

BROAD OVERVIEW OF ESTATE PLANNING

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INTRODUCTION

Estate planning is more than just the preparation of a Will. A comprehensive estate plan is an essential component of a client's overall financial plan. The objective of an estate plan is to develop a framework for the orderly distribution of a client's property consistent with his wishes and lifestyle at the minimum tax liability. An estate plan should be flexible enough to take into account future asset growth and changes in existing circumstances. Sometimes overlooked, an estate plan should also contemplate the possibility of a client's disability (physical or mental) prior to his death.

It is the attorney's responsibility to work with the client to develop an estate plan specifically tailored to meet the needs of the particular client. Such a plan can only be prepared by the attorney after receiving input from not only the client but also from his accountant, insurance agent, and financial advisor. The planning process may involve some or all of the following:

- an analysis of the client's objectives and concerns with respect to the disposition of his assets;
- a review of the client's asset holding to determine the nature, value and method of ownership of the assets, and possible recommendations for the shifting of assets to facilitate the plan;
- projections of the potential federal and state estate tax liability;
- an evaluation of the adequacy of liquid resources available to pay the debts, expenses, and estate tax liability and to provide for the financial security of the surviving spouse and children; and
- a review of insurance and retirement benefits and beneficiary designations.

The more familiar a client is with the fundamentals of the planning process, the greater the likelihood that a plan can be developed to meet most - if not all - of his objectives. In addition, an informed client will be less likely to inadvertently take action following the implementation of the plan that could jeopardize its effectiveness. A client is encouraged to ask questions because he should have the peace-of-mind that the plan addresses his particular needs and desires.

ESTATE AND GIFT TAXATION

The federal estate tax is a tax assessed on the assets an individual owned, or is considered to have owned, at the time of his death. Although this tax is entirely distinct from the income tax, the calculation of both taxes are similar. The estate tax liability is determined by adding the values of all assets in which the decedent had an interest as of his death and reducing that sum by all applicable deductions (such as deductions for debts, funeral and administrative expenses, charitable bequests, and property passing to the surviving spouse) and credits (such as the “applicable credit amount”). The federal estate tax rates now generally range from 37% to 45%.

Particular attention will be given to the concepts of “gross estate,” “marital deduction,” and “applicable credit amount” in developing an estate plan. The “gross estate” includes all property that the decedent owned (or is fictionally treated as having owned under the tax laws) as of the date of his death. The gross estate includes such diverse assets as cash, securities, real estate, and personal property. It also includes overlooked assets such as the decedent’s interest in jointly owned property, retirement benefits, and life insurance policies. It is particularly important for the effectiveness of an estate plan to have a realistic idea as to the potential size and nature of the gross estate so that potential problems can be spotted and addressed. Clients are often surprised over the size of their potential estates when insurance proceeds and retirement benefits as well as escalating real estate and stock prices are taken into account.

A “marital deduction” is allowed for the value of all property passing to the surviving spouse upon the decedent’s death. The property may pass either outright or by way of special trusts (such as a qualified terminable interest property trust a/k/a “QTIP Trust”). Use of the marital deduction is primarily intended to postpone payment of estate taxes until the death of the surviving spouse and is typically a key element of the estate plan for married individuals with a sizeable estate.

The “applicable credit amount” is the equivalent of a \$3,500,000 deduction for tax year 2009 (However, 2009 is a transitional year and it is not yet known what the credit amount may be for 2010 and 2011). Each person has one such nontransferable credit that will first be used to offset any lifetime gift tax liability and then any estate tax liability. A married couple taking full advantage of both spouses’ credit amounts could pass property having a total value of \$7,000,000 free of estate taxes to their children in 2009.

The federal gift tax is a liability of the donor assessed on the value of property passing to a non-spouse beneficiary during the donor’s lifetime. An annual gift tax exclusion of \$13,000 per donee per year (\$26,000 if the donor’s spouse agrees to make a special election on the filed gift tax return) is available for most gifts. Any taxable gift in excess of the annual exclusion will first be offset by the available applicable credit amount.

South Carolina does not assess any gift or estate tax, and so, is a tax advantaged state in which to retire. That was not always the case. Prior to 1992, the South Carolina estate and gift tax structure was in a transitional state and differed from the federal system. The major differences in the two systems prior to 1992 primarily related to the size of the credit amount and the tax rates.

SIMPLE VS. "CREDIT SHELTER" WILL PLAN

A Simple Will Plan leaves everything outright to the surviving spouse on the first spouse's death, or in the alternative, everything outright to the children if there is no surviving spouse. If a child-beneficiary is under the legal age of majority at the time of the death of the surviving parent, then provisions can be made for the appointment of a guardian and control of the assets until the child attains age eighteen. Generally, Simple Wills are appropriate for a married couple having combined gross estates of less than \$1,000,000 (possibly \$3,500,000 depending upon how the law may change in the next year or two). The Simple Will takes full benefit of the unlimited marital deduction to avoid any potential estate tax liability upon the first spouse's death even though the advantage of the first spouse's unified credit amount is completely wasted.

A Credit Shelter Will Plan should be considered for the majority of couples whose combined gross estates exceed \$1,000,000. Like a Simple Will, there will be no federal estate tax liability due on the first spouse's death. However, a Credit Shelter Plan is designed to minimize the estate tax liability on the second spouse's death by taking full advantage of each spouse's credit amount. The first spouse to die transfers assets worth up to \$3,500,000 free of federal estate taxes to a trust (a "Credit Shelter" Trust a/k/a "By Pass" Trust) established for the benefit of the surviving spouse. Any property in excess of the \$3,500,000 amount passes to the surviving spouse in a manner to qualify for the marital deduction. The Credit Shelter Plan is designed so that the \$3,500,000 Credit Shelter Trust will bypass estate taxation on the second spouse's death. A mathematical formula is included in the Will so that the Plan will be flexible enough to take maximum advantage of the interplay between the marital deduction and the unified credit amount even if the gross estate increases following the implementation of the estate plan. The potential federal estate tax savings generated by using a Credit Shelter Plan rather than a Simple Will Plan upon the death of the second spouse to die can be quite significant.

ESTATE TAX REPEAL IN THE 2001 TAX RELIEF ACT

The 2001 Tax Relief Act repeals the estate tax for one year only (2010), but repeal will not be effective until January 1, 2010. Most estate tax experts believe the law will be changed by Congress before 2010 so that the repeal of estate taxes never happens. The Act increased the credit amount over time from \$600,000 until 2009 when it became \$3,500,000. Married couples, with effective planning, are able to take advantage of two exemptions in their estates. Thus, in 2009 a couple with a \$7.0 million estate will not be subject to the estate tax if proper planning is done.

The other tax-saving feature during the transitional period is a reduction in the top estate and gift tax rates, historically 55% and 53%. This change will help only wealthier taxpayers. The top rates are now replaced with a rate of 45% on taxable estates in excess of \$2.5 million, and it remains at that level until the taxes are repealed at the end of 2009.

The Act also repeals the generation skipping transfer (GST) tax for transfers after December 31, 2009. This tax is imposed on gifts and bequests to grandchildren in more distant generations, and to trusts established for their benefit. The GST exemption is scheduled to increase in tandem with the estate tax exemption. There will also be a reduction in the current GST tax rate of 55% in tandem with the estate tax exemption.

To the surprise of many, the 2001 Act did not repeal the gift tax. Like the estate tax exemption, the gift tax exemption increases to \$1.0 million in 2002, but receives no further increases. In 2010 the maximum gift tax rate will drop to 35%, equal to the top income tax rate for individuals.

One of the negatives of the 2001 Tax Act was the lost of step-up in income basis at death. Currently, most property owned by decedents for estate tax purposes receives a date-of-death basis for income tax purposes. For persons dying after December 31, 2009, property acquired from a decedent will retain the decedent's tax basis. This is known as "carryover" basis. In most cases this will result in an increased capital gains tax. There are two major exceptions to carryover basis. First, the estate of every decedent who is a U.S. citizen will be entitled to increase the basis of the decedent's property by up to \$1.3 million. If the estate is valued at \$1.3 million or less, each asset will automatically receive a basis equal to its date-of-death value. If the estate is larger than \$1.3 million, the estate must file a return allocating the basis increase to specific assets. If the decedent was married, the estate is entitled to an additional basis increase of up to \$3.0 million for property passing to the surviving spouse outright or in the form of a Q-TIP trust.

Because the estate tax remains in effect until the end of 2009 it is not recommended that you immediately revise your estate plan to take advantage of its repeal. This is abundantly clear in that the Act provides for reinstatement of the entire estate tax system starting 2011, in effect repealing the repeal of estate tax. Because of the phased in increases in the unified credit that take place during the nine year transitional period, it is important that your current estate plan be reviewed to ensure that it takes advantage of this increase. Most estate planners are still recommending gifting strategies to reduce estate tax as if repeal will not happen.

ITEMS FOR CONSIDERATION

Some of the following items may need to be considered as part of the estate plan depending on your particular needs and circumstances:

- *Durable Power of Attorney* - a document giving your designated agent the ability to manage your property and take actions of your behalf. It is particularly valuable should you become incapacitated.
- *Living Will* - a document directing that you be allowed to die a natural death and not have your life prolonged by artificial means. A Health Care Power of Attorney is a related document that should be considered.
- *Revocable (Living) Trust* - a trust created during your lifetime. You retain the right to terminate or change the trust anytime prior to your death as well as the right to receive any income generated from the trust. A revocable trust can be funded before or after your death. Typically, any assets not on deposit in the trust as of the date of your death will be transferred to the revocable trust to provide for an orderly estate administration. Revocable trusts are particularly useful for persons having a sizeable amount of insurance or retirement benefits. Revocable trusts can also be used to minimize probate court fees and to plan for incapacity or incompetency.

- *Life Insurance Trust* - a useful tool for removing life insurance proceeds from your gross estate and directing the disposition of the proceeds following the insured's death. Although the trust would be the owner of the policy and therefore the policy would be excluded from your gross estate for tax purposes, the life insurance proceeds can be made available to provide a source of liquidity for the payment of your estate's debts and taxes as well as for the future financial security of the surviving spouse and children.
- *Children's Trust* - an irrevocable trust created either during or after your lifetime to hold assets for the benefit of your children. A Children's Trust can yield estate tax savings as well as possible income tax savings.
- *Grantor Retained Annuity Trust ("GRAT")* - an irrevocable trust wherein you retain the right to receive a fixed distribution amount each year from the trust for a predetermined number of years. The trust assets are distributed to previously designated beneficiaries upon the termination of the trust. For tax purposes, GRATs enable a creator to pass a significant amount of property - together with any future appreciation thereon - at a significantly discounted gift tax cost because of the term interest retained by the creator.
- *Charitable Remainder Trust* - an irrevocable trust that provides you a current income tax deduction upon the funding of the trust even though you and/or your spouse are entitled to receive a distribution of a fixed or varying amount each year from the trust. The charity receives the principal upon termination of the trust. This trust is sometimes used in connection with retirement and insurance planning. It also can be used as a mechanism for the tax-free conversion of low yielding securities into higher yielding securities while simultaneously fulfilling a charitable desire.
- *Buy/Sell Agreement* - a document created to control the disposition of an interest in a business to an outside party by another co-owner. In addition, this agreement typically provides for the purchase of a co-owner's interest in the business upon his death or permanent disability. This agreement can serve to fix the value of the business interest for estate tax purposes as well as to provide a source of estate liquidity for an otherwise illiquid asset.
- *Joint Survivor's Life Insurance* - a life insurance policy that pays a death benefit upon the death of the surviving spouse. The insurance proceeds from such a policy are normally designed to provide a source of liquidity with which to pay the estate tax liability on the death of the surviving spouse. The premium payment for a joint survivor's policy than those for a single life policy are normally significantly less expensive because the actuarial life expectancy of two lives on which the premiums are based is longer than the life expectancy of either individual alone.