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ATTORNEYS AT LAW – A PROFESSIONAL CORPORATION

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ESTATE PLANNING IN THE 21ST CENTURY

A fundamental rule of the federal estate tax[1] system is that one is estate taxed only on that which he or she owns on the date of death -- or said differently, "if you don't own it, you can't be taxed on it." As a result, a primary goal of most transfer tax planning is to give away appreciating assets prior to death. And both the process and timing of "giving it away" can be very simple or very complex.

Although some techniques may be seen as too complex or expensive, it is important that you consider the following common methods to reduce administrative costs and transfer taxes on your death.

Please understand that the following discussion is a very over simplified summary of some of the more common techniques and the list and descriptions are not complete or exhaustive. If any of the following ideas sound interesting or useful for you and your family, please let us know so we can discuss the planning opportunities with you more completely.

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1. **CREDIT SHELTER (BYPASS) TRUST FUNDING**. One of the most effective methods of estate planning is to fund a credit shelter trust (CST) on the death of the first spouse. This funding of the CST can occur either directly from the estate of the first spouse or by the surviving spouse disclaiming assets that he or she inherits on the death of the first spouse.

The "credit shelter trust" (CST) is also often referred to as the "bypass trust" and some planners call it the "family trust." The intent is to have the assets that are held in this trust be used to "shelter" the first spouses basic exclusion amount, and for those assets to "bypass" the estate of the surviving spouse.

We believe that funding a CST on the death of the first spouse remains one the most important planning techniques available. The primary benefit of funding a CST on the death of the

[1] As of January 2013, the federal estate tax (FET) rate is 45% on all amounts in excess of $5,340,000 million per person, and $10.6 million for a husband and wife if "portability" is timely elected on the death of the first spouse.

first spouse is that those assets held in the CST, and their appreciated value, will be sheltered from both future estate and generation skipping transfer taxes on the later death of the surviving spouse.

Given the current federal basic exclusion amount of $5.340 million (2014) and "portability" of the first spouse's basic exclusion amount, some might think that the that a CST is not necessary and should not be part of a husband-wife estate plan. We believe that good planning will dictate that most all husband-wife estate planning should incorporate into the planning documents the option to use and fund a CST.

There are a number of reasons to include a credit shelter trust in a current estate plan:

(1). Avoid Future Estate Taxes. As mentioned above, the appreciated value of any assets held in the CST on the following death of the surviving spouse will not be subject to federal estate tax – the assets in the credit shelter trust pass to the heirs estate tax free (the assets may still be subject to income tax). This estate tax savings can be significant depending on the rate of appreciation of the assets held by the trust. In addition, if the basic exclusion amount is lower on the death of the surviving spouse, then again the assets held in the CST will be protected from those future estate taxes.

(2). Creditor Protection. The CST will protect assets held in the trust from the creditors of the surviving spouse when the trust is properly administered. Although some may not have to worry about creditors, we believe that proper asset protection planning should always be considered in the estate planning process. Funding a CST will help to protect assets from creditors and may even from second-marriages. Thus, the CST can provide good asset protection planning.

(3). Medicaid Planning. If the CST is funded through a will (and not a revocable trust), the assets held by the CST for the benefit of the surviving spouse will not be subject to Medicaid taking or disqualification rules (under current law).[2]

(3). The Surviving Spouse can Benefit. The CST is normally structured either for the sole benefit of the surviving spouse, the benefit of the decedent's children, or a combination of the two.[3] Thus, although the assets are held in trust and not legally owned by the surviving spouse, the surviving spouse can be either the primary or sole beneficiary of the CST.

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[2] In general, 42 USC §1396p(d)(2)(A) provides that a trust created by a Will is protected from medicaid claims (assuming proper language is used), but is not if the trust is created and funded through a revocable living trust.

[3] Distributions from the CST to the surviving spouse and/or children can be many different reasons. Often, the trustee is authorized to make discretionary distributions of net income and/or principal for the "health, education, maintenance and support" of the spouse and/or children.

(4). The Surviving Spouse as Trustee. In some cases, it may be appropriate for the surviving spouse to be the trustee of the CST for so long as he or she is capable and competent. In other cases, the trustee can be another family member (a trusted adult child), or a commercial trustee (a bank or trust company). If the surviving spouse is the trustee and a beneficiary of the CST, then discretionary distributions must be limited to "health, education, maintenance or support."

(5). Generation Skipping Transfer Tax (GSTT) Exemption. Unlike the federal estate tax exemption amount, the GSTT exemption of the first spouse is not "portable" to the surviving spouse. By funding the CST, the fist spouse's GSTT exemption will be preserved. Although many clients will not consider the transfer of large amounts to a second generation (*i.e.*, grandchildren, etc.) so as to trigger a GSTT, if funds in fact ever do pass to a second generation, then protecting those assets from the GST tax is important.

For the above reasons, we will often recommend that a husband and wife incorporate a credit shelter trust in their estate planning.

2. **REVOCABLE "LIVING" TRUST**. Many believe one should always try to avoid probate – and that is especially true if you own assets in other states, and especially in California.[4] When avoiding probate is the goal, a revocable "living" trust is used. A revocable living trust will work to avoid probate *only if* all assets are owned and legally titled in the name of the revocable trust -- if you hold title to an asset on your death, then a probate will likely be required. It should also be noted that a "simple" revocable trust does not save income, estate or other types of taxes. However, just like a Will, a revocable trust can be drafted to help reduce transfer taxes. But to accomplish transfer tax savings, special provisions need to be added to the document. In addition, a revocable trust does nothing to protect assets from creditors.

Whether a person should use a revocable trust will depend on many factors: family, types of assets, location of assets, age, financial position and goals. In Alaska, the benefit of creating a revocable trust for the sole purpose of avoiding probate is debatable --- often the cost of avoiding probate is more expensive than probate itself. This is because probate in Alaska is relatively simple and often the costs incurred in post - death administration are not "true costs of probate," but rather costs that would have to be incurred whether one uses a probate or a revocable trust.

3. **TRUST PLANNING FOR CHILDREN.** Most will want to leave the bulk of their estate to a spouse and children. When funds are left to children, the funds can be left outright or in a short term or long term trust. As a general rule, it is not prudent to leave funds outright to a child who is not wise or

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[4] In one case, H and W owned a condo in San Diego. H's last will and testament will provided "I give everything to my wife and my wife shall be my personal representative." H's 50% interest in the condo had to go through California probate. The California probate court made the Wife post a $150,000 bond to ensure that she would administer the estate properly and transfer the 50%-interest in the condo to herself as the surviving spouse.

mature enough to handle appropriately an inheritance – whether that amount is $50,000, $500,000 or $5,000,000.

Short Term Children's Trusts. Often funds are left in separate trusts for each child with a third-party trustee who is granted the full authority and discretion to distribute income and/or principal to that child during the term of the trust. Often, the trust will also mandate distributions of principal to that child as follows: 10% at age 25; 20% at age 30 and the balance at age 35. The percentage and the ages of distribution selected by the parent will be dependent on the projected wisdom and maturity of that child. Some might say a child should only receive funds when they are older – 45, 55 or even 85.

Long Term Children's Trusts. Another option is leave the funds in trust for the life of the child. This is type of trust goes by may terms and is often referred to as a "*beneficiary inheritance trust*." In this plan, the funds are left in separate trusts for each child with a third-party trustee who is granted the full authority and discretion to distribute income and/or principal to that child during the term of the trust; but when the child attains some age (*e.g.*, 35), the child becomes the trustee over his or her own trust. When the child become trustee, he/she is authorized to make discretionary distributions of income and/or principal to himself, his children, grandchildren, etc., but only for health, education, maintenance and support needs.

The core benefit of the beneficiary inheritance trust is that as long as the funds stay in the trust, the funds are protected from a child's creditors, the child's divorcing spouse, and will pass estate tax free on the death of the child.

This type of trust is best use for children who are wise, mature and understand the benefits of the protecting the funds in trust. If a child is a spend-thrift, this trust will not be beneficial and will not work. Anyone with wise and mature children should consider this type of trust as part of their long-term estate plan.

Who should be the trustee of a trust for children? It should be some that is trusted and has a good (real) understanding of what the needs of a child might be during the different stages of that child's life. Generally, the trustee should have the same values as the parent does for education, work, vacation, spending, ... Although brother Joe may be a financial whiz, if he does not have children he may not be able relate to your daughter's need to attend figure skating camp or for a new prom dress at 17.

4. **ALASKA COMMUNITY PROPERTY**. Alaska has an *elective* community property statute. The Alaska "Community Property Act" provides that Alaska retains the traditional common law presumption of how assets are held between spouses, but spouses can now enter into a written agreement designating (electing) all or specific assets as community property. This statute is unique in that most states with community property make "community property" mandatory and not elective; Alaska's law is elective and not mandatory.

Electing into Alaska's community property has significant estate planning benefits for two reasons. First, a husband and wife can now elect to treat property as community property and fund

their credit shelter trust more easily without having to hold completely separate interests in the assets. In the past, we often required an equal division of assets between the husband and wife - often a difficult task as assets and value of assets change overtime.

Second, although each spouse is deemed to own a 50% undivided interest in the designated community property, both halves get a full (100%) adjustment (up or down) in income tax basis equal to fair market value on the death of the first spouse under IRC §1014(b)(6). Compare this to owning the asset under the common law rule as tenants by the entirety and receiving only a 50% adjustment in income tax basis on those assets owned at the death of the first spouse.[5]

It is anticipated that spouses will want to consider entering into an Alaska Community Property Agreement or and Alaska Community Property Joint Revocable Trust by designating all or specific assets as community property to obtain the favorable step-up in tax basis for highly appreciated assets. Converting to community property is best suited for business interests, real estate, brokerage accounts, and other assets with low basis and high appreciation. Community property is <u>not recommended</u> for an asset that has a fair market value that is <u>less than</u> its adjusted basis.

5. **ANNUAL GIFTS**. Annual gifts are used primarily to reduce federal estate taxes by currently transferring property to those who would ultimately receive the assets on a person's death, for example an individual's children. By making the transfer now, the asset is excluded from a person's taxable estate, and is not subject to federal estate taxes. Gifting of assets is a very beneficial planning tool because any appreciation of an asset after it is gifted away will not be part of your estate.

Generally, the gift must be of a <u>present</u> interest and the value of the gift cannot exceed $14,000 per donee,[6] per year to avoid federal gift tax. This $14,000 is called the "annual exclusion amount." There are a number of exceptions to this general rule.

First: A person may elect to allow his or her spouse to use both annual exclusions. This is called a "split gift." By splitting the gift, one spouse can transfer up to $28,000 per donee, per year, without gift tax consequences.[7]

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[5] Example: H&W purchased a 4-plex 20 years ago for $150,000. Over the past 20 years, they have taken tax depreciation deductions, and the current adjusted income tax basis is $20,000. If during their lives they sell the property for $335,000, they will have ordinary income of $130,000 ($150,000 - $20,000), and capital gains of $180,000 ($330,000 - $150,000). If the property is owned as community property, and the sale occurs after the death of the first spouse (assume same numbers), there will be $-0- ordinary income and $-0- capital gain, thus eliminating $310,000 of from income tax on the sale of the property by the surviving spouse.

[6] "Donee" is the person receiving the gift. The "Donor" is the person making the gift.

[7] For gift splitting, and election must be made on a timely filed federal gift tax return, Form 709, which requires the consent of both spouses.

Second: An individual can give a future interest in property if the donee is given the present right to receive the property. Typically, parents want to make a gift to a trust for their children or grandchildren, with distributions from the trust at age 30. When the transfer is made into the trust, if the donee is given the unrestricted right to withdraw the asset from the trust for 35 days, the gift is a present interest and thus qualifies for the $14,000 annual exclusion. Most parents who do this, strongly encourage their children or grandchildren not to withdraw the assets from the trust although there can be no prearranged agreement or conditions prohibiting the withdrawal.

Third: Generally, any gift made in excess of the $14,000 annual gift tax exclusion amount is subject to federal gift taxes. However, for gifts less than the lifetime gift tax exclusion amount ($5,340,000), you do not "pay" a federal gift tax, but rather your remaining basic exclusion amount is reduced dollar for dollar.

Fourth: Payments made directly to a college or medical facility are exempt from the gift tax and generation skipping tax. Therefore, a grandparent can pay for the entire college education of a grandchild free of gift and generation skipping tax provided that payments are made directly to the educational institution.

If you are considering making gifts to minor children or grandchildren, you will want to consider using an irrevocable trust, a UTMA (Uniform Transfers to Minors Act), UGMA or §529 Plan.

In many cases, a **§529 EDUCATION SAVING PLAN** is a perfect method to fund the future cost of education for family members. The §529 Plan can be established for each beneficiary (child, grandchild, etc.), and is an alternative to creating a UTMA or irrevocable educational trust account. A §529 Plan has many positive benefits:

a. The maximum that a person can contribute to an Alaska §529 Plan is $250,000.

b. A grantor can contribute to the §529 Plan account $70,000 in one year and then treat that amount as using his annual gift tax exclusion of $14,000 per year for the next 5-years.

c. The funds held in the Plan grow income tax free.

d. If funds are used for qualified education purposes, no income tax will be paid on the earnings.

e. The grantor can be the custodian and can control the distribution of the funds to the beneficiary.

f. The custodian can change the beneficiary of the account at any time.

g. The assets in the Plan account are excluded from the custodian's gross estate for estate tax purposes.

h. The assets are protected from claims of creditors.

i. Although the grantor cannot control how the funds are invested, the grantor does choose initially the general types of investment (income, growth, equity, etc.).[8]

j. For purposes qualifying for financial aid for college, the §529 account is deemed owned by the custodian and not the child-beneficiary.

Each state has its own §529 Plan program. The following websites provide additional information that you may want to review:

www.uacollegesavings.com
www.troweprice.com/college
www.collegesavings.org/index.aspx
http://money.howstuffworks.com/529.htm
www.morningstar.com/529/529table.html

6. **IRREVOCABLE LIFE INSURANCE TRUSTS**. Although generally life insurance proceeds are not subject to income tax, proceeds can be subject to estate taxes on the death of the policy owner. Thus, if a person owns a $750,000 term life insurance policy, a large amount of the policy may go to the IRS in estate taxes on his or her death [depending on tax rates, etc.].[9]

Because the federal estate tax taxes everything a person owns on date of death, if a person owns a life insurance policy, it will (may) be subject to federal estate taxes on the death of the owner.[10] Because life insurance will be subject to estate tax on the death of the owner, many choose to exclude current or new policies from their taxable estate by establishing an irrevocable life insurance trust (ILIT) for the benefit of a surviving spouse, children or grandchildren. With proper planning, the entire value of the life insurance can be excluded from the gross estate on death and thus escape estate taxes. If the trust is multi-generational, the funds can be held in trust for many generations and, depending on compounded growth, can provide a significant benefit to descendants for many generations.

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[8] Once the funds are contributed, the ability to direct investment is restricted. In response to public comments, the IRS published Notice 2001-55 which allows a plan to allow a grantor to change the investments once per calender year or when there is a change in the beneficiary. Please check the specific rules of the specific plan for complete details.

[9] Example: Joe has an estate of $2 million, and owns a $1 million life insurance policy on his life. Joe dies in 2013 when the basic exclusion amount is $1 million per person. His total taxable estate is $3 million, and the total federal estate tax paid on their deaths will be approximately $1 million.

[10] Life insurance will always have an “owner” (the person who controls the policy); the “insured” (the person whose life is insured); and, one or more named “beneficiaries” (those who get the money on the death of the insured).

7. **THE ALASKA TRUST**. Alaska law improves the benefits of establishing an irrevocable trust in Alaska for asset protection and estate planning. In short, a properly drafted Alaska asset protection trust will protect assets from the claims of creditors of the settlor and beneficiaries of the trust, including claims which may arise in a divorce of any beneficiary, even if the settlor is a discretionary beneficiary of the trust. In many respects, using an Alaska trust is similar to using an offshore asset protection trust, but without the inherent difficulties of transferring and maintaining assets offshore in some foreign jurisdiction.

With proper planning, the Alaska Trust provides a new dimension to estate planning because an individual can make a completed gift to an Alaska Trust, have the trust excluded from his or her estate, and still remain eligible to receive discretionary distributions from the trust.

8. **FRACTIONAL SHARE DISCOUNTS**. A gift of cash or assets is one of the simplest methods to reduce one's estate. Where a gift of cash is not practical, a gift of a fractional ownership interest in real property or business interest can be very effective.

For example, gifting a percentage ownership interest in the "Lake Cabin" can result in significant discounts in valuation on death. If husband and wife only own 30% of an interest in the property and the remaining 70% ownership is split between three children, the true value of the 30% interest is not worth as much because of the co-ownership and sharing that must occur between all the family members. Clearly, an unrelated third-party will never pay top-dollar for a minority interest in a cabin that has to be shared. Thus, discounts for lack of control and lack of marketability can be obtained when the gift occurs, and for the remaining amount included in your estate on death. Discounts can range from 10% - 50% or more.

To make the discounts more effective, we strongly encourage the co-owners enter into a restrictive "joint co-ownership agreement" that will govern the terms and conditions of how the property is to be developed, managed, sold and/or transferred.

9. **FAMILY OWNED BUSINESS VENTURES**. Similar to the above, some families are transferring their investment related assets into a family owned and controlled family limited liability company (FLLC). This can be a very effective long-term management and estate planning tool.

A family owned business is designed to hold <u>investment</u> type assets [rental properties, real estate, business interests, etc.] which the senior family members want to transfer to the next generation without giving up total control. A family owned business is designed to accumulate wealth, train family members in business management issues, grow assets, and to provide restrictions on transfer of ownership interests, asset protection both from unwanted transfers and creditors, and continuity of management.

In most cases, the parents transfer investment type assets into a family LLC in exchange for 100% of the ownership. In some cases, adult children will also transfer assets into the family LLC

in exchange for a pro rata share of ownership in the family LLC.[11] Then, over the next number of years, the parents transfer by gift non-management ownership interests to children, while retaining full management rights over the entity. In the long-run, as the children mature and are trained in wealth, management, control can be transferred to the next generation.

One of the more appealing aspects of a family LLC is a client's ability to make transfers of limited interests (through gifts or otherwise) to his or her descendants on a leveraged basis due to valuation discounts that are customarily associated with transfers of interests that have limited control and transfer rights. Valuation discounts are attributable to a family LLC interest because the characteristics of a family LLC interest generally cause the interest to be less valuable than the value of the underlying assets held by the family LLC.[12]

The cornerstone test for determining the value of a family LLC interest and the percentage of valuation discount to be applied on a transfer of a limited interest, is the amount a willing buyer would pay to a willing seller for the subject property (*i.e.*, an interest in the family LLC and not an interest in the underlying asset), where neither the buyer nor the seller is under a compulsion to buy or to sell and both the buyer and the seller have reasonable knowledge of the relevant facts of such transfer unless there is an actual sale, valuation is normally determined by an appraisal.

10. **QUALIFIED PERSONAL RESIDENCE TRUST [QPRT]**. A QPRT is a method to irrevocably transfer away a remainder interest in a principal residence or vacation home, but retain the right to live in the home for a specific term of years. Specifically, with a QPRT, a person will transfer their ownership interest in a primary or secondary residence into a trust, and retain the right to use the residence for a period of years (5 to 10 years); at the end of the term of years, the ownership of the home transfers to children or other named beneficiaries of the trust.

The benefit of a QPRT is that it can remove a valuable appreciating asset from the gross estate during life at a reduced gift and estate tax cost. The law provides that by making a gift of a remainder interest in a residence to a qualified trust for the benefit of children, the value of the gift is equal to the present value of the future remainder interest. Example: Assume husband and wife are ages 72 and 70, and they transfer a $350,000 vacation home into a QPRT for the term of seven (7) years. Based on the IRS tables, the value of the taxable gift (the remainder interest) is approximately $230,000. Thus, at the end of seven years, there has been a successful transfer of an asset worth $350,000 out of the estate for the gift tax cost of $230,000.[13]

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[11] There are a number of Tax Court decisions which hold that if a parent retains any rights in the family LLC on death, the entire value of the family LLC will be included in the parents estate. Ownership on death should be avoided.

[12] Since 2010, numerous rumors have been circulating that Congress may pass legislation disallowing the use of discounts in family related business entities as discussed above.

[13] As with all gifts made during life, the asset will transfer from the donor to the donee at the donor's adjusted income tax bases to the donee – this is called "carry over basis." Thus, assuming the asset is not included in the donor's estate on death, the asset will not receive an adjustment in income tax basis to fair

Along with meeting certain technical requirements of a QPRT, there are two negative aspects to a QPRT. First, if both spouses pass away during the term of the trust (seven years in the above example), the full value of the residence is brought back into the estate and the IRS treats the transaction as if it never occurred -- it is completely undone and ignored. Second, if the donor continues to live in the residence after the term of the trust, the donor will need to pay fair value rent to the new owners of the home.

From a planning perspective, the QPRT works well when one wants to transfer either a large primary residence or vacation property (the family cabin) to the next generation with minimal transfer tax costs. If a person knows they want the children to take over the ownership of the residence, this can be an effective method to transfer them interest. Further, the shorter the term of the trust, the greater the value of the remainder interest and the gift made to the remainder beneficiaries.

In some cases, the QPRT can be used to protect your home from creditors. Where that is the goal, a QPRT is established with a very long term (35 years) for your benefit, and at the end of the term, the asset passes to the next generation. In this case, the asset will likely be included in your estate for estate tax purposes and subject to estate tax, but under state law, a creditor could not get at the asset.

11. **GRANTOR RETAINED ANNUITY TRUST [GRAT]**. A grantor retained annuity trust may be an effective means for a wealthy client who wants or needs to retain all or most of the income from a high-yielding and rapidly-appreciating property to transfer the property to a child or other person with minimal gift or estate tax. GRATs are particularly useful where the client has one or more significant income-producing assets that he or she is willing to part with at some specified date in the future to save federal and state death taxes and probate costs, to obtain privacy on the transfer, and to protect the asset against the claims of creditors.

A GRAT is created by transferring one or more high-yield assets into an irrevocable trust and retaining the right to an annuity interest for a fixed term of years or for the shorter of fixed term or life. When the retention period ends, assets in the trust (including all appreciation) go to the named "remainder" beneficiaries. In some cases other interests, such as the right to have assets revert back to the transferor's estate in the event of the transferor's premature death, may be included.

GRATs provide a fixed annuity payment, usually expressed as a fixed percentage of the original value of the assets transferred in trust. For example, if $100,000 is placed in trust and the initial annuity payout rate is 6%, the trust would pay $6,000 each year, regardless of the value of the trust assets in subsequent years. If income earned on the trust assets is not sufficient to cover the annuity amount, the payments will be made from principal. Therefore, the client-transferor is assured of steady and consistent payments (at least until principal is exhausted).

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market value on the death of the donor. In general, this is an acceptable result given that the income tax rates are generally less than the federal estate tax rates.

All income and appreciation in excess of the amount required to pay the annuity will accumulate for the benefit of the remainder trust beneficiaries. Consequently, it may be possible to transfer assets to the beneficiaries when the trust terminates with values that far exceed their original values when transferred into the trust and, more importantly, that far exceed the gift tax value of the transferred assets. Therefore, the goal of the GRAT is to have the annuity-income payout be less than the appreciation and growth.

Prudent planning suggests that one "insure" or "bulletproof" the tax savings. The risk of inclusion of trust assets in the estate of the transferor if he dies during the term of the annuity should be covered by the purchase of additional life insurance. The life insurance policy should be owned by the appropriate beneficiary on the transferor's life in the amount of the anticipated federal estate taxes that would be saved if the transferor survives the term of the trust.

12. **THE FAMILY BANK TRUST**. This a variation of the Alaska Asset Protection Trust but will be treated as grantor trust for income tax purposes, meaning the grantor will pay all income taxes on the income of the trust. The goal is to irrevocably transfer into the trust very liquid (or soon to be liquid) assets into the trust which can then be used for future investing or even borrowing from at the lowest interest rate allowed by the IRS for family loans. Some will also use this to hold life insurance to increase the amount of funds in the trust on the death of the insured.

13. **HEETS - HEALTH EDUCATION EXCLUSION TRUST.** A "HEET" is an acronym for a long-term trust used to finance higher education and medical expenses for the client's descendants for a long time or until the assets of the trust are exhausted or is created on death.

In this context, a HEET is a non-exempt generation skipping trust ("GST") intended to take advantage of the GST tax exclusion for distributions to skip persons that are made only and directly to an educational or medial organization for payment of tuition or medical bills [IRC §2611(b)(1); PLR 9823006]. Generally, the funding of a HEET requires making a taxable gift, unless the transfer to trust can be sheltered by the donor's annual gift tax exclusions.

To prevent adverse GST tax consequences from occurring at the death of the last beneficiary who is a skip person, the trust must name a charity as a beneficiary of the trust. The interest of the charity in the trust must be "meaningful" to avoid the application of IRC §2652(c)(2) which provides that an interest in a trust will be disregarded if it exists primarily to postpone or avoid GST tax.

To the requirement of "significant interest" in the charity, the trust must require annual distributions to the charity. One method is to give the trustee the discretion to make payments of income and/or principal to the charity, but with a definite minimum floor amount. A required minimum distribution might be something like: (I) an annual distribution of 10% of the trust's value; (ii) an annual unitrust distribution of 4% - 6%; (iii) an annual distribution of 10% - 50% of the HEET's income, plus a percentage of trust principal. Unfortunately, there is not clear answer on how much is enough. Until the IRS provides guidance on this issue, uncertainty will remain.

14. **IDIT INSTALLMENT SALES**. Like a grantor retained annuity trust (GRAT), an installment sale at fair market value to an irrevocable defective income trust (IDIT) may be an effective means for a wealthy client to transfer part of the future income or appreciation from a high-income or rapidly-appreciating asset with little or no gift or estate tax cost.

With this plan, a grantor sets up an irrevocable trust, transfers cash to the trust which will be treated as a completed gift for gift and estate tax purposes. The cash is then used to purchase from the grantor high income producing or appreciating assets in exchange for a 10 or 15-year promissory note from the trust. The effect is that the grantor will report the income from the asset held by the trust, but at the end of the term, the appreciated asset will be out of the grantor's estate.

An "income trust" is a trust of which the grantor is considered the owner for federal income tax purposes. This means that the grantor must report on the grantor's individual income tax return, all of the income, deductions, and credits of the trust, just as if the grantor was the owner of the trust assets. The IRS has ruled that a sale or other transactions between an IDIT and the grantor do not result in any capital gain or loss, or any other tax consequences. The trust is ignored for federal income tax purposes and the grantor is still the owner of the trust assets for income tax purposes.

15. **SELF-CANCELING INSTALLMENT NOTE (SCIN)**. A self-canceling installment note is an installment note which contains a provision under which the buyer's obligation to pay automatically stops when a specified person dies before the end of the term of the note.

A normal installment note is useful when a client owns a highly appreciated asset he would like to sell and wants to spread the recognition of and taxation on the gain over a term of years.[14] In general, the fair market value of any unpaid normal installment obligation on the date of death is included in the estate of the seller. However, with a SCIN, the buyer is under no obligation to make any further payments after the seller's premature death, which leaves no unpaid balance to be included in the seller's estate. A SCIN will avoid adverse gift and estate tax treatment only if the self-cancellation provision is properly drafted in compliance with IRS rules and there is a premature death of the transferor before the end of the term of the note.

For a SCIN to work, there must be some "premium" assigned to the "cancellation on death" provision to reflect the inherent risk that the note is cancelled on death. The premium must be equal to value or benefit of the cancellation on death. For example, the purchase price might be higher or the interest rate might be higher.

16. **ASSET PROTECTION PLANNING**. Clients are often interested in asset protection planning techniques as part of the overall estate planning process. "Asset Protection Planning" is defined as the adoption of advanced planning techniques which place assets beyond the reach of *future potential creditors*. A "future potential creditor" is a term of art referring to an *unknown* creditor, *i.e.*,

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[14] Note: Any gain attributable to excess depreciation that is subject to recapture under IRS §1245 or §1250 is fully recognized in the year of sale. Also, under installment sale rules, if the subject of the note is publicly traded stock, then all gain is recognized in the year of sale even if payments on the note extend over several years.

the creditor with whom the person has not yet done (or contemplated doing) business with at the time of the transfer. Therefore, legitimate asset protection planning does not include any type of transfer that is done to hide assets or involves a fraudulent conveyance and should never involve any form of scheming to hinder, delay, or defraud creditors; it is not hiding assets from creditors; it is not lying about the extent or whereabouts of one's assets.

Asset Protection Planning techniques range from the simple to the complex – the more complex, the better the protection. Normal asset protection planning will include maintaining adequate liability insurance; the creation of co-tenancies; the outright gift of assets [*i.e.*, transfer to the spouse and others]; purchase of assets that are exempt from creditors [*e.g.*, a home in Florida]; creation of §529 educational plans; use of limited liability entities; creation of irrevocable trusts, including the Alaska Asset Protection Trust; and, offshore/foreign trusts and accounts. For many, just carrying a personal umbrella liability policy approximately equal to 1.5 times net worth may be sufficient.[15]

17. **CHARITABLE PLANNING**. If you have a charitable intent, there are numerous methods that can be used to reduce your estate either during your life or on death. The more common techniques are outlined below.

a. Charitable Bequests. A person can leave though his last will and testament a bequest to a charity of: (I) an asset; (ii) a percentage of his estate; (iii) a specific dollar amount; or, (iv) the "rest and residue" of his or her estate. The gift can be restricted or unrestricted. Any such amount will qualify for a charitable estate tax deduction.

b. Giving Life Insurance to Charity. If there is an un-wanted life insurance policy and have charitable goals, you can name the beneficiary to be a favorite charity.

c. Giving the Retirement Account to Charity. Where there are charitable goals, the best asset to leave to a charity is the balance of a qualified retirement plan or IRA. If such funds are left to family members, the funds will be subject to income tax, and possibly federal estate and generation skipping taxes --- the combined total tax rates can exceed 100%.[16] However, if the retirement plan assets or IRA is left to a qualified tax-exempt entity, then no such taxes will be paid. Thus, it is better to leave cash, stock or real property to the children, and the IRA to the charity.

d. Charitable Gift Annuity. A charitable gift annuity is a transaction in which an individual transfers cash or property to a charitable organization in exchange for the charity's promise to make fixed annuity payments to one or two life annuitants. The annuity payments can be made to you either monthly, quarterly or annually, depending on the terms of the agreement and the charity. The annuity rates offered in connection with charitable gift annuities are lower than those available from commercial insurance carriers. The annuity rate is based on the age and number of annuitants.

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[15] Obtaining a "personal umbrella liability policy" can and should be a person's first line of defense. The cost of such umbrella policy is surprisingly inexpensive.

[16] Income tax, 39.6%; estate tax, 50%; and GSTT tax, 50%.

e. Charitable Life Estate Agreements. Life estate agreements are ideal planning vehicles for those individuals who desire to retain the use of property during life and want to make a testamentary gift of real property to charity at death.

A tax advantaged qualified charitable life estate agreement can only be created using a personal residence or farm. A gift of a remainder interest in a personal residence or farm is a transaction in which an individual irrevocably transfers title to a personal residence or farm to a charitable organization with a retained right to the use of the property for a term that is specified in the gift agreement. The term is typically for the life of the donor or another person. At the conclusion of the measuring term, all rights in the property are transferred to the charity.

Many charities are reluctant to undertake this type of charitable planning given potential environmental liabilities.

f. Charitable Remainder Trusts. A charitable remainder trust (CRT) allows a donor to make a gift to charity but retain some rights or benefits from the asset given. The donor will create a CRT and irrevocably transfer to it cash or property; the CRT will provide for a specified distribution, at least annually, to one or more non-charitable beneficiaries. The distribution from the CRT must be paid at least annually (usually quarterly) for life or for a term not to exceed 20 years, with an irrevocable remainder interest to be held for the benefit of one or more qualified charities. There are two types of CRT: Charitable Remainder Annuity Trust (CRAT) and Charitable Remainder Unitrust (CRUT).

When assets are contributed to a CRT, the donor receives an income tax deduction that is equal to the present value of the remainder interest that will ultimately pass to the charity. The IRS regulations determine this amount, which is essentially calculated by subtracting the present value of the annuity from the fair market value of the assets placed in the trust.

For example, Joe is 65 and transfers $1,000,000 to a CRT, retaining the right to receive 5% of the assets per year for his life. Joe will obtain a charitable deduction of approximately $460,000, the present value of the remainder interest passing to the charity on his death.

g. Bargain Sale Transactions. A bargain sale occurs when a donor, who intends to make a charitable contribution, sells property to charity for less than its fair market value. The most common type of bargain sale occurs when a donor makes an actual sale of property to charity in exchange for cash or an installment note. The amount of gain realized by a donor is the amount that bears the same ratio to the gain that would have been realized if the entire property had been sold at its fair market value on the date of the bargain sale.

h. Donor Advised Funds. A donor advised fund (DAF) is an investment fund [like a mutual fund] that is managed under the tax exempt umbrella of a public charity. The donor makes an irrevocable gift-contribution to the tax exempt charity that has a DAF and gets a fair market value tax deduction in the year of the gift. The contribution can be of cash or appreciated assets. Assets are deposited into a personalized investment account where they grow income tax-free. The donor retains the right to *advise* the host charity as to administration of the DAF. Depending on the terms

of the DAF and the host charity, the donor's advice may include naming the fund, managing investments, recommending grants and selecting a replacement advisor at the death of the donor. Under no circumstances can DAF funds benefit the donor or any other private interest. The donor's role is only that of an advisor (hence the name "donor advised fund"). The donor cannot direct or require that specific action be taken. The concept of *advice* is key to DAF's superior tax treatment by the IRS. Examples of DAFs include:

The Alaska Community Foundation	www.alaskacf.org
Fidelity Charitable Gift Fund	www.charitablegift.org
World Vision	www.worldvision.org
National Christian Foundation	www.nationalchristian.com

i. Private Foundations. The private foundation is appropriate for individuals with substantial wealth who prefer to establish and endow their own foundation with no ties to any particular charitable organization. A private foundation is typically established by a single donor who wants to retain maximum control over grant making and create a legacy of family philanthropy that can continue over successive generations. However, the private foundation is not a practical option for many because: set-up expenses can be substantial; tax advantages are not as good as those available from gifts to public charities [30% entity vs. 50% entity]; lack of confidentiality — everything a private foundation does is public record; tax regulations such as, minimum pay-out requirements, excise taxes and complicated tax reporting can be very expensive. Often, a private foundation will have an entire full-time staff to keep it in compliance. For additional information, see also: www.foundationsource.com

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