10,000.

Strategy #31

Preserving Your Business With the IRS's Easy Payment Plan

Small business owners face particularly difficult estate tax problems. A business owner might be unable or unwilling to distribute ownership of the business to others during his or her lifetime. That means the entire value of the business is included in the gross estate. Unless a substantial amount of life insurance was purchased or the owner has substantial liquid assets other than the business, the business might have to be sold or broken up to pay the taxes. Sometimes enough can be borrowed against the value of the business can be used to pay the taxes.

There is an alternative some business owners rely on: the deferred payment plan that the tax law allows for some estate taxes. When an estate qualifies, the taxes can be paid in 10 equal annual installments, and the first installment would not have to be made for five years. In addition, a 2% interest rate is charged on the taxes attributable to the first $1 million plus the annual estate tax exclusion amount of the business's value. On taxes above that amount, interest is 45% of the regular IRS rate, which changes each month.

A business owner's estate qualifies for the installment plan when the value of the business is at least 35% of the estate. This immediately creates a problem for a number of successful small business owners. For example, Max Profits has pulled profits out of his business for years and built a substantial investment and real estate portfolio in addition to the business. It is difficult for Max's estate planner to ensure that the business will be at least 35% of the gross estate in the future. In addition, if Max were to die during a recession the value of the business would be reduced. So, while Max's heirs might benefit if his estate uses the deferral plan, he should not count on deferral being used. Max needs to use additional strategies and reserve the deferred payment as a backup.

Max feels the business will have no problem overcoming the second potential disadvantage of the deferral plan—having enough cash flow to make the installment payments. Max believes that the business always will generate enough excess cash to pay the taxes plus accumulated interest over time. Not every small business can be confident of this.

There is another reason Max decided not to rely solely on the installment plan. The deferral plan applies only to the portion of the estate taxes that are attributable to the small business’s value. Max knows that he still needs to plan for his investment portfolio, real estate, house, and other assets.

Another reason not to rely on the deferral option is that Congress might decide to repeal or modify the provision. By then, time that could have been spent implementing other strategies would be irretrievably lost.

Max decides that his executor probably should take advantage of the deferral provision to the extent that the estate qualifies and that there appear to be financial advantages. Max also decides it is not a good idea for him to assume that the estate will qualify and that the provision still will be available to his estate.

Strategy #32

Letting Your Business Pay the Estate Taxes

Suppose that like many small business owners, you would like the business to continue after your death. You also would like your survivors to financially benefit from the value of the business, but you know that none of them are interested in the business or are qualified to run it.

A strategy for you, if the business is incorporated, is to have the corporation buy the stock from the estate. A special provision of the tax code states that when a corporation buys (or redeems) its stock from an estate, that transaction is treated as a capital gain or loss to the estate instead of as a dividend. Since the estate's tax basis is the stock's fair market value on the date of your death, there will be no capital gain or loss to the estate on the redemption.

The result is that the value of the stock is included in the estate, but the estate immediately receives cash from the corporation for the stock. Part of the cash can be used to pay the estate taxes, and the rest of the estate goes to the heirs.

Of course, you have to be sure that the corporation will have the money to buy the stock. There are several options here. The corporation might set up a cash reserve over the years for this purpose, buy an insurance policy on your life, or use a line of credit. But it is important that if you plan to have the corporation redeem the stock from your estate, that you ensure the corporation will have a reliable source of cash.

There are several qualifications that must be met for the stock redemption to receive this favorable tax treatment. So, be sure you have an experienced estate planner involved in setting things up.

The IRS ruled that your estate can combine the deferred payment of estate taxes and the redemption of stock from the estate. You can have your corporation redeem the stock from the estate. Then the estate also can decide to pay the estate taxes using the deferral method, though it already received enough cash from the redemption to pay the taxes. Combining these two strategies lets the estate invest the cash and earn a higher return than the IRS charges under the installment plan. The result can be even more wealth for your heirs over time.

Strategy #33

How Partners Preserve the Business and Pay Estate Taxes

Business partners do not often realize it, but each should be concerned about the estate planning of the others. The death of a partner too often causes severe financial problems for the business because nobody planned for the contingency. (When I talk of partners in this section, I use the term generally. This discussion applies whether the business is operated as a corporation, partnership, limited liability company, or some other form.)

There are two main causes of business catastrophes after the death of a partner. One cause is that inexperienced individuals become partners. Your partner might be a great executive, but what about the spouse and children? Do you want them as your partners tomorrow? If they inherit your partner's ownership interest, they come in with your partner's authority.

The other cause of business catastrophes is lack of cash to pay estate taxes. Too often the deceased partner made no plans for paying the estate taxes on his or her share of the business. This means that either the surviving partner has to come up with the cash to buy the deceased partner's share, or the survivors must sell the share to an outsider. Another possibility is that the IRS seizes the shares to pay the estate taxes.

All these problems are avoided if partners enter into, and fund, a buy-sell agreement when they form the business, or at least when it becomes valuable enough to create estate planning problems.

In a buy-sell agreement, either the business or the other partners agree to buy out the estate of the first owner to die. The agreement should state the latest date after the owner's death that the sale must take place. Some agreements require the estate or survivors to sell to the business or the surviving partners, while others provide that the business or surviving partners have the first option of buying. The agreement also should contain a formula for determining the value of the business. There are too many problems when the price is stated to be prevailing market value or the average of a certain number of appraisals. It is better for the partners to agree on a fair formula while they are alive. After all they do not know who will die first, so they have a limited incentive to slant the formula one way or the other. Another option: Have the surviving partners determine the value per share then give the heirs of the deceased partner the option of either selling at that price or buying the surviving partners' shares at that price.

Then the partners must be sure that the cash will be available to comply with the buy-sell agreement. Usually this is done with life insurance. Either each partner buys life insurance on the other, or the business buys insurance on each owner.

Strategy #34

How to Keep the Business In The Family

There are several ways to reduce estate taxes so the family business can be passed to the next generation.

Here are the options that usually are presented to the small business owner drawing up an estate plan and a business succession plan. They are generally known as "estate freezes" because they try to freeze the value of the business that is included in your estate to its current value. Future appreciation is shifted to your heirs.

The traditional estate freeze is the corporate recapitalization. Take the simplest situation in which a corporation has one class of stock, and all the shares are owned by one person. The corporation would recapitalize so that it has one class of preferred stock and one class of common stock.

The goal at this point is for the owner to keep the preferred stock and shift the common stock to the future owners, such as his or her children. The preferred stock would pay income to the owner for as long as he owns it. Preferred stock generally does not appreciate with the business. All appreciation tends to be reflected in the common stock. Thus, the owner freezes the current value of the business that is in his estate to the value of the preferred stock.

The next step is to transfer the common stock to the future owners. There are a number of ways to shift the common stock. The owner could simply exchange most of his original common stock for the preferred stock, retaining a token amount of common. Future owners could purchase common stock from the corporation, earn it as compensation, or receive it through stock options.

Another route is for the owner to exchange some of his common stock for preferred stock. Over time he could give the common shares he retained to the children or other future owners. The stock could be given in small enough amounts to avoid gift taxes, or it could be given in larger amounts to ensure that it is not in the original owner's gross estate. The second path probably would trigger use of the lifetime estate and gift tax exemption and perhaps gift taxes.

Or the common stock could be sold to the children. Since the children are unlikely to have the cash to buy the stock, they can receive all the stock now and pay for it over time. There are two general ways for the children to pay for the stock over time.

One method is the private annuity. Under this method the children receive the stock in exchange for a promise to pay the seller an annuity for life, or for the joint lives of the owner and his or her spouse. The amount of the annuity payment is determined by IRS tables and depends on the value of the business, prevailing interest rates, and the age of the owner.

If the private annuity is set up properly, the common stock is excluded from the gross estate of the original owner. In addition, the private annuity terminates at death, so it should not be included in the gross estate of the original owner. The result should be that only the value of the preferred stock is included in the gross estate, but the founder gets income payments for life.

A similar option is the installment sale that terminates at death. The children promise to make payments for either a stated period or life, whichever ends first. The results are essentially the same as for the private annuity. The big difference is that there is a definite ceiling on the amount the children ultimately will have to pay for the stock. But the IRS says that to offset that, the children must make higher periodic payments under the installment sale than they would under the private annuity.

The private annuity and installment sale are not popular with the IRS and some members of Congress. They regularly propose ways to eliminate or restrict them. Be sure you work with an experienced estate planner who knows the latest status of these strategies before trying to implement them.

A big advantage to the estate freeze is that you can decide how quickly or slowly to turn over control of the business. Whether you are giving common stock to your children or selling it to them, you can decide how much they get each year. You do not have to give them control of the business until you are ready. Of course, the longer you retain control, the higher your potential estate and gift taxes are at that point and the greater the probability that you might pass away before implementing the plan. You do not have to be operating your business as a corporation to use these strategies, but they work best if you do incorporate the business. These strategies also work when you own real estate or a substantial investment portfolio instead of a business.

Strategy #35

Preserving Assets With the Family Limited Partnership

Another strategy for people who have substantial investment assets or small businesses is the family limited partnership. This has essentially the same goals and effects as the corporate estate freeze options, but there are some differences, and the partnership might offer more flexibility.

Here's how it works. You form a partnership with yourself and possibly your spouse as general partners having a 1% interest in the partnership. Then you transfer property into the partnership in exchange for the limited partnership interests.

At this point you have the options that are available after a corporate recapitalization. You can give or sell limited partnership interests to your children and grandchildren. You can do this all at one time or over a period of years.

The advantage of the partnership over the corporation is in the powers of the general partner. In a corporation, you must give your children substantial voting power when you give them common stock. Minority owners might be able to force sales, distributions, or even liquidation of the corporation. They could also get involved in decisions regarding the operation of the business. But in a limited partnership, the general partner usually makes the rules. The general partner determines how assets are managed, when cash is distributed, and how the partnership is run. Limited partners have very few rights. They are passive owners who often can do little more than collect income and cash distributions, though they do vote on major changes such as sales of significant assets.

Another benefit of the limited partnership is the possibility of protecting assets from creditors. If one of the owners has debt problems and his or her limited partnership interest is awarded to creditors, the creditors merely step into the shoes of the former owner. Usually, a creditor who becomes a limited partner has no greater right to force distributions than the prior limited partner did. But in a corporation, a creditor who is awarded shares of stock might be able to force the corporation to buy the stock at its current value, require higher dividend payments, or call for liquidation of the corporation.

A third benefit, and perhaps the biggest benefit of an FLP is the estate and gift tax discount. You might pay taxes at a discount of up to 40% discount when you give limited partnership interests to your children.

You get a discount from estate and gift taxes for two reasons. The first reason is that partnership interests you give to each of your children own only a minority of the business. A minority stake is worth less than its proportionate share of the partnership, because of the lack of control and influence. This is recognized when valuing the partnership interests for tax purposes. The second reason is that there won't be a ready market for the limited partnership interest. It can take a couple of years to find someone willing to buy an interest in a small business for what it is worth on paper. This allows another discount on the partnership interests, known as the marketability or liquidity discount.

The discounts allow you to save a bundle in gift and estate taxes by giving away the limited partnership interests while you are alive.

Another advantage of the limited partnership is that you can have the partnership own your life insurance policy. This might be better than having the policy owned by a corporation or irrevocable life insurance trust, because the partnership has more flexibility than either of the other two vehicles. The partners might be able to transfer the policy among themselves without the tax consequences that might occur if individuals owned the policy directly, and the partners would not be bound by the terms of a trust agreement as would be the case with an irrevocable life insurance trust.

Strategy #36

Saving Your Family Limited Partnership From The IRS

A strategy with as many benefits as the family limited partnerships is bound to attract the IRS's attention, and that has happened. A family limited partnership still is a good idea as part of your estate planning arsenal, but you must set it up carefully if you choose to use one. If you have an FLP, be sure to follow the guidelines in this section and from your estate planner.

The first line of attack from the IRS usually is on the valuation of the limited partnership interests. Congress helped the IRS in the 1997 tax law by stating that the statute of limitations on the gift tax doesn't start running unless the value of all gifts is disclosed on the gift tax return, including the amount of any discounts taken. The gift tax form even requires you to check a box if a valuation discount is taken. Under these rules you have to tell the IRS what you are doing on the gift tax return, making it easier for the IRS to find and challenge family limited partnership valuations.

You should prepare for an IRS challenge to valuations. Get at least one independent professional appraisal of the value of the overall business and of the limited partnership interests. The method used to determine any discounts

should be fully explained in the valuation. You also need to use an experienced estate planner who will review the appraisal for reasonableness.

Another area of IRS attack is the limited partnership that is formed shortly before the original owner's death or when the owner was terminally ill. The IRS argues that since the individual was dying, there was no intent to operate a partnership. The partnership is just a tax dodge that should be ignored for tax purposes. The IRS has had some success in the courts when the facts were extreme and in the IRS's favor. These IRS successes are another reason it is a good idea to start your estate planning early and get the family limited partnership operating normally for several years.

The IRS also continues to insist that a valid partnership requires a business purpose other than tax reduction. To the IRS, that means you need a small business or real estate to comprise most of the partnership assets. Contributing an investment portfolio to the partnership won't work, according to the IRS. Many estate planners disagree with the IRS interpretation, especially when several members of the family contribute investment assets. If you are forming a partnership with investments or other non-business assets, be sure to discuss the risks with your estate planner.

Finally, be sure you actually operate the partnership. In one sad case, the taxpayer formed a limited partnership, had all the proper documents drafted by the lawyers, and gave annual gifts of partnership interests to his children for a couple of years. Then everything stopped. Assets were not transferred to the limited partnership and the certificates of limited partnership were not filed for months. Even worse than these technical problems was that all the income from the partnership properties went into the parent's personal bank account instead of the partnership's. The Tax Court ruled that there was not a valid partnership, and all the partnership property was included in the parent's estate at full value. (*Schauerhamer Estate*, T.C. Memo 1997-242)

The problem there was follow-through. Lack of follow-through is common in many estate plans, especially those involving trusts and partnerships. It is not enough to have the lawyer prepare solid documents that detail the estate plan. You actually have to implement the plan and follow the rules. In this case, that meant transferring all the property to the limited partnership promptly and operating the partnership as an independent entity.

These and other court cases now give fairly clear rules for using this flexible tool to greatly increase the after-tax wealth left to your heirs while keeping most of the control over the assets. Follow these key points.

Start early. The IRS likes to attack estate planning strategies that were set up shortly before death, especially if the death was expected due to illness. The courts sometimes support the IRS on these deathbed plans.

Use experts. It can cost $10,000 or more to have an experienced estate planner set up an FLP. Don't try to save the expense by attending a seminar and using fill-in-the-blank forms. Every little detail has to be right for the FLP to stand up to the IRS and the courts. The property and partnership interests have to be transferred properly. Valuation of the partnership interests is key. You need a qualified appraiser (or two) determining the value and documenting the reasons for the dis- count. The partnership formalities must be observed. You can't cut corners.

Keep business and personal expenses separate. Don't pay personal expenses with the FLP checkbook or credit cards. The IRS then will ignore the partnership as a sham. Don't put your home in the FLP. To survive a challenge, the FLP should have a business purpose beyond tax reduction and putting a home in an FLP doesn't pass the test.

As I mentioned, some advisers aren't comfortable putting only a securities portfolio in an FLP. They insist that the FLP can be used only for an operating business or rental real estate. But others favor putting securities in an FLP and say they have gotten FLPs with only securities through audits.

Don't mix the FLP with other vehicles. Be careful about combining the FLP with either an offshore trust or a charity. That gets the IRS geared up. Also, don't combine the FLP with an IRA unless you have very good tax advice.

The FLP can generate substantial estate and gift tax discounts. But you must operate the FLP properly and follow the rules carefully. If you get sloppy or don't have good advice, the IRS won't allow you the benefits.

Strategy #37

Two Tax-Wise Ways to Transfer a Business

There are a lot of ways to transfer ownership of a business. Consider all the options before deciding which works for you. Here are a couple of other strategies to consider. These strategies let you use the business's cash flow to transfer it in tax-advantaged ways.

In one court case, a taxpayer owned 100% of a corporation. His adult children were directors of the corporation, and he wanted them to take over both ownership and operation of the business.

He gave some of his stock to the kids. The business redeemed the rest of his shares in exchange for an installment note. The children now owned 100% of the outstanding stock, and he received regular payments under the note from the business.

A redemption like this qualifies for long-term capital gain treatment when the selling shareholder terminates all his interest in the corporation, other than any interest as a creditor. When less than the full interest is sold or the shareholder retains other interests in the business, the sale of the stock is treated as a dividend. Also, the gift of stock to the children mustn't be primarily tax motivated. This owner asked the IRS for an advance ruling, and it ruled in his favor.

But do this transaction wrong, and the redemption will be treated as a dividend to either the children or you. Be sure you work closely with an experienced estate planner who handles all the paperwork and oversees a valuation of the business.

The other strategy is to use an employee stock ownership plan (ESOP). There are a lot of tax breaks for setting up the plan and selling your business to it.

In a typical ESOP, a small business owner creates the ESOP and a related trust. The company borrows money from a bank and in turn lends that money to the trust. The owner sells some or all of his stock to the trust. Over time, the company makes annual contributions to the trust, which are deductible by the business. The trust uses the money to repay the loan from the company, which the company uses to repay the loan from the bank.

Special tax breaks allow the company to deduct both the interest and principal it pays on the loan. It also gets to deduct contributions made to the trust as well as dividends it pays on stock owned by the trust.

The owner also gets tax breaks. Any gain from the sale of the stock to the ESOP is deferred if within a year the owner uses the proceeds to purchase securities issued by domestic companies and meets other restrictions. Taxes are due only as the owner sells those investments. The owner can sell whatever percentage of his stock he wants to the ESOP. In many ESOPs, the owner still retains a majority of the company after selling shares to the ESOP.

An ESOP is best for an owner whose children do not want to run or own the company but can be used in other situations. The ESOP establishes accounts containing shares of the of company for each employee. The ESOP must meet nondiscrimination rules; the owner can't pick and choose which employees receive a higher share of ownership. When an employee leaves the company, he receives cash equal to the value of his ESOP account. Employees generally are allowed to vote on major corporate changes, such as mergers and acquisitions.

Strategy #38

Smart Transitions for Small Businesses

Planning the exit strategy from your small business is critical, but most business owners do it horribly wrong. You need to get this right, because most of your wealth, and perhaps your family legacy, are tied up in the business. Your net worth can drop substantially when the planning and execution fall short.

Preparations for a transition of business ownership or management must begin years in advance. If you want to maximize value, start working at least five to 10 years before you might leave or scale back your role in the firm. The nice thing about planning the small business exit is you don't have to leave when the target time in the plan is reached. But to generate value you must prepare for the potential sale or transition and have things set before you decide to make the move. Keep in mind that many people retire before they were planning. Health problems and other life events often intervene before their planned retirement date.

Another reason to plan early is the value of a small business fluctuates greatly with the economy and interest rates. You need to be ready to go to market when conditions are favorable, or you'll leave a lot of money on the table for others.

Here are steps to maximize the value of a small business when the ownership changes.

Tighten the systems. Accounting and other systems usually are weak in a small business. You and your finance person or people might know what's going on, at least well enough to suit your needs. But a new owner wants to function without relying on you. The new owner also might be interested in data that's different or more comprehensive than what you use to run the business. In addition to professionalizing the financial systems, it's a good idea to begin having annual audits performed. It costs some money, but it also builds confidence in potential buyers and allows you to increase the asking price.

The same applies to your other systems and processes. As many tasks as possible should be documented and standardized. Your business needs systems, not knowledge in someone's head, for conducting daily operations.

Build a team. A small business that depends on the owner isn't worth much to others. You need to build a team and delegate. Customers and clients need to be comfortable working with others at the firm instead of insisting on working with the owner. Other employees need to be generating sales and revenues and handling key tasks. Your work force also needs to have low turnover and high quality if you want to maximize the sale price.

Separate the family support. Many small businesses also serve as charities for the owners' families. To the extent possible, expenses are run through the business. Family members are given jobs for which they aren't ideally qualified. You need to be able to show buyers that the business is being run as a business. Family members who are involved or receive payments from the business should be qualified for their roles. Otherwise, you might have trouble finding buyers.

Diversify the revenue base. Buyers will be hesitant when the business is dependent on a small number of clients or customers. The risk that one or more will leave when you do is high, so they'll bid less to buy the business.

Show growth. Many business owners reach a point where they're comfortable with the size of the business and its income. They stop aggressive growth efforts. A buyer, however, isn't going to pay much for a stagnant business, even one that's profitable.

Determine a reasonable value. Business owners rarely are objective about what their businesses are worth. Have one or two business valuation experts study your business and estimate the value. They also should be able to explain how they reached their values and actions you can take to increase the value.

Build your experts. At a minimum you want a lawyer who's focused on small business transfers. There are nuances in both the tax and non-tax aspects of small business transfers that aren't in the knowledge base of lawyers who spend their time on other areas of the law. When you prepare years ahead of time, you can interview several prospective lawyers, get a feel for their expertise and philosophy, and learn how they work. When you're closer to transferring ownership, you'll be able to move quickly and profitably

Plan taxes early. A classic small business mistake is to negotiate a sale price and terms, and then bring the tax expert in and ask how taxes can be minimized. By then it's too late to maximize savings. Taxes potentially will take a hefty share of the sale proceeds of a small business. Review options with a tax expert early. You might be able to make changes in the years before the sale, such as giving shares to family members, that save quite a bit of money.

Consider an inside sale. Current employees or family members often are the best buyers for a business. I've long believed that an employee stock ownership plan (ESOP) is the most neglected business sale vehicle. The ESOP provides substantial tax benefits in addition to flexibility. It allows you to spread the sale over time or prepare for it and trigger the sale when you're ready to exit. I discussed the ESOP option in detail in Strategy #37.

An ESOP or any inside sale also makes it easier for the owner to make a gradual transition out of the business instead of an abrupt shift from running the business to being completely uninvolved.

Most small business owners don't know the values of their businesses to others and are unfamiliar with how to maximize that value to an outside buyer. They need to prepare for a transition well ahead of time, because preparing for a sale is the best way to attract buyers and maximize the sale price.

Strategy #39

More Ways To Keep The Business In The Family

The sad fact for most owners of family businesses is that, even if you follow all the estate planning advice I give, few of those businesses will survive to benefit your children. And a scant few will benefit your grandchildren. But that doesn't have to happen.

Lack of preparation is what hurts most family businesses. There are two types of preparation. The financial and legal type I discuss in most of this book and in monthly issues of *Retirement Watch*. That preparation involves wills, trusts, life insurance, buy-sell agreements, family limited partnerships, and that sort of thing. Believe it or not, that is the easy part.

The second type of preparation involves the personal and family issues. That's the hard part. In fact, a reason many people put off dealing with the financial and legal issues is that the personal and family issues are so tough. I show you how to tackle those issues.

Family businesses tend to mix personal and family goals, and the goals might be in conflict. The business goal usually is pretty simple—economic success. Look at how family goals might conflict with that.

The parents want to use the business to build the self-esteem and maturity of their children, to nurture them into responsible adults, and to provide for them financially. That's fine, but sometimes it means the business becomes a kind of family welfare agency. In addition, the parents often feel obliged carry over their personal family policy and treat the children equally in the business, even when the children don't have equal skills, interest, and business savvy.

The children might use the business to continue their childhood sibling rivalries or to look for signs of favoritism by the parents. And many children feel that simply being a family member entitles them to certain benefits from the business and gives them the right walk around the business issuing orders.

You can see how the personal and business goals can conflict. If the business goals don't prevail, then the business won't be run properly and might founder. In addition, the children might spend their time fighting instead of working, and even nonfamily employees will be unhappy. Quality employees often leave a firm when they see children of the owning family overpaid or occupying jobs their abilities don't warrant.

You can avoid these problems and get your business on the road to supporting several generations of your family. The first thing you need to do is focus on the long-term for a while. It is easy to get caught up in the daily operations. But for now, you need to spend some time thinking about the very long-term interests of the business.

You also are going to have to set up a communications system. Often, the biggest problems in family business succession and survival begin with poor communication. You also might need to work with a family business counselor or another professional who is experienced in helping family businesses survive for generations.

Here are some specific steps to take.

- Identify the areas in which family and business issues mix and often conflict. These include hiring, compensation, ownership, and management succession. Your business and family might have additional issues.
- Put some order to these issues by drawing up objective rules, guidelines and agreements concerning them. The goal here is to create written policies that ensure there will be arms-length, objective dealings with family members when the family and business goals conflict. That way, everyone will know the rules ahead of time and will know why they exist. And problems will be handled the same way each time they come up.
- Set up a family governance structure. This structure will be used to help identify the problems and set up the rules and agreements. The guidelines will work much better if everyone is involved in the process of developing them through this governance structure.

The first part of the governance structure can be the Family Council. This includes all family members affected by the business, and their spouses. You need to involve spouses, so that they will be fully informed and might be less inclined to say things outside of the governance structure that undermine the agreements. The council should know what is going on with the business, what decisions are being made, and what the ownership and compensation arrangements are. The council should meet at least annually, and more often as issues arise.

The second part of the structure is the Family Board. This is a smaller group that includes the major owners and key managers of the business. It could be the same as the business's board of directors. As the business grows you probably want some outside expertise and perhaps some key non-family employees on your board of directors, so the Family Board might be different from the business's board. The Family Board is the group that actually manages the business and, perhaps more importantly, manages the areas in which family and business conflict. This group also will decide when money is paid out of the business and how much is distributed.

This structure accomplishes two important goals. It opens up communication. Everyone gets the same information about the business and knows what rules govern the relationships. Everyone also knows there is a forum for airing complaints, suggestions, and grievances.

Using this structure, the family council can write and agree to rules and policies that cover the important issues. For example, there might be guidelines that say family members who work in the business receive compensation and benefits based on ability and performance, not family or ownership status or longevity; those owners are compensated based on ownership share, not through salaries; and that profit distributions from the business will be made only to the extent that the cash needs, including reserves, of the business are satisfied.

The policies also need enforcement mechanisms, which will depend on the policy issue. At times the policy might provide for a third party to make a judgment or settle a dispute.

Doing all this is a lot of work, and most of that work involves meetings and communication. But the only way to make the business last and to keep all family members involved is to develop a structure everyone understands and can live with. You need every member to recognize that the continuing success of the family business is the most important goal, and everything else is secondary.

Strategy #40

Avoiding the Double Tax on Retirement Benefits

IRAs and other retirement plans are included in the estate of the owner and subject to federal estate taxes when the estate is valuable enough. Unlike other assets, the tax basis of IRAs is not increased to current fair market value by those who inherit them. The beneficiaries who inherit an IRA or retirement plan account must include distributions in their income just as the owners would have. This means that the retirement plan was subject to estate taxes when included in the original owner's gross estate and taxed again when distributions are included in the gross income of the beneficiaries. Fortunately, there are two ways to reduce or eliminate this double tax.

First, the heirs should realize that they get a deduction against their income tax for any estate taxes paid that were attributable to the retirement plans. This is a fairly complicated section of the tax code known as "income in respect of a decedent" that few financial professionals are acquainted with. Pension plans pay income in respect of a decedent, and IRA beneficiaries qualify for a deduction to the extent that the estate paid taxes on the retirement assets. But the deduction is not all it appears at first. The deduction is an itemized deduction for miscellaneous expenses. That means you can take the deduction only if you itemize expenses on Schedule A. Finally, the deduction can only be taken in years when income is received from the IRA, and most tax professionals believe it can be taken only up to the amount of the income for the year. Unused deductions can be carried forward to future years.

Second, the IRA beneficiaries can disclaim any interest they might be entitled to in the retirement plans. This makes sense when there is a surviving spouse who is listed as a beneficiary or contingent beneficiary for the account along with the children. If the children disclaim their interests in the IRA, then the retirement plan would pass to the surviving spouse and would avoid estate taxes because of the marital deduction. That would leave only one level of tax, the income tax, when the spouse takes distributions. Any assets that remain when the spouse dies might be subject to the estate tax again at that time. The children would include in gross income any distributions they receive from the IRA after inheriting it from the second spouse. But in the interim, everyone would have been able to plan for ways to develop the surviving spouse’s plan to minimize taxes on the IRA.

Strategy #41

Skipping Around the Grandparent's Tax

Some years ago, Congress realized that wealthy parents were able to avoid one level of estate taxes by leaving money or property directly to the grandchildren, either in their own names or through trusts. This might result in an estate tax at the grandparents’ level, but it avoided an estate tax that might be due if the grandparents gave it to their children who then left it to the grandchildren.

To prevent this tax avoidance, Congress provided that an additional tax will be imposed on any transfer of property to a generation below that of the children of the transferor. This is known as the generation-skipping tax, or GST. It is imposed at the highest marginal gift and estate tax rate (regardless of the estate tax rate imposed on the rest of the estate). The GST is in addition to any estate or gift tax but is imposed only on the value of the property after subtracting regular estate taxes due from the property.

There are several ways to avoid or reduce this tax. The GST applies only to transfers that are subject to the gift or estate tax. So you can use the annual gift tax exclusion to give property to the grandchildren while avoiding the extra tax. The GST also does not apply if no estate or gift tax is due because of the unified estate and gift tax credit. With these two exceptions, most middle-income families are free to give to the grandchildren without worrying about the added tax.

Another, and more valuable tool, is the lifetime exemption from the GST for each spouse. The lifetime GST exemption is the same amount as the lifetime estate and gift tax exemption (but is in addition to the estate and gift tax exemption). Each spouse has a separate GST exemption, but the portability provision of the lifetime estate and gift tax

credit doesn't apply to the GST. The money or property can be given outright or through trusts to qualify for the exemption. This exemption allows many wealthy families to provide adequately for grandchildren without getting hit with the additional tax.

Another exemption takes effect when a trust was established for the benefit of the surviving spouse, with the remainder to go to a child of the couple, then to the grandchildren. If the child dies before the surviving spouse and the grandchildren, then this transfer does not count when computing the GST.

A third strategy involves the use of an insurance trust. You set up an irrevocable life insurance trust and each year give it enough money to buy a large life insurance policy. The proceeds from this insurance will not be used to pay estate taxes.

Instead, the insurance will be part or all of your children's or grandchildren's inheritances.

The key here is that after the trust receives the life insurance proceeds, under the terms of the trust agreement the trust immediately bursts into separate trusts for each beneficiary, each having a share of the insurance proceeds. Your children act as trustees of each trust. The trustees vote whether to distribute principal or income each year to the children or the grandchildren. Your hope is that the children will vote to preserve most of the money for the grandchildren.

A number of technical provisions must be met for the trust to avoid both estate taxes and the GST. For example, each child should not be able to vote income or principal distributions to himself or herself. In the right situation this arrangement, which is a variation of dynasty trust, can provide for a couple of generations while avoiding all taxes.

Strategy #42

Estate Planning for Modern Families

Traditional estate plans don't work well for many families these days. A traditional plan is for couples who are in their first and only marriage and have only kids from that marriage. Different plans, tools, and strategies might be needed for people with other life stories.

<u>Let's start with planning for the single person</u>. Many people now are unmarried for a substantial part of their adult years. They might be widowed, divorced, or never married. They might be in relationships that don't include legal marriage.

Several issues are the same for all of them.

The first focus of a single adult's estate plan should be to ensure that someone competent will manage the property and other matters if the individual is unable to. The best solution usually is a durable financial power of attorney or a living trust or both. These were discussed earlier in this book.

You also need a medical directive, which can include a medical power of attorney, living will, and other instructions. These documents designate one or more people to make decisions about your medical care when you aren't able to. They also were discussed earlier.

<u>These tools also are important for traditional couples, but they are more important for others</u>. State and federal law often provide some protection and presumptions for married couples but not for singles. As with married couples, the key to making these tools work is naming the right people to make the decisions for you and being sure the documents properly empower them.

Surprisingly, you're also likely to need a document naming people who can visit if you are in a hospital or other facility. This might be in the medical directive or a separate document. Many medical providers now interpret federal privacy law to restrict access only to family members unless there is a clear statement from the patient.

Long-term care insurance or some other plan for long-term care might be more important for an unmarried person than for a married couple. A single person doesn't have a spouse who might be able to assist him or her. While, Medicaid will pay for nursing home care and allow the retention of some assets, a married couple usually is allowed to retain more assets than a single person. In addition to a single person's being able to retain fewer assets for a legacy, the assets of any partner of the single person might be endangered under Medicaid, especially if the assets are owned jointly.

Those are common issues for all single persons. Now, let's look at different situations single persons might face.

Unmarried estate planning candidates fall into three categories: Those who have children from a previous marriage or relationship; those who never had children; and those who are part of a couple but won't be getting married or whose state doesn’t recognize their marriage. The categories can overlap, but each category has some unique challenges.

As with a married person, a single person who passes away without a will has the disposition of the property determined by state law. If there are biological children, in most states the property will be divided equally among the children. If there are no children, the disposition can be very unexpected, depending on the state and which relatives are alive. The property could go to half-sib- lings, cousins, or nieces and nephews. Single adults, especially those without children, are more likely to have nonfamily and charities as objects of affection and so prefer a disposition different from that offered by state law.

Other issues about children from more than one relationship and nonbiological children are discussed later in this strategy in the discussion of patchwork families.

With a traditional couple in these situations, the solution is to draft a will, but single people might prefer having most assets pass through a revocable living trust. Depending on the state, the probate process for a will might require notice to everyone who would have been eligible to inherit if there had not been a will. For an unmarried person, especially one without children, that can mean constructing a family tree and proving the demise or divorce of extended family members.

Property in a living trust avoids probate, and the terms of the trust determine who inherits the property. A will still is needed because it might not be possible to transfer all property to the trust, but the living trust might minimize delays and costs.

Another key issue for singles is the choice of an executor or successor trustee when there is no spouse or adult child to take the role. There might be friends or family members who are able and willing to handle the position. Otherwise, a trusted advisor, such as an accountant or attorney, might be the best choice.

There are a number of assets that aren’t covered by a will or living trust. These assets include IRAs, retirement plans, annuities, and life insurance. Singles need to decide who they want to benefit from these assets, complete their beneficiary designation forms, keep copies of the forms, and update the documents when appropriate. The executor of your estate needs to know about these assets and where to locate your records.

Taxes are an interesting planning issue. The income tax law can be more generous for unmarrieds, but the estate tax is less generous to singles than to married couples.

Often a married couple pays higher income taxes than two single people with the same incomes. Partly for that reason, some seniors choose to live together without getting married. Staying unmarried allows them to file separate returns, and a couple might be able to shift some deductions to the one in the higher tax bracket.

Under the estate and gift tax, singles do not have the advantage of the marital deduction. An unmarried person still can use the annual gift tax exclusion, make unlimited gifts for education and medical expenses, and use the $5.34 million lifetime estate and gift tax exemption. The lack of a marital deduction now matters only to fairly wealthy unmarried seniors, but for them it does limit the after-tax amount that can be left to noncharitable beneficiaries. For them, life insurance might be more attractive than it is for married couples.

The annual gift tax exclusion can be used to benefit anyone. Those without children often use it to benefit nieces, nephews, and other relatives.

Care must be taken when using the lifetime gift tax exemption amount. It often is better to make gifts early as long as sufficient assets are retained to support the standard of living. Yet, the objects of affection might change over time, especially in nontraditional families. So, if the exemption is used early, be sure the recipients of the largess are likely to be permanent objects of affection.

For many single seniors, especially those without children, a legacy of charitable giving is more important than it is for marrieds. The singles’ estate plans might contain more charitable gifts than others. In addition, they might make more use of lifetime strategies, such as charitable trusts, to generate current income tax savings and income during their lifetimes, reduce the size of their taxable estates, and leave charitable gifts.

Social Security and pensions leave few options. Social Security does not allow designation of a beneficiary other than the spouse, and a number of employer pension plans have the same restriction. The only option to replace this income for a surviving loved one who is not a spouse is to buy life insurance or have other assets to leave the person. A

possible strategy is to place assets in a charitable remainder trust that pays income to a beneficiary for life or a period of years, and then the remaining assets go to charity.

The unmarried population is increasing, and it faces unique estate planning challenges. These individuals should be sure to work with an estate planner who understands their special situations.

Another type of nontraditional family often is called a "patchwork family." These are families in which at least one spouse is in a second or later marriage and there are children from one or more of the marriages or other relationships.

Estate planning issues generally are important in these families. The spouses usually want to provide for each other. But they might have different objectives beyond that.

A common situation is that a spouse wants his or her assets to provide for the surviving spouse during his or her lifetime, but wants any remaining assets eventually go to his or her biological children. There might be a concern that if property is left outright to the surviving spouse, the assets ultimately might not be distributed among the children as desired. Also, when there are children from more than one relationship, there might be a preference to favor one set (such as the younger children) over the other. Some people want to provide for stepchildren, while others don't.

For patchwork families, trusts are the usual way to resolve these issues. The primary goal of the trusts isn't tax reduction. Instead, the trusts are used to control how the property is managed and distributed over time. The terms and number of the trusts vary based on the family situation. There might be one family trust or separate trusts that filter down to different members or branches of the family. The estate owner needs to determine his or her goals and have the estate planner write a plan that best meets those goals.

The downside to using trusts is that you probably can't make full use of both spouse's life- time estate and gift tax exemptions. That's not an issue for most families, because of the $11.4 mil- lion individual exemption, but can result in tradeoffs for wealthier families.

Patchwork families also seem to have more will contests and other disputes than do traditional families. This risk can be reduced if the spouses sign a premarital or post marital agreement. Otherwise, if you have only a will, it is easier for your spouse or even your spouse's children to challenge the terms. Also, let your children know generally how you intend to distribute the assets between the families. If you state this at the outset, it becomes much more difficult for one of them to challenge the plan.

When it's a second or later marriage, the spouses almost certainly should have separate attorneys for their estate plans. There are just too many potential conflicts for one attorney to serve the two spouses. In addition, to avoid potential conflicts and suspicions, many estate planners recommend that you give your durable power of attorney, health care proxy, or living will to one or more adult children or other people instead of your spouse.

Strategy #43

Planning for Those with Special Needs

Estate planning often focuses on healthy people and their families. Many families, however, have one or more members with chronic illnesses or conditions. That changes the estate planning equation. The person with the illness or condition might be the estate owner or a loved one of the owner, especially a child. In either case, the estate plan requires some adjustments and special considerations.

First, we will focus on the case of the estate owner who has the chronic condition or disease. The initial task is to determine whether the disease is likely to lead to a cognitive or mental decline or the effects primarily are physical. This is important, because when the effects primarily are physical the owner can retain control of decisions longer. When the effects are cognitive, the estate planning documents need to be developed and signed sooner rather than later. Otherwise, the documents are easier to challenge. In addition, the powers of attorney become more urgent as are the selections of the decision makers or agents. When documents are signed, have your physician write a letter affirming that you were competent at the time.

When the disease can affect handwriting, by making it shaky for example, some attorneys advise that you execute an affidavit that explains the changes in your signature.

You need a separate financial power of attorney and health care power of attorney. These documents appoint people to make decisions in these areas when you are unable. We have discussed these documents in detail elsewhere in this book.

A key point is you probably want separate people for these tasks, because the person you want making medical decisions might not be competent to make financial decisions and vice versa. You also should consider appointing two or more people under each document. Some people believe a committee of trusted people will result in better consideration of all the factors and better decisions.

Another key point is the agents must be prepared to perform the tasks for a long time, since you are known to have a chronic condition. You also want a mechanism for appointing successor agents, since the status of the agents can change over the years. Because of the long time and effort that might be involved, you might consider paying even relatives to perform these tasks.

While living wills and medical powers of attorney are common estate planning documents, preparing them takes more care for those with chronic conditions. You might be able to customize them, because you will have more knowledge of the future path of your health. For example, many POAs or living wills state flatly the person does not want special life extension care in case of a terminal illness. But some terminal illnesses do not affect mental function. You might prefer to receive treatment if you know you will be mentally alert. You also might decide you want any experimental treatment that becomes available, or that you don't. The point is that knowing you have a specific condition means your medical care documents can be customized. Even when you have existing documents that after a review seem to meet your needs, it is a good idea to re-execute or reaffirm them to forestall any arguments you did not consider the issues in light of your illness. Financial accounts should be consolidated. I advise this for everyone, but it seems especially important for someone with a chronic condition. Consolidation simply makes life easier and reduces the potential for oversight and mistakes.

When periodic hospitalization or other treatments are likely, you might need to prepare a series of temporary limited powers of attorney. You want someone to be able to pay bills and perform other necessary tasks when you are not able to while in the hospital or under treatment.

Living trusts become more important to those with chronic illness or conditions. These trusts allow a co-trustee to manage trust assets any time you are unable to without taking additional action.

They also allow you to be in control while the co-trustee performs ministerial tasks such as writing checks. A living trust provides a smooth transition when needed as a successor trustee takes over when you are unable to handle the tasks.

With POAs and living trusts, be sure to coordinate with your bank and other financial services firms. They often require the documents to be on file with them and reviewed by their attorneys and might require the use of their own forms.

Your investment strategy also might need to be reviewed. The condition might change your income needs, risk tolerance, or time horizon. If you have an investment advisor, he or she should be made aware of your condition and any changes it might require in your strategy.

Now, let's look at the case when the person with the chronic condition is not the estate owner but a loved one. Often, it is a child who has special needs that are likely to last for life. The parents are concerned with how to provide for the continuing care in their estate plans.

A common mistake in these situations it that government programs will handle any shortfall. For most special needs persons, the government steps in only if the person is impoverished and eligible for Medicaid. Even then, only subsistence food, shelter, and medical care are provided most of the time.

It also can be problematic to leave assets to the other children with instructions to take care of the special needs child. You don't know what might happen. The other children might die first, or their assets could be dissipated in divorce or their own financial difficulties.

The first step usually is to have a life care plan drafted by the person's doctor or other medical provider. The plan provides a roadmap of how much support is likely to be needed over the person's lifetime and when it is likely to be needed. This plan can be used to determine an investment strategy and trust terms.

The solution for providing funding usually is to set up a special needs trust. This is a particular type of trust that is drafted so that it does not count as part of the beneficiary's income or assets under government programs such as Medicaid. A SNT might be set up with the special needs person's own assets, such as when a child was injured in an accident and received a settlement. Under the law, the person could qualify for Medicaid during life but after the person's death Medicaid is reimbursed from the trust.

The SNT also could be set up with assets of others, such as the parents or the benefits of a life insurance policy. Medicaid is not reimbursed from these trusts. Any remainder in the trust could go to the other siblings or other heirs.

With the special needs child, it is important to use an experienced estate planner so the will, trust, and any gifts do not make the child ineligible for Medicaid or other government programs. A key term of the trust should be that it will provide only supplemental care beyond that provided by the government and any income the child earns. Otherwise, the trust assets are considered the child's assets.

You also should review beneficiary designation forms on your IRAs, annuities, life insurance, and any other assets. Having the child listed as a beneficiary also could make him or her ineligible for Medicaid and other programs.

Finally, and usually most importantly, consider life insurance. This can be used to fund the SNT. Or it can be used to provide for other heirs while leaving most of the estate to the SNT. For younger parents, life insurance is key. Otherwise, their estate is not likely to be enough to support the special needs child if the parents die prematurely.

Strategy #44

Reducing the State Taxman's Take

Many people are resting easy about estate taxes because of the $5 million federal estate tax exemption. They shouldn't. About 20 states and the District of Columbia have a death tax as of the end of 2014. Most of those states impose the taxes at lower levels then the federal tax. Also, because of budget problems, a number of states imposed or increased the taxes the last few years.

You need to worry about state and inheritance taxes when you live in one of the states with the taxes. You also need to be especially careful when you own real estate in or reside in more than one state.

There are four different types of state taxes on estates and inheritances. Knowing how they differ and which one a state imposes is as important as knowing the tax rate and the level at which it's imposed.

Estate tax. These are similar to the federal tax, but a few states have their own versions instead of exactly mirroring the federal tax.

Pickup tax. Many of the states use this method because it's easy to administer. The federal estate law and estate tax return are used, but the state selects its own exemption amount and tax rate table.

Modified pickup tax. It's exactly what the name indicates.

Inheritance tax. This tax is imposed on those who receive the assets instead of on the estate. Some states tax everything received by each beneficiary, while other states exclude some beneficiaries or amounts. This usually is a variation of a pickup tax, because the federal law is the basis. New Jersey and Maryland have both a pickup tax and an inheritance tax.

Readers need to know the estate and inheritance tax situation in every state in which they own real estate or spend time. When any of them has a tax, you need to meet with an estate planner to learn the details. Be sure to stay current on the latest changes in the law, because states have been changing them quite a bit.

There was a time when this didn't really matter. Most states had estate taxes that simply piggybacked on the federal tax. Plus, the federal tax had a state death tax credit that effectively had the federal government paying your state-level taxes. That credit now is repealed. Also, the states that now have death taxes have many variations with different exemption levels and other details.

One trap you want to beware of is having the same property hit with taxes from more than one state or having property taxed in a high tax state when it could have been taxed in a lower tax state. There are several strategies and traps to be aware of.

Personal property (that is, movable property) generally is taxed in the state in which you were considered to be domiciled or resident. The two terms are very different under the law. A domicile is not the same as a residence.

Most states say that you are resident there if you were present in the state for more than 183 days during the year. One common phrasing is that your state of domicile is the place in which you intend to reside indefinitely, but a residence is where you actually are living. So, once you are a domicile of a state, you are considered to be domiciled there until you affirmatively show an intention to abandon the domicile. You could leave the state or even the country for an extended period and still might be considered a domicile of the state under this rule. New York and some other high tax states aggressively track down people who have any contacts with New York and argue that their estates

should be fully taxed in New York. New York believes that once you are a domicile, it will try to tax you and your estate until you abandon all contacts with the state.

You need to disclose to your estate planner all the places in which you've lived and own property or visit regularly. Then, the two of you need to closely examine the laws of those states to determine how they tax estate and inheritances. Finally, you can structure things so that your estate is taxed only in one state and preferably the one with the lowest tax burden.

You want to be especially careful if you've owned real estate in different states If you lived in a state and continue to own residential real estate there, you are a prime candidate to have your estate taxed there. The best solution is to either sell the property or convert it to a rental property of which you cannot make personal use. If this is not acceptable, be sure to limit your visits. Definitely do not stay in the state more than 183 days and have clear documentation of your travels that will stand up to scrutiny.

A number of factors are examined to determine residence. These include the state where you register to vote, register your cars, hold a driver's license, receive most of your mail, and spend most of your time. There are many other factors a state looks at to determine your residence. There is a checklist on the members' section of the *Retirement Watch* web site. Click the "Extras" tab and look for "Checklists" on the next page. Anyone who has homes in several states or who has contact with more than one state, should discuss this issue with an estate planner.

Businesses and real estate generally are subject to death taxes in the states in which they are located. One way that usually is available to avoid this is to incorporate the property or business. Then you own personal property—shares of stock. You can have the same result with a partnership, limited liability company, or a trust. The personal property should be taxed in the state in which you were resident. But each state has its own rules.

Strategy #45

How Heirs Can Save A Bad Estate Plan

It is not unusual for someone to die with no estate plan or one that is inadequate or out of date. In many of these cases, the heirs might be able to snatch money from the tax man or make other improvements by using a device known as the qualified disclaimer. A disclaimer is simply when an heir refuses all or part of the inheritance to which he or she is entitled under either the will or the law. One heir can disclaim or any combination of them can. The property they disclaim rights to then goes back into the estate for distribution to other heirs as described under the will or state law.

Here's an example from an IRS ruling. A California woman died and left a will giving all of her community property to a trust for the benefit of her spouse for life, with the remainder going to her sons. She intended to set up a QTIP trust. But the trust did not meet the qualifications for the marital deduction, so it looked as though her entire estate would be depleted by the federal estate tax.

The sons and their father got together and agreed not to submit the will to probate. Instead, they let the estate be distributed according to state law. Then the sons filed a document with the court disclaiming their legal interests in the estate, except for $413,000. This amount was enough to take advantage of their mother's remaining federal estate tax credit. The rest of the estate went to their father under state law and qualified for the marital deduction. The result was that there was no estate tax. The share that went to the sons was sheltered by the estate tax credit, and the father's share qualified for the marital deduction. The IRS allowed this treatment. (Letter Ruling 9228004)

Most of the property then was in the father's estate, and he needed to do estate planning to ensure that this property avoided estate taxes on his death.

A qualified disclaimer must meet a number of technical requirements. Do not attempt this strategy without the advice of an experienced estate planner.

Strategy #46

How The Markets Can Change Your Estate Plan

A new tax law isn't the only reason to revisit your estate plan. Investment market and interest rate changes can alter the effects of many estate plans, often without their creators knowing the consequences. Here's a guide to how investment market changes might affect your estate plan.

- The values of many estates change with fluctuations in the stock market. That can be important if your will leaves specific dollar amounts to individuals or to charity.

Suppose your will leaves $50,000 to charity, which two years ago was no more than 10% of your $500,000 in liquid assets. But you invested aggressively, the market went against you, and your portfolio is down by 30% to $350,000. Now, the charity would get about 15% of your assets. More importantly, your survivors would get about $315,000, instead of the $450,000 you intended. In a variation, suppose you have two IRAs at different fund companies. They had similar balances two years ago, so you named one child as beneficiary of one account, and the other child as beneficiary of the other IRA. But the IRAs were invested very differently and now there is a 20% difference in the values of the two accounts.

Market fluctuations are a good reason not to leave simple, specific bequests in your estate plan.

Instead of leaving specific dollar amounts, use an equation setting upper and lower limits on a bequest. For example: "Charity A gets $50,000 or 10% of my estate, whichever is less." Instead of leaving specific accounts or assets to beneficiaries, leave them comparable values or percentages of your estate. Let the executor decide whether to give specific accounts to each beneficiary or to sell assets and distribute cash. Or let the heirs choose. Designate a specific asset only when there is something unique about it such as art, antiques, jewelry, heirlooms, a family business, or items of personal significance. In the example of the two IRAs, you could have named each child as equal co-beneficiary of each IRA. Let them split the IRAs after they inherit. Or you could have invested them the same way.

- Market fluctuations after the estate is settled also can cause problems. Suppose some heirs get assets while others get cash. If the assets appreciate significantly, those who received cash will be unhappy. But if the assets decline, those who received the assets will complain. Consider making everyone equally subject to asset fluctuations, or the executor should sell assets and distribute only cash.
- Deductions and valuations for strategies such as charitable trusts and qualified personal residence trusts vary with interest rates. Estate planning strategies that become more attractive after interest rates increase are charitable remainder annuity trusts and qualified personal residence trusts. But charitable lead annuity trusts are more attractive as rates decline. A grantor retained annuity trust also is more valuable with lower rates.

The list goes on. The benefits of strategies increase or decrease with interest rates, depending on the strategy. When implementing an estate plan, keep an eye on interest rate trends. You could save thousands of dollars by waiting a few years to implement a strategy or by implementing a strategy quickly before market changes occur. Also, a strategy that you rejected a few years ago might be more attractive now because of market changes.

- Estate executors also should follow the markets. Generally, assets in an estate are valued as of the date of death of the owner, and estate taxes are based on that value. But the law provides for an alternate valuation date of six months after the owner's death. That's something to keep in mind for the any executor. Choosing the alternate valuation date could save a bundle in taxes if asset values take a tumble.
- Market interest rates also affect the benefits of low-interest or no-interest loans to family members.

Strategy #47

The Family Bank Strategy

Have you heard of the Secret 770 Account? The President's Account? What about Banking on Yourself® or Infinite Banking? Becoming Your Own Banker, The Personal Bank, or The Retirement Miracle?

If you read financial publications, especially online, you almost certainly have heard of some of these. You've been told these financial tools are confidential, new, revolutionary, and of course, Wall Street's hidden secret. You're told that only a privileged few of the well-connected have used them, including presidents, major corporations, and the very wealthy. You might be told banks and Wall Street don't want you to know about them.

These marketing pitches used to be a backwater of the financial world, but they've been storming near the forefront lately thanks to aggressive, well-funded promoters and favorable market conditions.

Over the last several years I've discussed these ads with my friend and estate planning expert, David T. Phillips, CEO of Estate Planning Specialists. As marketing, the ads are very good. The hype creates a lot of intrigue and curiosity. But, since David and I know exactly what the ads are referring to, we're concerned they mislead. The over-the-top nature of the promotions also turns off people who could benefit from what actually is a very good estate planning strategy.

So, we decided to cut through the hype, lay things bare, and tell you exactly what all the fuss is about, who can benefit from the strategy, when it should be considered, and how to learn more about it.

The names listed earlier all describe the same thing. The strategy isn't new, secret, or exclusive. It has been and is used by many prominent and well-connected people as well as major businesses. Walt Disney Co. and McDonald's were started with the help of the strategy.

But it's just as readily available to you.

More importantly, recent events made the strategy more attractive than it has ever been. People who wouldn't have considered it in the past should consider the strategy now. It's a good way to build your estate. You earn safe, steady tax-free returns of 5% to 8% on your cash value investment account, and you don't have to worry about market risk. You also have tax-free cash available to you and your family whenever it is needed. In essence, you have a family bank, which is why David calls it **The Family Bank Strategy**.

There are other benefits to the Family Bank Strategy, some of which I'll explain shortly.

The linchpin of this strategy is cash value permanent life insurance. That's right, you reap these benefits from a product that's been around for at least a couple of hundred years, when you structure the strategy correctly and follow the rules.

Cash value life insurance has been maligned over the years, some of which was warranted. But things have changed. Permanent life insurance policies now are more favorable to policyholders. You won't have the opportunity to earn double-digit returns in the cash value account, but you won't be subject to investment losses or limited to the fixed 2% returns of the past. You'll earn those steady, solid returns of 5% to 8% I mentioned on your cash value, and those returns compound tax free. You also don't have market risk. Once you've earned a return, the markets can't take it away.

Taxes are another reason the strategy works for more people these days. Income and capital gains tax rates on higher-income taxpayers were increased in 2012. Many states also increased their taxes in recent years. After-tax wealth is what counts. Both the death benefit and the cash value account within a life insurance policy have been totally free of income and capital gains taxes since the passage of the 16th Amendment (income tax) in 1913.

Unlike term insurance, permanent life insurance doesn't expire, and the premiums don't increase as you age. More importantly, with permanent life insurance, you can have a cash value account that earns steady interest, and that interest accumulates and compounds tax free.

You can borrow from the cash value account tax free and interest free. When you need money for an investment or expense, you can borrow from the policy. If a family member needs money, you can make a loan to him or her from the policy. You don't have to charge interest, and you can forgive the loan later if you want.

The loans from the policy can be paid back on your schedule or no schedule at all. When loans aren't repaid, the unpaid loans reduce the death benefit paid to your beneficiaries.

Your loved ones or charity eventually receive the policy's death benefit. They won't owe income taxes on it, and the income that compounded, net of the cost of all the life insurance over the years, avoids income and capital gains taxes.

The foundation of the Family Bank Strategy is the life insurance benefit, which is passed to your beneficiaries tax free. But if you minimize the death benefit, staying within IRS limits, you increase the rate at which the tax-free cash value account grows.

The Family Bank Strategy is creditor proof, and you don't take the risk of investing with frauds, cons, and corporate thieves. Your investment and income are backed by an insurance company. Most insurers are over 100 years old. They have survived and thrived through the world's most difficult financial crises.

Life insurance, of course, doesn't have contribution limits and doesn't have required distributions for you or your heirs, as an IRA does.

Who should consider the Family Bank Strategy?

One good candidate is someone who is keeping money in conservative investments as a safety net or in case someone in the family has an unexpected need. It's not money that's designated for regular living expenses. He could transfer some of this money into permanent life insurance and establish a Family Bank.

Another good candidate is someone with a large IRA, either a traditional or a Roth IRA. The traditional IRA eventually triggers income taxes. You'll also be required to take minimum distributions after age 70½ that are subject to income taxes. Your beneficiaries who inherit what is left will be required to take minimum distributions and pay income taxes.

In this situation, everyone might be better off if money is taken out of the traditional IRA today, the taxes paid, and the after-tax amount put in permanent life insurance. The future earnings on the cash value will accumulate tax-free and will compound for the rest of your life if you want. If money is needed, it can be taken tax free as loans. Eventually, your beneficiaries inherit the life insurance benefit tax-free.

This strategy is especially good when you convert only enough of your IRA to bring your taxable income up to the maximum of your tax bracket. For example, a couple earning $150,000 will be in the 28% federal income tax bracket until their income reaches $226,850. They could transfer another $76,000 annually from the IRA into the Family Bank Strategy before jumping up to the 33% bracket.

The really big advantage is that the life insurance benefit is always going to be worth substantially more than the money you transferred into the policy. And, unlike an IRA, market changes aren't going to cause the insurance policy's value to decline. If your loved ones inherit a traditional IRA, they'll really inherit only the after-tax balance.

Even a Roth IRA owner might be better off with the Family Bank Strategy. If the Roth IRA exceeds your likely needs and primarily is for loved ones to inherit, consider turning it into a permanent life insurance policy. That way, your beneficiaries will inherit the tax-free policy benefit, which is going to be higher than the Roth IRA balance. There's no investment risk with the insurance policy, and you still have tax-free access to the money through loans.

The Family Bank Strategy also should be considered by someone who still is working and has excess cash flow. The savings need to be invested. The Family Bank Strategy might be the best long-term use for some of that money, especially when the contribution limits already are reached for 401(k)s and IRAs.

Consider this example. Max Profits, age 60, is in good health and he wants to transfer $200,000 into The Family Bank Strategy. Instantly, he increases his estate to $795,890, four times the deposit, because of the life insurance benefit. His cash account at the end of the first year will be $203,195 and will grow to $295,091 in 10 years and $516,768 in 20 years, assuming 7% inter- est. The formula used in this example to credit the cash value account has an average annual 30- year return of 7.6%.

There are four general types of permanent life insurance, and many variations of each. For the Family Bank Strategy, you only want to consider Participating Whole Life or Indexed Universal Life. There's a vigorous debate among insurance professionals who implement the strategy over which type of policy to use. You need to know the arguments on each side and decide which is best for you.

That's why David Phillips wrote *The Family Bank Strategy*, a book that does an excellent job of setting the record straight and explaining the options and choices. David explains 17 positive features of The Family Bank Strategy and lists 10 factors that have come together to make it one of the premier safe money strategies today. It's available on Amazon for $19.95, but David makes it available to my readers for $9.95 for as long as supplies last, which includes shipping and handling. Call David's office at 888 892-1102 to order your book.

Don't be turned off by the phony hype about secret strategies or the negative attitudes about permanent life insurance. For many of you, the Family Bank Strategy is a way to lock in the value of your estate for loved ones, earn a solid tax-free return on your cash value, and have tax- free access to the capital when you need it. It can play an important role in increasing your family's after-tax wealth.

Strategy #48

Trusts That Almost Eliminate Estate & Gift Taxes

There are two standard trusts, the grantor retained income trust and the charitable lead trust, that can be used aggressively to nearly eliminate estate and gift taxes while getting substantial amounts of property out of your estate. These strategies are ideal for rapidly appreciating property, such as stocks in a bull market.

The strategies are known as the "near-zero GRAT" (grantor retained annuity trust) and the "zeroed-out CLAT" (charitable lead annuity trust). The GRAT is referred to as "near-zero" because IRS regulations don't allow the elimination of gift taxes on the GRAT, while it is possible to eliminate the taxes with the CLAT.

Here's an example of how a zeroed-out CLAT can work. Max Profits transfers $1,000,000 to a CLAT for the benefit of his son, Hi. The trust will pay a charity a substantial amount annually for six years. Hi will inherit the remainder interest after six years.

What's the benefit? The IRS requires the use of current market interest rates to compute the present value of the trust for gift tax purposes. Max used the current interest rate to estimate the payout to the charity that will result in zero gift taxes and a maximum charitable contribution deduction. Then the trust is invested in assets that Max hopes will earn a higher return than the IRS interest rate. If it does, then Hi receives tax-free the amount by which the trust's investments exceed the IRS's interest rate. If the IRS rate is 5.4% and the trust earns 10%, about $231,950 will remain in the trust at the end of six years. Hi will pocket it free of gift taxes. Max has made a substantial gift to charity, received a tax deduction for it, and still managed to leave a significant additional amount to Hi at zero tax cost.

If Max planned to benefit the charity anyway, he hasn't lost anything if the trust's investments don't exceed the IRS's interest rate.

You can get a similar result with a GRAT that will pay you income for a few years then leave the remainder for your children. The IRS won't let you get the gift tax down to zero, but you can get it down to a very small percentage of the amount put in the trust. Usually a near-zero GRAT is designed to last only two to four years. It is funded with assets that the creator expects will appreciate rapidly, such as growth stocks, especially stock in a company owned by the creator. The major difference is that the income from a GRAT is paid to the creator instead of the charity.

What is the benefit of a near-zero GRAT? Again, a meaningful amount of property is out of your estate and in the hands of your heirs at a very low tax cost. But with a GRAT very large annual distributions are made to you for a few years. That money is back in your estate. Some GRAT creators use the income to make charitable contributions. Or it can be used to buy life insurance, after paying income taxes on the distributions.

These are aggressive strategies. They work well when done carefully. Be sure such plans are set up by an experienced estate planner and that you know all the potential consequences of a strategy. Also, there are frequent proposals by the IRS and Congress to eliminate them.

Strategy #49

Combining Strategies

Throughout this chapter of the report, I generally have discussed strategies one at a time.

An estate plan, however, is going to use more than one strategy to achieve the goals set for it. Several strategies often are combined to achieve the desired goals. For example, you might begin a program of making annual gifts. You also might put your business into a family limited partnership and a vacation home into a qualified personal residence trust. The rest of the estate might be given partly to your spouse and partly to a credit shelter trust or QTIP trust. Remember there is no one right or wrong estate plan for each person. There are many possibilities. Estate planning is a series of tradeoffs. By carefully evaluating the tradeoffs, you will reach all or most of your estate planning goals. There are some limits put on you by the tax law and state law. In most cases, however, the real limits are imposed by the creativity of the estate owner and estate planner. Make note of the strategies in this report that might be appropriate for you. Then, be sure your estate planner considers them, along with his or her own ideas, when presenting options for your plan.

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Biography

Bob Carlson is editor of the monthly newsletter and website, *Retirement Watch.* He has served on the Board of Trustees of the Fairfax County Employees' Retirement System since 1992 and been chairman since 1995. The system has more than $4 billion in assets. Carlson was a member of the Board of Trustees of the Virginia Retirement System, which oversaw $42 billion in assets, from 2001-2005. He was appointed to the Virginia Retirement System Deferred Compensation Plans Advisory Committee in 2011.

His latest book is "Where's My Money?: How to Get the Most from your Social Security" (Regnery Capital; 2021). He also wrote the revised edition of "The New Rules of Retirement" (Wiley, 2016; first edition 2004). He also co-authored "Personal Finance after 50 for Dummies" (with Eric Tyson; Wiley, 2020) and wrote "Invest Like a Fox…Not Like a Hedgehog" (Wiley, 2007).

He has written numerous other books and reports, including "The New Rules of Estate Planning," "Securing Your Lifetime Stream of Income," "Tax Wise Money Strategies, Retirement Tax Guide," "How to Slash Your Mutual Fund Taxes," "Bob Carlson's Estate Planning Files" and "199 Loopholes That Survived Tax Reform." He also has been interviewed by or quoted in numerous publications, including *The Wall Street Journal*, *Reader's Digest*, *Barron's*, *AARP Bulletin*, *Money*, *Worth*, *Kiplinger's Personal Finance*, the *Washington Post* and many others. He has appeared on national television and on a number of radio programs. He is past editor of *Tax Wise Money*.

Carlson also was a Commissioner on the Fairfax County Redevelopment and Housing Authority. Carlson is an attorney and passed the CPA Exam. He received his J.D. and an M.S. (Accounting) from the University of Virginia and received his B.S. (Financial Management) from Clemson University. He also is an instrument rated private pilot. He is listed in many editions of *Who's Who in America* and *Who's Who in the World*.