SELECTING THE BEST ESTATE PLANNING STRATEGIES

CONTENTS

ESTATE PLANNING BASICS **2**
Fundamental questions **2**
Will or living trust? **3**
Other facts about estate settlement **6**
Determining potential estate taxes **7**

ESTATE TAX SAVING STRATEGIES **10**
The marital deduction **10**
Life insurance **13**
Annual gifting **16**
Charitable contributions **20**
Strategies for family-owned businesses **21**
Special strategies for special situations **24**
Community property issues **27**

IMPLEMENTING AND UPDATING YOUR PLAN **31**
Where do you go from here? **31**
Estate planning worksheet **32**

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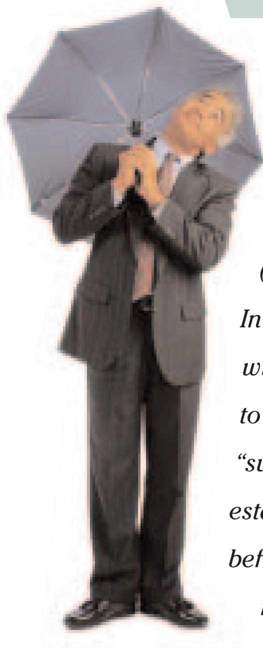
ESTATE PLANNING BASICS

When you hear the phrase "estate planning," the first thought that comes to mind may be taxes. But estate planning is about more than just reducing taxes. It's about ensuring your assets are distributed according to your wishes. That's why, even with the estate tax reduction under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), estate planning is still critical. In addition, estate taxes still pose a threat with respect to wealth available to transfer to the next generation. Remember, the "sunset" provision means that in 2011 the estate tax will return to where it stood before EGTRRA, unless Congress takes further action to change the law.



In addition, the act includes other provisions that increase the complexity of estate planning, such as gradual repeal of the generation-skipping transfer (GST) tax; reduction in the top gift tax rate but no repeal of the gift tax; increases in gift, GST and estate tax exemptions; and repeal of the step-up in basis at death.

As a result, estate planning is more important than ever — without proper planning, you could still lose to estate taxes a large share of what you've spent a lifetime building.

This booklet will help you start preparing a plan to reduce estate taxes taking into account EGTRRA. And if you already have a plan in place, it will show you how to make the adjustments necessary to take advantage of these changes and suggest strategies you currently may not be employing. We begin in this first section by offering you an overview of basic estate planning principles. Then on page 10 we start discussing estate tax saving strategies.

Certainly this booklet is no replacement for professional financial, tax and legal advice. Because of the complexities and new issues EGTRRA creates, Congress is likely to make further estate tax law changes that could affect the issues discussed here — or your estate plan. Be sure to get professional advice before implementing any estate planning strategies.

Planning tip 1

KEEP IN MIND COMMUNITY PROPERTY

Some of the strategies in this booklet depend on the ownership of assets. Alaska, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin have community property systems. (Alaska's is elective.) Under such a system, each spouse usually has a one-half interest in property acquired during marriage. (Turn to page 27 for more information.) If you live in a community property state, keep this in mind as you relate our ideas to your situation.

FUNDAMENTAL QUESTIONS

Because estate planning is not just about reducing taxes but also about making sure your assets are distributed as you wish both now and after you're gone, you need to consider three questions before you begin your estate planning.

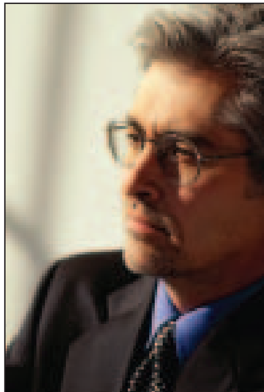
1. Who should inherit your assets?

If you are married, before you can decide who should inherit your assets, you must consider marital rights. States have different laws designed to protect surviving spouses. If you die without a will or living trust, state law dictates how much passes to your spouse. Even with a will or living trust, if you provide less for your spouse than state law deems appropriate, the law will allow the survivor to receive the greater amount.

Once you've considered your spouse's rights, ask yourself these questions:

- Should your children share equally in your estate?
- Do you wish to include grandchildren or others as beneficiaries?
- Would you like to leave any assets to charity?

2. Which assets should they inherit?



You may want to consider special questions when transferring certain types of assets. For example:

- If you own a business, should the stock pass only to your children who are active in the business? Should you compensate the others with assets of comparable value?
- If you own rental properties, should all beneficiaries inherit them? Do they all have the ability to manage property? What are each beneficiary's cash needs?

3. When and how should they inherit the assets?

To determine when and how your beneficiaries should inherit your assets, you need to focus on three factors:

- The potential age and maturity of the beneficiaries,
- The size of your estate versus your and your spouse's need for income during your lifetimes, and
- The tax implications.

Outright bequests offer simplicity, flexibility and some tax advantages, but you have no control over what the recipient does with the assets once they are transferred. Trusts can be useful when the beneficiaries are young or immature, when your estate is large, and for tax planning reasons. They also can provide the professional asset management capabilities an individual beneficiary lacks.

WILL OR LIVING TRUST?

You have two basic choices for transferring your assets on your death: the will, which is the standard method, and the living trust, which is rapidly growing in popularity. If you die without either a will or a living trust, state law controls the disposition of your property. And settling your estate likely will be more troublesome — and more costly.

The primary difference between a will and a living trust is that assets placed in your living trust avoid probate at your death. Neither the will nor the living trust document, in and of itself, reduces estate taxes — though both can be drafted to do

this. Whether a will or a living trust is better for you depends on many personal factors. Let's take a closer look at each vehicle.

Wills

If you choose just a will, your estate will have to go through probate. Probate essentially is a court-supervised process to protect the rights of creditors and beneficiaries and to ensure the orderly and timely transfer of assets. The probate process has six steps:

1. ***Notification of interested parties.*** Most states require disclosure of the estate's approximate value as well as the names and addresses of interested parties. These include all beneficiaries named in the will, natural heirs and creditors.

2. ***Appointment of an executor.*** If you haven't named an executor, the court will appoint one to oversee the estate's liquidation and distribution.

3. ***Accumulation of assets.*** Essentially, all assets you owned or controlled at the time of your death need to be accounted for.

4. ***Payment of claims.*** The type and length of notice required to establish a deadline for creditors to file their claims vary by state. If a creditor does not file its claim on time, the claim generally is barred.

5. ***Filing of tax returns.*** This includes final income and estate taxes.

6. ***Distribution of residuary estate.*** After the estate has paid debts and taxes, the executor can distribute the remaining assets to the beneficiaries and close the estate.

A will can be advantageous because it provides standardized procedures and court supervision. Also, the creditor claims limitation period is often shorter than for a living trust.

Planning tip 2

TITLE ASSETS RIGHT

Only assets titled in your living trust's name avoid probate. When you create the trust, make sure you direct your legal advisor to change the title of all assets you want managed by your trust's provisions.

Living trusts

Because probate is time-consuming, potentially expensive and public, avoiding probate is a common estate planning goal. A living trust (also referred to as a revocable trust, declaration of trust or inter vivos trust) acts as a will substitute, providing instructions for the management of your assets on your death, and, if funded, during your life. You will still also need to have a short will, often referred to as a "pour over" will.

How does a living trust work? You transfer assets into a trust for your own benefit during your lifetime. You can serve as

trustee or select a professional trustee. You completely avoid probate only if all of your assets are in the living trust when you die. The pour over will can specify how assets you didn't transfer to your living trust during your life will be transferred at death.

Essentially, you retain the same control you had before you established the trust. Whether or not you serve as trustee, you retain the right to revoke the trust and appoint and remove trustees. If you name a professional trustee to manage trust assets, you can require the trustee to consult you before buying or selling assets. The trust does not need to file an income tax return until after you die. Instead, you pay the tax on any income the trust earns as if you had never created the trust.

A living trust offers additional benefits. First, unlike probate, your assets are not exposed to public record. Besides keeping your affairs private, this makes it more difficult for anyone to challenge the disposition of your estate. Second, a living trust can serve as a vehicle for managing your financial assets if you become mentally incapacitated or disabled. A properly drawn living trust avoids embarrassing guardianship proceedings and related costs and offers greater protection and control than a durable power of attorney because the trustee can manage trust assets for your benefit.

Who should draw up your will or living trust?

A lawyer! Don't try to do it yourself. Estate law is much too complicated. You should seek competent legal advice before finalizing your estate plan. While you may want to use your financial advisor to formulate your estate plan, wills and trusts are legal documents. Only an attorney who specializes in estate matters should draft them.

Selecting an executor or trustee

Whether you choose a will or a living trust, you also need to select someone to administer the disposition of your estate — an executor or personal representative and, if you have a living trust, a trustee. An individual, such as a family member, a friend or a professional advisor, or an institution, such as a bank or trust company, can serve in these capacities. (See Planning tip 3.) Many

Planning tip 3

PROFESSIONAL VS. INDIVIDUAL EXECUTOR OR TRUSTEE

Advantages of a professional executor or trustee:

- Specialist in handling estates or trusts
- No emotional bias
- Impartiality — usually free of personal conflicts of interest with the beneficiaries
- Independence — sensitive to but not hindered by emotional considerations
- Financial expertise

Advantages of an individual executor or trustee:

- More familiarity with the family
- Potentially lower administrative fees
- Ability to hire professional advisors as needed

people name both an individual and an institution to leverage their collective expertise.

What does the executor or personal representative do? He or she serves after your death and has several major responsibilities, including:

- Administering your estate and distributing the assets to your beneficiaries,
- Making certain tax decisions,
- Paying any estate debts or expenses,
- Ensuring all life insurance and retirement plan benefits are received, and
- Filing the necessary tax returns and paying the appropriate federal and state taxes.

Whatever your choice, make sure the executor, personal representative or trustee is willing to serve, and consider paying a reasonable fee for the services. The job isn't easy, and not everyone will want or accept the responsibility. Provide for an alternate in case your first choice is unable or unwilling to perform. Naming a spouse, child or other relative to act as executor is common, and he or she certainly can hire any professional assistance needed.

Finally, make sure the executor, personal representative or trustee doesn't have a conflict of interest. For example, think twice about choosing an individual who owns part of your business, a second spouse or children from a prior marriage. A co-owner's personal goals regarding the business may differ from those of your family, and the desires of a stepparent and stepchildren may conflict.

Selecting a guardian for your children

If you have minor children, perhaps the most important element of your estate plan doesn't involve your assets. Rather, it involves who will be your children's guardian. Of course, the well-being of your children is your priority, but there are some financial issues to consider:

- Will the guardian be capable of managing your children's assets?
- Will the guardian be financially strong? If not, consider compensation.
- Will the guardian's home accommodate your children?
- How will the guardian determine your children's living costs?

If you prefer, you can name separate guardians for your child and his or her assets. Taking the time to name a guardian or guardians now ensures your children will be cared for as you wish if you die while they are still minors.

OTHER FACTS ABOUT ESTATE SETTLEMENT

You also should be aware of the other procedures involved in estate settlement. Here is a quick review of some of them. Your attorney, as well as the organizations mentioned, can provide more details.

Transferring property

When thinking about transferring your property, what probably first comes to mind are large assets, such as stock, real estate and business interests. But you also need to consider more basic assets:

Safe deposit box contents. In most states, the bank seals the box as soon as it learns of the death and opens it only in the presence of the estate's personal representative.

Savings bonds. The surviving spouse can immediately cash in jointly owned E bonds. To cash in H and E bonds registered in the deceased's name but payable on death to the surviving spouse, they must be sent to the Federal Reserve.

Receiving benefits

The surviving spouse or other beneficiaries may be eligible for any of the following:

Social Security benefits. For the surviving spouse to qualify, the deceased must have been age 60 or older or their children must be under age 16. Disabled spouses can usually collect at an earlier age. Surviving children can also get benefits.

Employee benefits. The deceased may have insurance, back pay, unused vacation pay, and pension funds the surviving spouse or beneficiaries are entitled to. The employer will have the specifics.

Insurance they may not know about. Many organizations provide life insurance as part of the membership fee. They should be able to provide information.

DETERMINING POTENTIAL ESTATE TAXES

The next step is to understand some estate tax basics. First you need to get an idea of what your estate is worth and whether you need to worry about estate taxes, both under today's rates and as exemptions increase under EGTRRA.

How much is your estate worth?

The first step is to add up all of your assets. Use Chart 1, and include cash, stocks and

Chart 1
Totaling up your estate

Cash	$__________
Stocks and bonds	$__________
Notes and mortgages	$__________
Annuities	$__________
Retirement benefits	$__________
Personal residence	$__________
Other real estate	$__________
Partnerships, business interests	$__________
Life insurance you own	$__________
Automobiles	$__________
Artwork	$__________
Jewelry	$__________
Other (furniture, collectibles, etc.)	$__________
Gross estate	$__________

bonds, notes and mortgages, annuities, retirement benefits, your personal residence, other real estate, partnership interests, life insurance, automobiles, artwork, jewelry, and collectibles. If you are married, prepare a similar chart for your spouse's assets. And be careful to review how you title the assets, to include them correctly in each spouse's chart.

If you own an insurance policy at the time of your death, the proceeds on that policy usually will be includable in your estate. Remember: That's *proceeds*. Your $1 million term insurance policy that isn't worth much while you're alive is suddenly worth $1 million on your death. If your estate is large enough, a significant share of those proceeds may go to the government as taxes, not to your chosen beneficiaries, though the estate tax impact will decrease gradually under EGTRRA. (See Chart 2.)

How the estate tax system works

Here's a simplified way to compute your estate tax exposure. Take the value of your estate, net of any debts. Also subtract any assets that will pass to charity on your death — such transfers are deductions for your estate. Then if you are married and

Chart 2

Transfer tax exemptions, highest rates and potential liability under EGTRRA

Year	Gift tax exemption	Estate[1] and GST tax exemption	Highest estate, GST and gift tax rates	Estate tax on $2.5 million	Estate tax on $5 million
2002	$1 million	$1 million[2]	50%	$680,000	$1,930,000
2003	$1 million	$1 million[3]	49%	$680,000	$1,905,000
2004	**$1 million**	**$1.5 million**	**48%**	**$465,000**	**$1,665,000**
2005	$1 million	$1.5 million	47%	$460,000	$1,635,000
2006	$1 million	$2 million	46%	$230,000	$1,380,000
2007	$1 million	$2 million	45%	$225,000	$1,350,000
2008	$1 million	$2 million	45%	$225,000	$1,350,000
2009	$1 million	$3.5 million	45%	$0	$675,000
2010	$1 million	(repealed)	35% (gift tax only)	$0	$0
2011	$1 million	$1 million[4]	55%[5]	$680,000	$2,045,000

[1] *Less any gift tax exemption already used.*
[2] *The GST tax exemption is $1.1 million.*
[3] *The GST tax exemption is $1.12 million.*
[4] *The GST tax exemption is indexed for inflation.*
[5] *The benefits of the graduated estate and gift tax rates and exemption are phased out for estates/gifts over $10 million.*

Source: U.S. Internal Revenue Code

your spouse is a U.S. citizen, subtract any assets you will pass to him or her. Those assets qualify for the marital deduction and avoid estate taxes until the surviving spouse dies. (If you are single or your spouse is not a U.S. citizen, turn to pages 24 and 25 for more information.) The net number represents your taxable estate.

Chart 3
2004 gift and estate tax rates

Taxable estate (after deductions)	2004 tax	Marginal tax rate (tax on next dollar)
$1 million	$0	41%
$1.25 million	$102,500	43%
$1.5 million	$210,000	45%
$2 million	$435,000	49%

Source: U.S. Internal Revenue Code

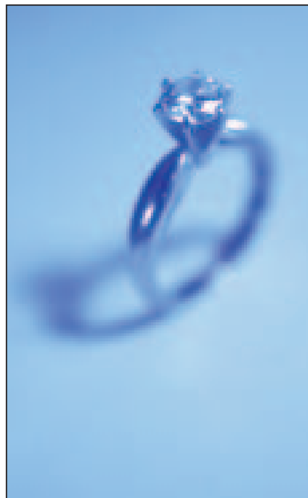
You can pass up to the exemption amount during your life or at death free of gift and estate taxes. This amount will increase until the estate tax is eliminated in 2010. (See Chart 2.) But note that the gift tax exemption does not increase beyond $1 million, and even in 2010, the gift tax is not repealed — so lifetime gifts of more than $1 million will be subject to tax.

If your taxable estate is equal to or less than the exemption and you haven't already used any of the exemption on lifetime gifts, no federal estate tax will be due when you die. But if your estate exceeds this amount, it will be subject to estate tax. (See Chart 3 for 2004 marginal rates.) The top rate will gradually decrease through 2007. (See Chart 2.)

ESTATE TAX SAVING STRATEGIES

Here's a look at the most important estate planning tools and how you can use them to minimize taxes and maximize your estate's value as the tax rules change over the decade. You'll learn how the marital deduction, lifetime gift and estate tax exemption, various trusts, life insurance, family business structures, charitable contributions, and other estate planning techniques can help you achieve your goals. You will also see why it will be helpful to seek professional financial, tax and legal advice about ways to use these techniques effectively. Please let us know if you have any questions about how they might apply to your situation.

THE MARITAL DEDUCTION



The marital deduction is one of the most powerful estate planning tools. Any assets passing to a surviving spouse pass tax free at the time the first spouse dies, as long as the surviving spouse is a U.S. citizen. Therefore, if you and your spouse are willing to pass all your assets to the survivor, no federal estate tax will be due on the first spouse's death — even before the estate tax is repealed.

But this doesn't solve your estate tax problem. First, if the surviving spouse does not remarry, that spouse will not be able to take advantage of the marital deduction when he or she dies. Thus, the assets transferred from the first spouse could be subject to tax in the survivor's estate, depending on when the surviving spouse dies. Second, from a personal perspective, you may not want your spouse to pass all assets to a second spouse even if it would save estate taxes.

Preserve both exemptions with a credit shelter trust

Since assets in an estate equal to the exemption amount are exempt from estate taxes, a married couple can use their exemptions to avoid tax on up to double the exemption amount. And this amount will gradually increase until it reaches $7 million in 2009 — the year before the estate tax repeal. (See Chart 2 on page 8.) An effective way to maximize the advantages of the exemption is to use a credit shelter trust.

Let's look at an example: As shown in Chart 4, left column, Mr. and Mrs. Jones have a combined estate of $4 million. At Mr. Jones' death in 2004, all of his assets pass to Mrs. Jones — tax free because of the marital deduction. Mr. Jones' taxable estate is zero. Shortly thereafter, and still in 2004, Mrs. Jones dies, leaving a $4 million estate. The first $1.5 million is exempt from estate tax, but the remaining $2.5 million is subject to $1,185,000 in taxes, leaving only $2,815,000 for the children.

The problem? Mr. and Mrs. Jones took advantage of the exemption in only one estate.

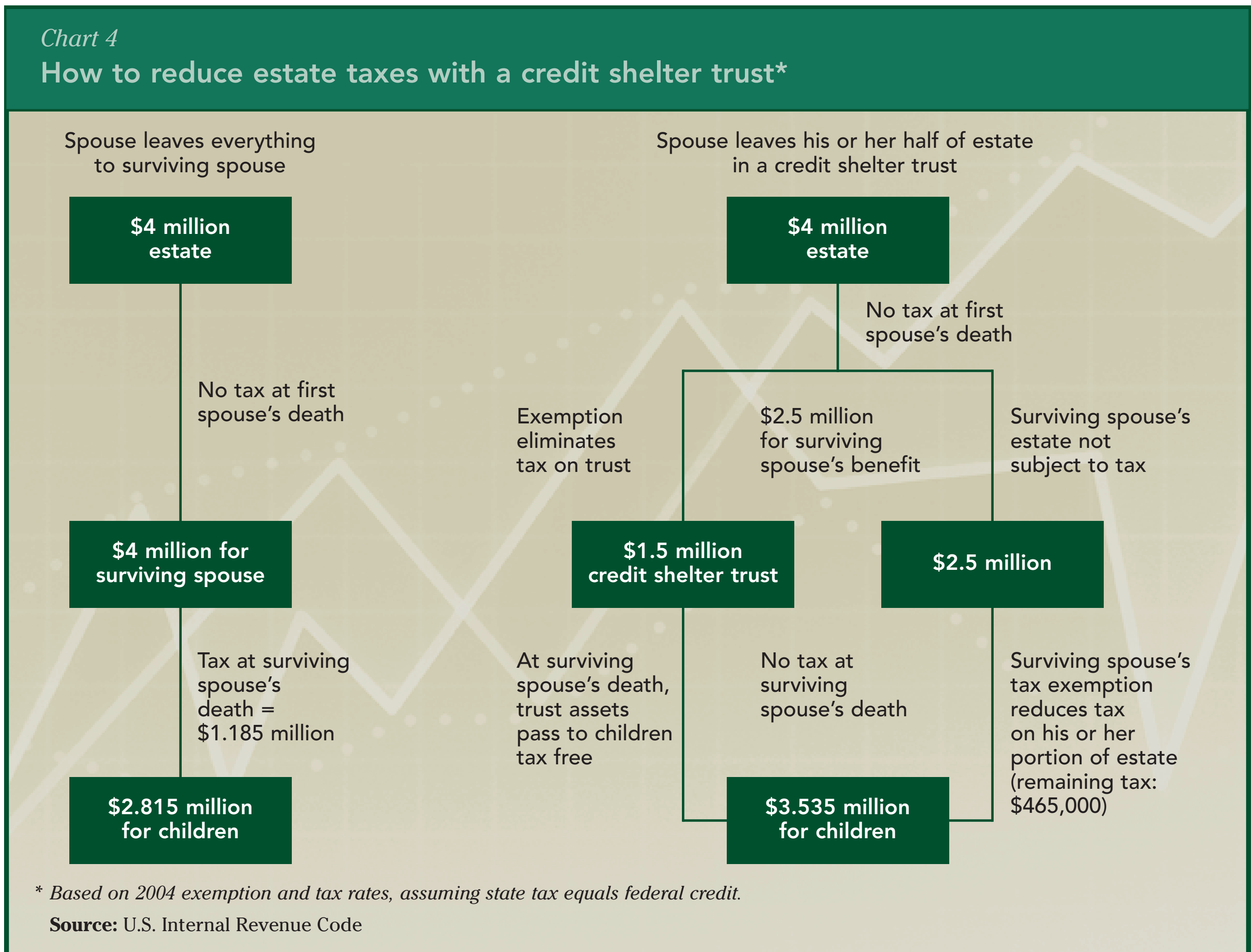
Let's look at an alternative: As shown in Chart 4, right column, Mr. Jones' will provides that assets equal to the exemption go into a separate trust on his death. This "credit shelter trust" provides income to Mrs. Jones during her lifetime. She also can receive principal payments if she needs them to maintain her lifestyle. Because of the trust language, Mr. Jones may allocate his $1.5 million exemption amount to the trust to protect it from estate taxes. If there were remaining assets (assets over $1.5 million), they would pass directly to Mrs. Jones.

Because the $1.5 million trust is not included in Mrs. Jones' estate, her taxable estate drops from $4 million to $2.5 million. Thus, the tax at her death is reduced, as both spouses' exemptions are used. By using the credit shelter trust in Mr. Jones' estate, the Joneses save $720,000 in federal estate taxes.

The Joneses do give up something for this tax advantage. Mrs. Jones doesn't have unlimited access to the funds in the credit shelter trust because, if she did, the trust

Chart 4

How to reduce estate taxes with a credit shelter trust*



* *Based on 2004 exemption and tax rates, assuming state tax equals federal credit.*

Source: U.S. Internal Revenue Code

Case study I

SPLITTING ASSETS WITHOUT SPLITTING UP THE MARRIAGE

Does it matter which spouse dies first? Maybe. Let's go back to our friends the Joneses. Assume Mr. Jones owns $3.5 million of assets under his name and Mrs. Jones has $500,000 under her name. If Mr. Jones dies first, the credit shelter trust can be funded with $1.5 million from his assets. But if Mrs. Jones dies first, only the $500,000 under her name would be available to fund the trust. Mrs. Jones' estate can take advantage of only $500,000 of her $1.5 million exemption amount.

To take maximum advantage of the credit shelter trust strategy, be sure property in each estate totals at least the exemption amount. Ensuring each spouse has enough assets may require reviewing how your assets are currently titled and shifting ownership of some assets. Even if you can't perfectly divide assets, any assets owned up to the lifetime exemption limit will reduce the total tax.

A warning here is appropriate: Assets can be retitled between spouses without any negative federal tax effect, but some states treat transfers between spouses as taxable gifts for state tax purposes. Seek professional advice before transferring titles.

would be includable in her estate. Still, Mr. Jones can give her all of the trust income and any principal she needs to maintain her lifestyle. And the family comes out ahead by $720,000. But the outcome would be quite different if both spouses didn't hold enough assets in their own names. (See Case study I.)

Control assets with a QTIP trust

A common estate planning concern is that assets left to a spouse will eventually be distributed in a manner against the original owner's wishes. For instance, you may want stock in your business to pass only to the child active in the business, but your spouse may feel it should be distributed to all the children. Or you may want to ensure that after your spouse's death the assets will go to your children from a prior marriage.

You can avoid such concerns by structuring your estate plan so your assets pass into a qualified terminable interest property (QTIP) trust. The QTIP trust allows you to provide your surviving spouse with income from the trust for the remainder of his or her lifetime. You also can provide your spouse with as little or as much access to the trust's principal as you choose. On your spouse's death, the remaining QTIP trust assets pass as the trust indicates.

Thus, you can provide support for your spouse during his or her lifetime but retain control of the estate after your spouse's death. Because of the marital deduction, no estate taxes are paid on your death. But if your spouse dies while the estate tax is in effect, the entire value of the QTIP trust will be subject to estate tax.

LIFE INSURANCE

Life insurance can play an important role in your estate plan. It is often necessary to support your family after your death or to provide liquidity. Not only do you need to determine the type and amount of coverage you need, but also who should own insurance on your life to best meet your estate planning goals.

When you quantify the numbers to determine what cash flow your family will need, the result may be surprisingly high.

Support your family

Your first goal should be maintaining your heirs' lifestyles in the event of your death. Carefully analyze how much from insurance proceeds they'll need to replace your lost earning power. The first question is whether your spouse is employed. If your spouse is, consider whether becoming a single parent will impede career advancement and earning power. If your spouse isn't, consider whether he or she will start to work and what his or her earning potential will be.

Next, look at what funds may be available to your family in addition to your spouse's earnings and any savings. Then estimate what your family's living expenses will be. Consider your current expenditures for shelter, food, clothing, medical care, and other household and family expenses; any significant debts, such as a mortgage and student loans; and your children's education, which can be difficult to estimate.

How do you determine the amount of insurance you need? First calculate how much annual cash flow your current investments, retirement plans and any other resources will provide. Use conservative earnings, inflation and tax rates. Compare the amount of cash flow generated with the amount needed to cover your projected expenses. Life insurance must cover any shortfall. When you quantify the numbers to determine what cash flow your family will need, the result may be surprisingly high. Remember that you may be trying to replace 25 or more years of earnings.

Avoid liquidity problems

Insurance can be the best solution for liquidity problems. Estates are often cash poor, and your estate may be composed primarily of illiquid assets such as closely held business interests, real estate or collectibles. If your heirs need cash to pay estate taxes or for their own support, these assets can be hard to sell. For that matter, you may not want these assets sold.

Even if your estate is of substantial value, you may want to purchase insurance simply to avoid the unnecessary sale of assets to pay expenses or taxes. Sometimes second-to-die

insurance makes the most sense. (See Planning tip 4.) Of course, your situation is unique, so please get professional advice before purchasing life insurance.

Choose the best owner

If you own life insurance policies at your death and you die while the estate tax is in effect, the proceeds will be included in your taxable estate. Ownership is usually determined by several factors, including who has the right to name the beneficiaries of the proceeds. The way around this problem? Don't own the policies when you die. But don't automatically rule out your ownership either.

Determining who should own insurance on your life is a complex task because there are many possible owners, including you or your spouse, your children, your business, and an irrevocable life insurance trust (ILIT). Generally, to reap maximum tax benefits you must sacrifice some control and flexibility as well as some ease and cost of administration.

To choose the best owner, you must consider why you want the insurance, such as to replace income, to provide liquidity or to transfer wealth to your heirs. You must also determine the importance to you of tax implications, control, flexibility, and ease and cost of administration. Let's take a closer look at each type of owner:

You or your spouse. Ownership by you or your spouse generally works best when your combined assets, including insurance, do not place either of your estates into a taxable situation. There are several nontax benefits to your ownership, primarily relating to flexibility and control. The biggest drawback to ownership by you or your spouse is that on the death of the surviving spouse (assuming the proceeds were initially paid to the spouse), the insurance proceeds could be subject to federal estate taxes, depending on when the surviving spouse dies.

Planning tip 4

CONSIDER SECOND-TO-DIE LIFE INSURANCE

Second-to-die life insurance can be a useful tool for providing liquidity to pay estate taxes. This type of policy pays off when the surviving spouse dies. Because a properly structured estate plan can defer all estate taxes on the first spouse's death, some families find they don't need any life insurance then. But significant estate taxes may be due on the second spouse's death, and a second-to-die policy can be the perfect vehicle for offsetting the taxes. It also has other advantages over insurance on a single life. First, premiums and estate administrative costs are lower. Second, uninsurable parties can be covered. But a second-to-die policy might not fit in your current irrevocable life insurance trust (ILIT), which is probably designed for a single life policy. Make sure the proceeds are not taxed in either your estate or your spouse's by setting up a new ILIT as policy owner and beneficiary.

Your children. Ownership by your children works best when your primary goal is to pass wealth to them. On the plus side, proceeds are not subject to estate tax on your or your spouse's death, and your children receive all of the proceeds tax free. There also are disadvantages. The policy proceeds are paid to your children outright. This may not be in accordance with your general estate plan objectives and may be especially problematic if a child is not financially responsible or has creditor problems.

Your business. Company ownership or sponsorship of insurance on your life can work well when you have cash flow concerns related to paying premiums. Company sponsorship can allow premiums to be paid in part or in whole by the company under a split-dollar arrangement. But if you are the controlling shareholder of the company and the proceeds are payable to a beneficiary other than the company, the proceeds could be included in your estate for estate tax purposes.

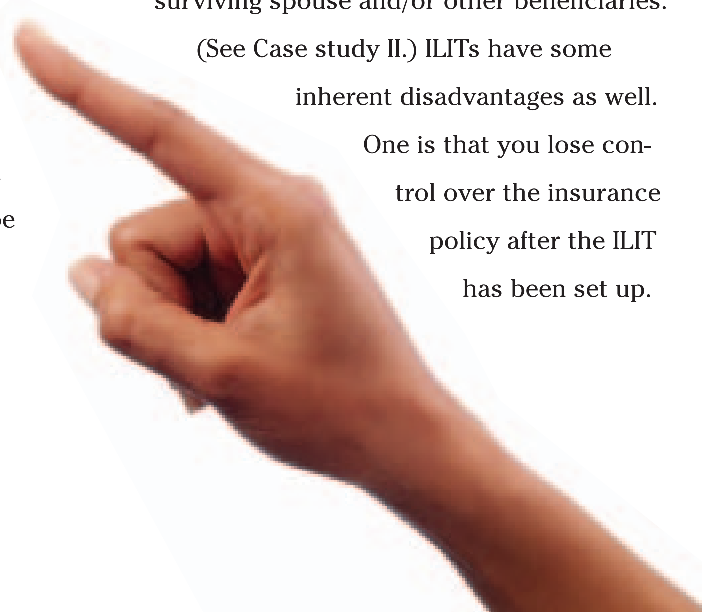
Case study II

IN AN ILIT WE TRUST

Walter was the sole income provider for his family. While working on his estate plan, he and his advisor determined he needed to purchase life insurance to provide for his family if something happened to him. After calculating the size of the policy his family would need, Walter had to determine who should own it.

Because his children were still relatively young, Walter ruled them out as owners. He was concerned that if his wife was the owner and something happened to her, his children would lose too much to estate taxes. So Walter decided to establish an irrevocable life insurance trust (ILIT) to hold the policy. Despite the loss of control over the policy, Walter felt the ILIT offered the best protection for his family, even if the estate tax was no longer an issue.

An ILIT. A properly structured ILIT could save you estate taxes on any insurance proceeds. Thus, a $1 million life insurance policy owned by an ILIT instead of by you individually could reduce your estate taxes by as much as $480,000 in 2004 (if you are in the highest estate tax bracket). How does this work? The trust owns the policies and pays the premiums. When you die, the proceeds pass into the trust and are not included in your estate. The trust can be structured to provide benefits to your surviving spouse and/or other beneficiaries. (See Case study II.) ILITs have some inherent disadvantages as well. One is that you lose control over the insurance policy after the ILIT has been set up.



ANNUAL GIFTING

Even with exemptions and insurance proceeds out of your estate, you still can have considerable estate tax exposure. One effective way to reduce it is to remove items from your estate before you die. Even with the pending estate tax repeal in 2010, this strategy makes sense — as long as you can make the gifts without incurring gift tax — because the estate tax might not actually be repealed, and even if it is, the tax will return in 2011 if there's no further legislation.

Taking advantage of the annual gift tax exclusion is a great way to reduce your estate taxes while keeping your assets within your family. Through 2001 each individual was entitled to give as much as $10,000 per year per recipient without any gift tax consequences or using any of his or her gift, estate or GST tax exemption amount. This amount increased to $11,000 in 2002 under an indexing provision. The exclusion will increase only in $1,000 increments, so it will probably not increase again for a few more years. Case study III shows the dramatic impact of an annual gifting program.

Case study III

THE EARLY BIRD CATCHES THE TAX SAVINGS

Five years ago, Mr. and Mrs. Brown had a combined estate of $4 million, which in 2004 would give them a federal estate tax exposure of $465,000, even if they took advantage of each of their $1.5 million exemptions. But Mr. and Mrs. Brown began a gift program, giving their combined annual exclusion amount ($20,000 in 2000 and 2001, and $22,000 in 2002, 2003 and 2004) to each of their two sons, two daughters-in-law and four grandchildren annually. This reduced their combined estates by $848,000 in five years, resulting in a combined estate tax exposure of $68,400 in 2004. That's an estate tax savings of $396,600.

The savings may actually be even greater. If Mr. and Mrs. Brown had not made the annual gifts, those assets might have generated income or appreciated in value each year. This additional income and appreciation would have been includable in their estate. By making the gifts to their children and grandchildren, they passed on not only the $848,000 of assets free of tax, but also the future income and appreciation of those assets.

Make gifts to minors without giving control

To take advantage of the annual exclusion, the law requires that the donor give a present interest in the property to the recipient. This usually means the recipient must have complete access to the funds. But a parent or grandparent might find the prospect of giving complete control of a large sum to the average 15-year-old a little unsettling. Now we'll cover a few ways around that concern:

Take advantage of Crummey trusts. Years ago, the Crummey family wanted to create trusts for their family members that would provide restrictions on access to the funds but still qualify for the annual gift tax exclusion. Language was inserted in the trust that allowed the beneficiaries a limited period of time in which to withdraw the funds that had been gifted into the trust. If they did not withdraw the funds during this period, the funds would remain tied up in the trust. This became known as a "Crummey" withdrawal power.

The court ruled that because the beneficiaries had a present ability to withdraw the funds, the gifts qualified for the annual gift tax exclusion. Because the funds weren't actually withdrawn, the family accomplished its goal of restricting access to them.

The obvious risk: The beneficiary can withdraw the funds against the donor's wishes. To protect against this, the donor may want to explain to the beneficiaries that they're better off not withdrawing the funds, so the proceeds can pass tax-free at his or her death. Your tax or legal advisor can counsel you about other ways of drafting the document to protect against withdrawals.

Establish trusts for minors. An excellent way to provide future benefits (such as college education funding) for a minor is to create a trust which provides that:

- The income and the principal of the trust may be used for the benefit of the minor until the age of 21, and
- Any income and principal not used passes to the minor at 21 years of age.

A trust of this type qualifies for the annual gift tax exclusion even though the child has no current access to the funds. Therefore, a parent can make annual gifts into the trust while the child is a minor. The funds accumulate for the future benefit of the child, and the child doesn't even have to be told about the trust. But one disadvantage is that the child must have access to the trust assets once he or she reaches age 21.

Leverage the annual exclusion by giving appreciating assets

Gifts don't have to be in cash. Any asset qualifies. In fact, you will save the most in estate taxes by giving assets with the highest probability of future appreciation. Take a look at Chart 5. Cathy gave her daughter a municipal bond worth $11,000. During the next five years, the bond generated $550* of income annually but did not appreciate in value. After five years, Cathy had passed $13,750 of assets that would otherwise have been includable in her estate.

** This amount is hypothetical and is used for example only.*

Chart 5

The power of giving away appreciating assets

	Municipal bond	Appreciating stock
Value of gift	$11,000	$11,000
Income and appreciation (5 years)	2,750*	7,000*
Total excluded from estate	$13,750	$18,000

By giving an appreciating asset, Cathy removes an extra $4,250 from her estate.

** These amounts are hypothetical and are used for example only.*

Source: U.S. Internal Revenue Code

Suppose Cathy gave her daughter $11,000 in stock. If the stock generated no dividends during the next five years but appreciated in value by $7,000*, Cathy would have given her daughter $18,000 of assets — and taken them out of her estate.

** This amount is hypothetical and is used for example only.*

You will save the most in estate taxes by giving assets with the highest probability of future appreciation.

Remember that a recipient usually takes over the donor's basis in the property gifted. If an $11,000 gift cost the donor $8,000, the recipient takes over an $8,000 basis for income tax purposes. Therefore, if the asset is then sold by the recipient for $11,000, he or she has a $3,000 gain for capital gains tax purposes.

Consider whether "taxable" gifts make sense

The estate and gift tax system is a combined one. Taxable gifts are subject to the same progressive tax rate schedule as taxable estates, with one important exception: Under EGTRRA, the gift tax is never repealed — though in the year of the estate tax repeal (2010), the top gift tax rate will decrease another 10 percentage points to 35%. Taxable gifts equal to or less than the gift tax exemption amount made by an individual create no gift tax, just as assets in an estate equal to or less than the estate tax exemption amount create no estate tax. But note that this is on a combined basis. In other words, if you make $200,000 of taxable gifts during your life, the amount of assets in your estate that will avoid estate taxes will be reduced by $200,000. You can use the exemption during life or at death, but not both.

With the estate and gift exemption increase to $1 million in 2002, those who had already used up their exemptions in earlier years have additional amounts to work with. The estate tax exemption has now increased further, to $1.5 million for 2004. Continued increases are scheduled through 2009, but the gift tax exemption remains at $1 million.

Because many assets appreciate in value and there is no guarantee the estate tax repeal will last beyond 2010 (or even that Congress won't pass further legislation repealing the repeal or reducing the exemption increases), it may make sense to gift up to the exemption amount in 2004 if you haven't already. (See Case study IV.)

Remember, each spouse is entitled to his or her own exemption. If a couple uses up their gift tax exemption by making $2 million in taxable gifts in 2003, and after five years the assets have increased in value by 50%, they will have removed an additional $1 million from their taxable estates without having to use an additional portion of their exemptions.

Before EGTRRA, making taxable gifts even beyond the exemption made sense, but this is no longer the case in most situations. What did the benefit used to be? First, as with the gift in the previous scenario, future appreciation is removed from the estate. Second, gift tax is less expensive than estate tax. Gift tax is paid only on the amount of the transfer itself, while estate tax is paid on the amount of the transfer plus the amount of tax paid on the transfer. But now it doesn't make sense to pay gift tax when the assets may be able to be transferred tax free at death.

Case study IV

WHEN "TAXABLE" GIFTS SAVE TAXES

Let's say John has an estate of $3 million. In 2004 he has already given $11,000 for the year to each of his chosen beneficiaries and then gives away an additional $1.5 million of assets. Assume that, in the next five years, his assets will increase in value by 50%. John uses his $1.5 million exemption by making the taxable gift. Therefore, his estate can't use it. But by making the taxable gift, he also removes $750,000 of future appreciation from his estate within five years, based on a 50% increase in value. This amount escapes the estate tax.

Control assets while you give them away with an FLP

FLPs can be excellent tools for long-term estate planning, even in light of EGTRRA, because they allow you to leverage gifts you make. But they are controversial, so caution is needed when implementing them. (For more details, see below.) This type of partnership converts an estate plan into a family business, allowing you to remain actively involved throughout your lifetime. FLPs are special because they allow you to give assets to your children (and grandchildren) without giving up control of those assets.

Here's how it works: First you select the type of assets (such as cash, stocks, real estate) and the amount (based on the gift tax rules discussed earlier) and place them into the FLP. Next you give some or all of the limited partnership interests to your children and grandchildren.

The limited partnership interests give your family members ownership interests in the partnership, but no right to control its activities. Control remains with the small percentage (at least 1%) of partnership interests known as general partnership interests, of which you retain ownership. The result is that you can reduce your taxable estate by giving away assets, while retaining

control of the underlying assets and the income they produce.

Because the limited partners lack any control, these interests can often be valued at a discount. Recent court cases cast doubt on FLPs' legality. Please seek professional advice about how this or any other legislation might affect the outcome when you create an FLP or make a gift of FLP interests. In any case, when making a gift of an FLP interest, obtaining a formal valuation is generally advisable to establish the value of the underlying assets and the amount of the discount, if any is permitted.

Because the limited partners in an FLP lack any control, these interests can often be valued at a discount.

CHARITABLE CONTRIBUTIONS

If you share your estate with charity, it will cut your estate tax bill. Direct bequests to charity are fully deductible for estate tax purposes. Leave your entire estate to charity, and you'll owe no estate taxes at all.

In addition to tax advantages, contributing to charity is a good way to leave a legacy in your community or to instill in your heirs a sense of social responsibility.

But what if you want to make a partial bequest to charity and a partial gift or bequest to your natural beneficiaries? A trust can be the answer.

Provide for family today and charity tomorrow with a CRT

Your will can create a trust that will pay income to beneficiaries you name for a period of time. At the end of the stated period, the remaining trust assets pass to your charitable organization(s) of choice. This is a charitable remainder trust (CRT).

For example, let's say you want to provide for your elderly father. Income from the trust you create goes to him until he dies. At that time, the remainder passes to charity. You get what you wanted — you provide for both your father and charity. And, since you are making a partial charitable donation at the time of your death, your estate receives a deduction for a portion of the trust's value. Government tables determine the size of the estate tax deduction based on the value of the trust assets, the trust term and the income to be paid to the beneficiary.

Take the reverse approach with a CLT

Now let's reverse the situation. You wish to provide income to a charity for a set period, with the remainder passing to your beneficiaries. The charitable lead trust (CLT) provides such a vehicle and also a partial charitable deduction for your estate.

Gain an income tax deduction with lifetime charitable gifts

You can use the above techniques during your lifetime as well. And if you create a charitable trust during your life, you may be entitled to an income tax deduction for the portion that government tables calculate to be the charitable gift. This way, you can reduce both your income and estate taxes.

The benefits are even greater if you fund the trust with appreciated assets. Let's say you transferred appreciated securities to a CRT. After receiving the stock, the trustee sells it and reinvests the proceeds. Because it is a charitable trust, no capital gains tax is owed. The trustee is able to reinvest the proceeds in a higher yielding investment, thus increasing the annual cash income to you or your chosen beneficiaries.

STRATEGIES FOR FAMILY-OWNED BUSINESSES

Few people have more estate planning issues to deal with than the family-business owner. The business may be the most valuable asset in the owner's estate. Yet, two out of three family-owned businesses don't survive the first generation. If you are a business owner, you should address the following concerns as you plan your estate:

Who will take over the business when you die? Owners often fail to develop a management succession plan. It is vital to the survival of the business that successor management, in the family or otherwise, be ready to take over the reins.

Who should inherit your business? Splitting this asset equally among your children may not be a good idea. For those active in the business, inheriting the stock may be critical to their future motivation. To those not involved in the business, the stock may not seem as valuable. Perhaps your entire family feels entitled to equal shares in the business. Resolve this issue now to avoid discord and possible disaster later.

Planning tip 5

LEAVE A LEGACY WITH A PRIVATE FOUNDATION OR DONOR-ADVISED FUND

You can form a private foundation to support your charitable activities or to make charitable grants according to your wishes. If the foundation qualifies for tax-exempt status, your charitable contributions to it will be deductible, subject to certain limitations.

An alternative to consider is a donor-advised fund. Generally, such funds are sponsored by a large public charity that allows you to make contributions that are used to create a pool of funds you control. Thus, a donor-advised fund is essentially a small-scale private foundation that requires much less administration.

Whether a private foundation or a donor-advised fund is right for you depends on various factors. Although there may be less incentive to create such vehicles in light of the increasing estate tax exemption (and potential repeal), they are still viable options worth exploring.

How will the IRS value your company? Because family-owned businesses are not publicly traded, knowing the exact value of the business is difficult without a professional valuation. The value placed on the business for estate tax purposes is often determined only after a long battle with the IRS. Plan ahead and ensure your estate has enough liquidity to pay estate taxes and support your heirs.

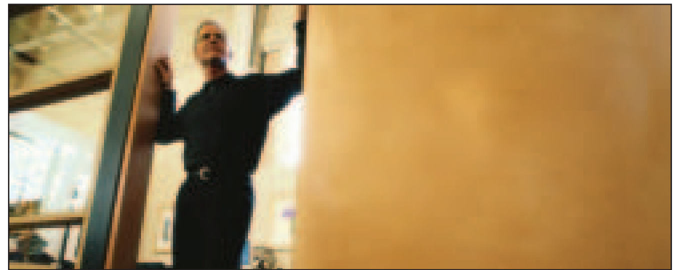
Take advantage of a special estate tax break

Congress has long struggled with whether it should grant additional tax benefits to family-owned businesses, recognizing that families might have to sell their businesses just to pay estate taxes. This, of course, will no longer be of concern if the estate tax repeal is made permanent. But until that time, it will be critical for business owners to plan carefully.

As part of the Taxpayer Relief Act of 1997, Congress passed an increased exemption provision to provide relief for family-business owners. The exemption, when added to the regular estate tax exemption, can equal as much as $1.3 million per individual. But a family business must meet a number of technical requirements and perhaps implement some difficult planning decisions for the business to qualify. Under EGTRRA, this exemption is effectively eliminated this year, when the estate tax exemption increases to $1.5 million.

In addition, the law has provided two other types of tax relief for business owners:

Section 303 redemptions. Your company can buy back stock from your estate without the risk of the distribution being treated as a dividend for income tax purposes. Such a distribution must, in general, not exceed the estate taxes, funeral and administration expenses of the estate. One caveat: The value of your family-owned business must exceed 35% of the value of your adjusted gross estate. If the redemption qualifies under Section 303, this is an excellent way to pay estate taxes.



Estate tax deferral. Normally, your estate taxes are due within nine months of your death. But if closely held business interests exceed 35% of your adjusted gross estate, the estate may qualify for a deferral of tax payments. No payment other than interest is due until five years after the normal due date for taxes owed on the value of the business. The tax related to the closely held business interest then can be paid over 10 equal annual installments. Thus, a portion of your tax can be deferred for as long as 14 years from the original due date. Interest will be charged on the deferred payments. (See Case study V.)

Ensure a smooth transition with a buy-sell agreement

A powerful tool to help you control your — and your business's — destiny is the buy-sell agreement. This is a contractual agreement between shareholders and their corporation or between a shareholder and the other shareholders of the corporation. (Partners and limited liability company members also can enter into buy-sell agreements.)

The agreement controls what happens to the company stock after a triggering event, such as the death of a shareholder. For example, the agreement might provide that, at the death of a shareholder, the stock is bought back by the corporation or that the other shareholders buy the decedent's stock.

A well-drafted buy-sell agreement can solve several estate planning problems for the owner of a closely held business and can help ensure the survival of the business. (See Planning tip 6.)

Planning tip 6

PROTECT YOUR INTERESTS WITH A BUY-SELL AGREEMENT

A buy-sell agreement offers three key benefits:

1. It provides a ready market for the shares in the event the owner's estate wants to sell the stock after the owner's death.
2. It sets a price for the shares. In the right circumstances, it also fixes the value for estate tax purposes.
3. It provides for stable business continuity by avoiding unnecessary disagreements caused by unwanted new shareholders.

Remove future appreciation by giving stock

The key to reducing estate taxes is to limit the amount of appreciation in your estate. We talked earlier about giving away assets today so that the future appreciation on those assets will be outside of your taxable estate. There may be no better gift than your company stock — this could be the most rapidly appreciating asset you own.

For example, assume your business is worth $500,000 today, but is likely to be worth $1 million in three years. By giving away the stock today, you will keep the future appreciation of $500,000 out of your taxable estate.

Case study V

SOMETIMES PUTTING OFF UNTIL TOMORROW MAKES SENSE

Lee owned a small manufacturing company that accounted for 50% of his estate. When he died in October 2003, his estate's total estate tax liability was $1 million. Half of the liability was due at the normal due date of his estate's tax return in July 2004 (nine months after Lee's death). The other $500,000 of liability could be paid in 10 installments, starting in July 2009 (five years and nine months after Lee's death) and ending in July 2018. Lee's estate would also have to pay interest on the unpaid liability each year, but at special low rates.

A flexible strategy for the business owner was reinstated in late 1990 when Congress retroactively repealed the estate freeze provisions that became law in 1987. Before 1987, business owners commonly recapitalized their businesses, retained preferred stock interests and gave some or all of the common stock to their beneficiaries. This way, they retained control of their companies and froze the value of their stock for estate tax purposes. All future appreciation affected only the common shares, not the owners' preferred stock.

Congress saw the loophole and created Section 2036(c) in an attempt to prevent future estate freezes. The section had been under constant attack since its creation and was finally repealed retroactively in 1990. In its place, Congress passed legislation that once again permits estate freezes, but only if certain requirements are met.

Gifting family business stock can be a very effective estate tax saving strategy. But beware of some of the problems involved. The gift's value determines both the gift and estate tax ramifications. The IRS may challenge the value you place on the gift and try to increase it substantially. Seek professional assistance before attempting to transfer portions of your business to family members.

A recent law change requires the IRS to make any challenges to a gift tax return within the normal three-year statute of limitations, even though no tax is payable with the return.

SPECIAL STRATEGIES FOR SPECIAL SITUATIONS

Standard estate planning strategies don't fit every situation. Single people, unmarried couples, noncitizen spouses, individuals planning a second marriage and grandparents are among those who might benefit from less common techniques. In this section, we look at several special situations and estate planning ideas that may apply to them.

Singles

For single people, the repeal of the estate tax is especially helpful because it eliminates the disadvantage of not having the unlimited marital deduction, which allows a spouse to leave assets to a surviving spouse's estate tax free. But a will or a living trust can ensure that your loved ones receive your legacy in the manner you desire. In addition, with the use of trusts, you can provide financial management assistance to your heirs who are not prepared for this responsibility.

Second marriages

Estate planning for the second marriage can be complicated, especially when children from a prior marriage are involved. Finding the right planning technique for your situation can not only ease family tensions but also help you pass more assets to the children at a lower tax cost.

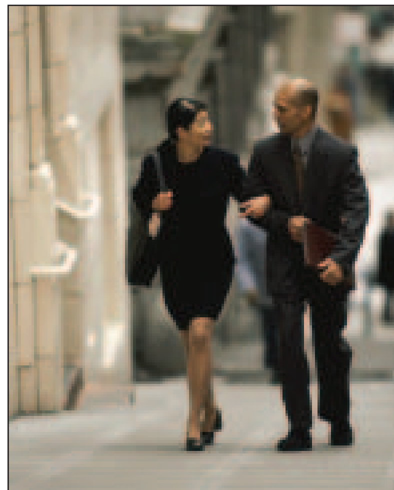
A QTIP marital trust can maximize estate tax deferral while benefiting the surviving spouse for his or her lifetime and the

children after the spouse's death. Combining a QTIP with life insurance benefiting the children or creatively using joint gifts or GST tax exemptions can further leverage your gifting ability. (Turn back to page 12 for more on QTIP trusts.)

A prenuptial agreement can also help you achieve your estate planning goals. But any of these strategies must be tailored to your particular situation, and the help of qualified financial, tax and legal advisors is essential.

Unmarried couples

Because unmarried couples are not granted rights automatically by law, they need to create a legal relationship with a domestic partnership agreement. Such a contract can solidify the couple's handling of estate planning issues. In addition, without the benefit of the marital deduction, unmarried couples face a potentially overwhelming estate tax burden as long as the estate tax is in effect.



There are solutions, however. One partner can reduce his or her estate and ultimate tax burden through a traditional annual gifting program or by creating an irrevocable life insurance trust or a charitable remainder trust benefiting the other partner. Again, these strategies are complex and require the advice of financial, tax and legal professionals.

Noncitizen spouses

The marital deduction differs for a non-U.S. citizen surviving spouse. The government is concerned that, on your death, your spouse could take the marital bequest tax free and then leave U.S. jurisdiction without the property ever being taxed.

Thus, the marital deduction is allowed only if the assets are transferred to a qualified domestic trust (QDOT) that meets special requirements. The impact of the marital deduction is dramatically different because any principal distributions from a QDOT to the noncitizen spouse and assets remaining in the QDOT at his or her death will be taxed as if they were in the citizen spouse's estate. Also note that the gift tax marital deduction is limited to a set amount annually.

Grandparents

You may be one of the lucky ones who is not only financially well-off yourself, but whose children are also financially set for life. The down side of this is that they also face the prospect of high taxes on their estates. You may also want to ensure that future generations of your heirs benefit from your prosperity. To reduce taxes and maximize your gifting abilities, consider skipping a generation with some of your bequests and gifts.

But your use of this strategy is limited. The law assesses a generation-skipping transfer (GST) tax equal to the top estate tax rate (see Chart 2 on page 8) on transfers to a "skip person," over and above the gift or estate tax, though this tax is being repealed along with the estate tax. A skip person is anyone more than one generation below you, such as a grandchild or an unrelated person more than 37½ years younger than you.

Fortunately, there is a GST tax exemption, which this year equals the estate tax exemption of $1.5 million. (Also see Chart 2.) Each spouse has this exemption, so a married couple can use double the exemption. If you exceed the limit, an extra tax equal to the top estate tax rate is applied to the transfer — over and above the normal gift or estate tax.

Case study VI

SKIPPING OUT ON ESTATE TAXES

Saul and Eleanor have accumulated a sizable estate, as has each of their children. Because their children are financially secure, Saul and Eleanor have structured their wills so that the full generation-skipping transfer (GST) tax exemption amount from each of their estates goes to their grandchildren after both of their deaths. By doing this, they are each able to take advantage of their generation-skipping transfer tax exemption. Although their estates must pay estate taxes, they avoid having their assets taxed again in their children's estates. They can also pass the future appreciation on those assets to their grandchildren tax free.

Outright gifts to skip persons that qualify for the annual exclusion are also exempt from GST tax. A gift or bequest to a grandchild whose parent has died before the transfer is not treated as a GST.

Taking advantage of the GST tax exemption can keep more of your assets in the family. By skipping your children, the family may save substantial estate taxes on assets up to double the exemption amount (if you are married), plus the future income and appreciation on the assets transferred. (See Case study VI.) Even greater savings can accumulate if you use the exemption during your life in the form of gifts.

If maximizing tax savings is your goal, consider a "dynasty trust." The trust is an extension of this GST concept. But whereas the previous strategy would result in the assets being included in the grandchildren's taxable estates, the dynasty trust allows assets to skip several generations of taxation.

Simply put, you create the trust either during your lifetime by making gifts or at death in the form of bequests. The trust remains in existence from generation to generation. Because the heirs have restrictions on their access to the trust funds, the trust is sheltered from estate taxes. But if any of the heirs have a real need for funds, the trust can make distributions to them.

COMMUNITY PROPERTY ISSUES

Ten states have community property systems: Alaska (elective), Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin. Under a community property system, your total estate consists of your 50% share of community property and 100% of your separate property. What's the difference?

Community property usually includes assets you and your spouse acquire under two conditions: 1) during your marriage, and 2) while domiciled in a community property state. (See Planning tip 7.) Each spouse is deemed to own a one-half interest in the community property, regardless of who acquired it. For example, wages and other forms of earned income are treated as community property, even if earned by only one spouse.

Separate property usually includes property you and your spouse owned separately before marriage and property you each acquire during marriage as a gift or inheritance that you keep separate. In some states, income from separate property may be considered community property.

In most community property states, spouses may enter into agreements between themselves to convert separate property into community property or vice versa. This can be an important part of your estate plan, but remember, improper agreements or incorrect transfers can lead to unwanted results.

Remember, marital rights are expanded

Community property states start out with greater protection for the surviving spouse because he or she is deemed to own 50% of any community property interest. But some states go much further, and the laws can be complex. For example, rules may vary depending on how many children you have and how much the surviving spouse owns in relation to the decedent.

In some cases, the surviving spouse is entitled to full ownership of property. In other situations, he or she is entitled to the income or enjoyment from the property for a set period of time. Seek professional advice in your state, especially if your goal is to limit your surviving spouse's access to your assets.

Planning tip 7

DETERMINE YOUR DOMICILE

There is no one definition or single set of rules establishing domicile. Because you can have a residence in, and thereby be a resident of, more than one state, domicile is more than just where you live. Domicile is a principal, true and permanent home to which you always intend to return, even if you are temporarily located elsewhere.

Plan carefully when using a living trust

If a living trust is not carefully drafted, the property may lose its community property character, resulting in adverse income, gift and estate tax consequences. For example, improper language can create an unintended gift from one spouse to the other. To avoid any problems, the living trust should provide that:

- Property in the trust and withdrawn from it retains its character as community property,
- You and your spouse each retain a right to amend, alter or revoke the trust, and
- After the death of one spouse, the surviving spouse retains control of his or her community interest.

(For more on living trusts, turn to page 4.)

Reap the basis benefit

Assets are usually valued in your estate at their date-of-death fair market values. (Sometimes assets are valued six months after death, but only if the estate has dropped in value since the date of death.) For example, stock you purchased for $50,000 worth $200,000 at the time of your death would be valued in your estate at $200,000.

Community property owners receive a double step-up in basis benefit.

The good news is that your assets receive a new federal income tax basis equal to the value used for estate tax purposes. (In 2010, with the estate tax repeal, the step-up in basis will be limited. But the laws are complex, so consult a professional advisor on how this change will affect your estate plan.) In our example, your heirs can sell the stock for $200,000 and have no gain for income tax purposes. Their income tax basis is $200,000 instead of your $50,000.

Community property owners receive a double step-up in basis benefit. If the $200,000 of stock in the previous example were community property, only one-half of the stock ($100,000) would be included in the estate of the first spouse to die. But, the income tax basis of all of the stock rises. Therefore, the surviving spouse can sell his or her 50% share of the stock at no gain, as well as the decedent's 50% share.

Sometimes the basis rule works against you. If property is valued in your estate at less than the cost to you, the heirs still receive an income tax basis equal to the date-of-death value. If you had purchased stock for $75,000 that was valued in your estate at $50,000, your heirs would receive a basis of $50,000. If the heirs later sell the stock for $100,000, they will have to realize a gain of $50,000 ($100,000 – $50,000) rather than a gain of $25,000 ($100,000 – $75,000).

Watch out for unwanted tax consequences with ILITs

Several community property state issues must be taken into account to avoid unwanted tax consequences when an ILIT owns a life insurance policy. These relate to who owns the policy before it is transferred to the trust, whether the future premiums are gifted out of community property or separate property, etc.

For example, if you gift an existing policy that was community property to an ILIT and the uninsured spouse is a beneficiary of the trust, the estate of the surviving uninsured spouse could be taxed on 50% or more of the trust. However, proper titling of the policy, effective gift agreements between spouses and proper payment of premiums can avoid this problem. Be sure to get professional advice on these arrangements.

(For more on ILITs, see page 15.)

Distinguish between separate and community property for FLPs

For community property state residents, it is important to state in the FLP agreement whether the FLP interest is separate or community property. In addition you should consult your attorney to determine if a partner's income from an FLP is community property or separate property.

(For more on FLPs, see page 19.)

Community property can be the perfect vehicle for generation-skipping transfers.

Get spousal consent before making charitable gifts

Under the community property laws in many states, a valid contribution of community property cannot be made to a charity by one spouse without the consent of the other spouse. Consent should be obtained before the close of the tax year for which the tax deduction will be claimed.

(For more on charitable contributions, see page 20.)

Enjoy easier generation-skipping transfers

Community property can be the perfect vehicle for generation-skipping transfers. In 2004, a married couple with $2.24 million of community property would qualify for

effective utilization of this strategy without the necessity of transferring any assets to each other.

(For more on generation-skipping transfers, see page 25.)

Weigh your property treatment options

You don't always have to follow the property system of your state of domicile or the state in which you buy real estate. For example, if you live in a community property state and want to avoid having to obtain your spouse's consent to sell or make gifts of community property, you may elect out of community property treatment. But you also can retain community property treatment if you move from a community property state to a separate property state.

To do this, consider establishing a joint trust to hold the community property when you move to the new state or simply prepare an agreement outlining the status of the assets as community property. But you must ensure the community property assets remain segregated. If they become intermingled with separate property assets, you could lose the community property status.

Another option is to leave assets in a custody account governed by the laws of the community property state. It may be possible to retain the community property nature of the assets by simply segregating them from other assets on arriving in the new state, but the estate planning documents that dispose of the segregated assets should provide for the disposition of only one-half of the assets at the death of each spouse.

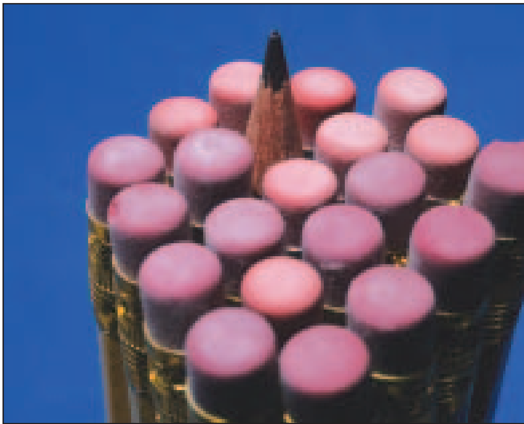
Be sure to execute similar strategies if you have separate property that you wish to remain separate when you move to a community property state. Again, to retain its separate property status, it cannot become intermingled with community property. Make a well-thought-out decision about how you would like your property to be treated.

If you aren't concerned about the limits on community property and are interested in obtaining its tax advantages but don't reside in a community property state, consider taking advantage of the Alaskan system, which allows nonresidents to convert separate property to community property. Note that implementing such a decision is complex, involves placing property in trust, and requires careful planning and coordination with your advisor.

IMPLEMENTING AND UPDATING YOUR PLAN

Estate planning is an ongoing process. You must not only develop and implement a plan that reflects your current financial and family situation, you must also constantly review your current plan to ensure it fits any changes in your circumstances.

Of course, with the extensive changes under EGTRRA and the probability that more changes will occur in this decade, reviewing your estate plan regularly is now more critical than ever. You'll especially want to update it after any of the events in Planning tip 8.



WHERE DO YOU GO FROM HERE?

Remember, estate planning is about much more than reducing your estate taxes; it's about ensuring your family is provided for, your business can continue and your charitable goals are achieved. So even if the estate tax is permanently repealed, you will want to have an up-to-date plan in place.

Planning tip 8

4 MORE REASONS TO UPDATE YOUR ESTATE PLAN

1. ***Family changes.*** Marriages, divorces, births, adoptions and deaths can all lead to the need for estate plan modifications.
2. ***Increases in income and net worth.*** What may have been an appropriate estate plan when your income and net worth were much lower may no longer be effective today.
3. ***Geographic moves.*** Different states have different estate planning regulations. Anytime you move from one state to another, you should review your estate plan.
4. ***New health-related conditions.*** A child may develop special needs due to physical or mental limitations, or a surviving spouse's ability to earn a living may change because of a disability. Such circumstances often require an estate plan update.

To this end, use the estate planning checklist on the next page to identify areas where you need more information or assistance. Or jot down a few notes about things you want to look at more closely and discuss with a professional advisor. It may be easy for you to put off developing a detailed estate plan — or updating it in light of changes in tax law or your situation. But if you do, much of your estate could go to Uncle Sam — and this could be very hard on your family.

So please call us with any questions you have about the strategies represented here or how they can help you minimize your estate tax liability. We would welcome the opportunity to discuss your situation and show how we can help you develop and implement an estate plan that preserves for your heirs what it took you a lifetime to build.

ESTATE PLANNING WORKSHEET

If you have any questions about the topics covered in this guide, or if you want more information on how they relate to you, please fill out this worksheet and mail or fax it to us. We will be happy to help you with these or any other questions you may have about your estate planning strategies.

ESTATE PLANNING NEEDS EVALUATION

Please check all boxes that apply to your situation.

Do you have an estate plan in place?

❑ Yes (date last reviewed: __________)

❑ No, but I would like to develop one

I need help with:

❑ Understanding the new tax law

❑ Writing my will

❑ Selecting an executor and trustees

❑ Establishing a living trust

❑ Valuing my estate

❑ Reducing estate taxes

❑ Creating a family limited partnership

❑ Transferring property

❑ Creating a buy-sell agreement

❑ Planning for a second marriage

❑ Planning for a noncitizen spouse

❑ Determining the role of life insurance

❑ Planning for community property

❑ Updating my estate plan

❑ Other______________________________

I would like to learn more about the following estate planning strategies:

❑ Gifting as a technique for transferring wealth

❑ Setting up a trust for my heirs

❑ Creating a succession plan and transferring ownership of my business

❑ Making taxable gifts

❑ Giving to charity

❑ Implementing generation-skipping transfers

❑ Other______________________________

❑ My greatest estate planning concern/need is:

____

____

____

____

____

____

____

____

Fax or mail this form to our office for more information, or call us to discuss your estate planning needs.

NAME

TITLE

ORGANIZATION

ADDRESS

CITY STATE ZIP

PHONE FAX

E-MAIL