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**Advising the Affluent Client:**

**Estate Planning**

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## ABOUT GREENE CONSULTING ASSOCIATES, LLC

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## Introduction

Top producers are always looking for an idea that can help them distinguish themselves in an increasingly competitive marketplace.  One of the most powerful ways to differentiate yourself is by broadening your ability to provide more comprehensive financial advice.  The ability to address estate planning issues for clients will give you an edge over the countless others trying to survive by applying a one-dimensional approach.  Those who continue to focus on a limited array of solutions will fail to capitalize on significant opportunities to grow their business and will become increasingly vulnerable.

The benefits of being able to address your clients' estate planning needs are significant.  Specifically, integrating estate planning into your approach will enable you to expand your reach while increasing production and client retention.

* **Expand Reach** - Expand your current client relationships by:
  + Forming trust relationships with your clients provides an opportunity to develop relationships with their heirs, increasing the continuity of the relationship through an unprecedented era of inter-generational transfers of wealth that will occur from baby-boomers to their heirs.
  + Providing more comprehensive and timely financial advice for your clients.
* **Increase Production -** By addressing estate planning issues, you will be equipped with additional resources to:
  + Target a higher net worth clientele
  + Uncover and capture additional assets with existing clients
* **Increase Retention -** Studies show that most affluent clients prefer to work with a single advisor. Those advisors who are unable to address a comprehensive array of their needs will eventually lose relationships to those who can. Additionally, statistics show that relationships that include a trust have an average lifespan of more than 13 years – over twice that of non-trust related relationships.

## Why Studying this Material is Important

Many reasons are often given to stress the importance of helping clients address their estate planning needs. For example:

* Clients tend to procrastinate planning their estates and need someone to motivate them.
* Clients lack the necessary technical expertise to recognize they have a planning need.
* Or, it is an excellent way to identify assets that you are not currently managing.

All of these points are true. However, the primary reason you should address estate planning needs with your clients is because it moves you beyond merely addressing the management of the client’s assets to addressing the ultimate goals, dreams, and fears associated with those assets.

The fact is that no other financial conversation you can have with a client takes place at such a deeply emotional level. It is a conversation that allows you to gain insight into what is of ultimate importance to the client.

This results in the client making a significant emotional commitment to your relationship. Having made that commitment, the client is reluctant to do so elsewhere, particularly when you have done a good job of helping the client address these emotionally-charged issues. This moves the client beyond merely being a “satisfied” client to becoming a “loyal client.” Creating loyal clients has two payoffs for you:

* First, it extends the duration of the relationship.
* Second, it increases the assets clients bring to you. In fact, one recent study, which defined loyal clients as those who had made an emotional commitment to the relationship, found that 90% of loyal clients will contribute new assets every year ***without*** being asked to do so.

## Objectives and Course Structure

The objective of this course is to equip you to help clients address their most common estate planning needs, which are listed on the right.

|  |
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| **Common Estate Planning Needs**   1. The Need for a Plan 2. Providing Protection (for oneself and for loved ones) 3. Maintaining Control (as to ***who*** will ultimately receive the assets and ***when*** they will receive them) 4. Deciding Who Will Act as Executor/Trustee 5. Minimizing the Impact of Estate and Gift Taxes 6. Maximizing Charitable Intent |

To accomplish this goal, the course is structured around each of these needs. For each need, the following resolution practice will be discussed. **Click each technique to learn more**

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| **The context within which a solution can be formed** |
| To identify needs and potential solutions, it is necessary to first understand the environment in which a response is formulated. Depending upon the need being addressed, this may require an understanding of essential vocabulary, legal requirements, taxation, etc. After the needs have been identified, your client should work with his or her legal and tax advisors to design the plan that will address the need. Please note that your work must not replace the advice of the client’s legal and tax advisors. |
| **Potential solutions** |
| Once you understand the context, it becomes possible to explore common solutions. |
| **Approaches to take with clients** |
| It is not enough that you understand the need and possible solutions; nothing will happen until your client ***sees*** the need and ***wants*** a solution. Therefore, for each of the primary client needs, we will discuss effective methods you can use to help your client see the need and want a solution. |

This last step of getting the client to recognize the need and desire a solution requires some understanding of how people make the decision to “buy,” whether they are buying something tangible like a car or a planning solution. Therefore, we will explore this methodology of converting a need to a want on the next page, and then proceed on to addressing each of the six needs listed above.

## Capitalizing on Opportunities

The key to being a successful advisor is not so much about the ability to give advice as it is about the ability to ask questions. In fact, ***the hallmark of a great advisor is asking the right questions at the right time.***

Not all questions are the same. Some questions are for gathering information. These are generally referred to as ***profiling questions***. This is where you begin. By asking a series of fact-finding questions, it becomes possible for an advisor to identify potential needs and establish the framework for applying his or her skill in formulating potential solutions.

Once a client's need is uncovered through profiling, that need must then be turned into a sales opportunity. All too often, advisors attempt to accomplish this by diagnosing a need and immediately telling the prospect how to solve it. In other words, they make the mistake of trying to sell the facts, on the assumption that the mere offering of their diagnosis and solution will be sufficient to motivate the client to action. This seldom works because: ***individuals typically buy what they want, not necessarily what they need.***

DocumentationIcon_32px**Click the icon to view an example.**

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| **Example - Purchasing a Car**  If the decision of which car to purchase was influenced solely by facts, we would all simply input our specifications into a worksheet and - voila - the most appropriate make and model for you would appear. But we all know the process is much different. In fact, many decide what car they want based upon issues such as appeal of the style, how they feel sitting behind the wheel, or how they feel the car reflects their own personality or sense of status. Then, after deciding what they want, they mentally justify their decision with facts such as "it's a good value" or "it scored well in Consumer Reports." |

To get the client or prospect to ***want*** the solution, the advisor must first engender an emotional response that leads people to be unwilling to accept their current situation. This is because: ***people typically buy on emotion, and justify with facts.***

Don't misunderstand this. We're not suggesting that advisors should manipulate emotions. However, we ARE saying that advisors will not bridge the gap between a need and a want until the client or prospect experiences the need on an emotional level. Individuals will not truly want a solution with any degree of urgency until they become concerned and discomforted by the presence of their need.

The best path to engendering this emotional response is by asking another type of question, which we call ***awareness questions***. Such questions help clients become aware of their needs AND, having raised their awareness, foster a sense of urgency within the client to address the need.

DocumentationIcon_32px**Click the icon to view an example.**

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| **Creating a Sense of Urgency**  Good awareness questions create a sense of urgency that can never be achieved by simply telling a client of a need. To illustrate, consider the following scenario:  You are walking down the street and see that a piano is about to fall on a bystander. If you tell the person, "You need to move," the person is not going to be very motivated to do so because he or she has no idea WHY there is a need to move. However, if instead you say, "How are you going to avoid being crushed by that piano dangling over your head?" you probably should step to the side because the person will be quite motivated to move! |

As you begin mastering the skill of asking awareness questions, evaluate your questions relative to the simple criteria listed below. **Click the criteria to learn more**.

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| **How…?** |
| Questions that begin with the word "How" are, by their nature, process-oriented. They make the client think through the process of resolving the situation you propose. (Note: This does not mean that every awareness question must begin with "How," but this is a good general rule of thumb, especially as you begin building expertise in asking these types of questions.) For example:   * "How have you made the determination that you would prefer to pay more taxes at death than reduce them through lifetime gifts?" * "How have you made the determination that this is the best strategy for saving for college expenses?" |
| **Focus on Consequences** |
| A good awareness question causes a client or prospect to confront the consequences of continuing with the current strategy (or lack thereof). For example:   * "How does your current plan provide for the support of you and your family if you should become incapacitated?" * "How have you determined that appointing your sister rather than one of your brothers as your executor will not strain family ties?" |
| **Non-Confrontational** |
| Be careful to avoid embarrassing or confronting your clients when asking a question. One way to do this is by asking your question in a manner that presumes they have good reasons for the decisions they have made. When they don't have a good reason, they will generally have no problem responding with, "Well, I really hadn't thought about that" and they will not feel demeaned by having you point out their failings to them.  For example, don't ask:  **"Why did you buy taxable bonds when you could clearly have increased your after-tax income by purchasing municipals?"**  Instead, ask the question in this manner:  **"How have you structured your bond portfolio to optimize your after-tax return?"**  The first question is confrontational. While the second question may surface the fact that the client or the client's current advisor did NOT take after-tax return into consideration, it is clearly non-confrontational and more likely to solicit an inquiry as to what you might suggest. |
| **Focus on the Advisor** |
| If a person is currently working with another advisor, frame the question to focus on the advisor instead of on the individual. For example, "How has your advisor structured your portfolio to meet your objectives?" This will avoid the risk of embarrassing the prospect, while fostering consideration in the prospect's mind regarding the performance of the other advisor. It will also position the client to be curious as to how your approach might be different. |
| **Know How You Would Answer** |
| There is an old adage that an attorney should never ask a question of someone on the witness stand without first knowing the answer. This is also true for financial advisors. Whenever you ask an awareness question, be prepared for the client to ask how **you** would answer the question you just asked. For example, if you ask "How has your advisor structured your portfolio to meet your objectives," be prepared to explain how **you** would go about structuring the portfolio. In short, be prepared to present your solutions once the client is ready to hear it. |

Applying any type of rigid formula to the sales process is misguided. However, using the above rules as reference tools can ensure that you master the art of asking effective awareness questions. Throughout this course, we will make frequent reference to applying the art of asking the right questions.

## Need #1 – Lack of an Estate Plan

***Estate planning is primarily about planning for the transfer and application of assets***. This is an important issue for everyone who owns assets because all of us are mortal and will eventually die. That means the assets we own *will* someday transfer to someone, whether we plan for the event or don't. Those assets will also be applied to achieving someone’s goals. Without planning, they may serve someone else’s goals, not our own.

Far and away the most common estate planning mistakes individuals make is failing to put in place any plan at all.  In fact, a recent survey sponsored by LexisNexis found that the majority of Americans (58%) do not have a basic will. The powerful message contained within this staggering statistic is simple - a significant opportunity to distinguish yourself by suggesting appropriate solutions and capture assets exists with many of the affluent individuals you encounter every day.

Potential Implications

Understanding that many people fail to engage in thoughtful planning, let's examine the potential implications.  Although the consequences of not planning are far too numerous to list completely, the following are a few that should be considered.  **Click each consequence to learn more.**

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| [**Paying Unnecessary Taxes**](javascript:void(0)) |
| Simple planning can eliminate or defer estate taxes for many individuals. Even with the Tax Relief Act of 2012, which prevents federal Gift and Estate taxes from being a significant issue for most affluent clients, there may still be state tax issues for many to consider. Therefore, for some affluent clients, estate taxes could be considered a choice - either choose to plan or, if by default you have a taxable estate, choose to pay taxes. |
| [**Failure to Protect Loved Ones**](javascript:void(0)) |
| Lack of planning can result in unduly burdening family with managing complex financial matters, providing them large sums of money they are not ready to handle, or, in the case of minor children, possibly leaving them in the hands of the courts. |
| [**Failing to Maximize Charitable Intent**](javascript:void(0)) |
| Rather than waiting until death to give money to charities, proper planning may enable individuals to enjoy the emotional benefits of their gift during their lifetime while enabling them to capitalize on significant financial benefits as well. |

Another important issue that many affluent clients fail to properly address is how their property is titled. The titling of assets can itself be a form of estate planning, with implications that often escape the notice of clients. Clients often generate consequences they never intended through the titling of their assets, even when an estate plan has been put in place. The importance of properly titling assets is illustrated in the following case:

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| **The Case of Unintended Results**  Jim andMary Jones married 15 years ago after previous divorces, each with a child from prior marriages. The children were grown when the marriage occurred and have never gotten along. Three years ago, Mary began to show signs of Alzheimer's and Jim has been her sole caregiver until his recent death. Mary's health is not good and she is not expected to live much longer.  Jim’s estate is valued at $1.2 million and Mary's is worth $1 million. At his death, Jim’s will directs his assets to go into a trust until Mary’s death, at which time the trust will terminate and the assets will be distributed to his child. Mary has a similar will, with assets ultimately going to her own child. When the wills were executed, the documents were consistent with the desire of each spouse to ultimately pass on their estates to their respective children.  Unfortunately, after putting the plan together, neither spouse paid attention to how titling of assets might affect this plan. Among Jim’s estate assets, $500,000 is his half interest in their house and the balance of his estate is in an investment account; both the house and investment account are titled as joint tenants with right of survivorship with Mary. Consequently, all of Jim’s assets will transfer at death directly to Mary, completely bypassing Jim’s will. In short, this failure to be mindful of the titling of their assets has undermined the intent of their estate plan and will potentially disinherit Jim’s child. |

****Awareness Questions****

When you encounter a client that has not done proper planning or does not review their plan periodically to ensure it is appropriate, ask the client the following questions.

DocumentationIcon_32px**Click the icon to view example questions.**

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| **Effective Questions**   * **What process did you use to construct an effective estate plan for you and your family?** * **How have you reviewed your estate plan in light of recent tax law changes?** * How have you titled your property to ensure you do not undermine your estate plan? |

## Need #2 - Providing Protection

One of the most powerful estate planning tools for providing protection for an individual and the individual's family is a trust. This is because a trust can continue functioning, in accordance with the purposes and guidelines with which it was established, despite the incapacity or death of the person who established it. This makes it possible to provide some degree of financial protection against the possibility of a period of incapacity, without the need of a court-appointed guardian of the property. It also makes it possible to provide post-death financial protection for family members. To better understand how this is accomplished, let's first elaborate on the nature of a trust.

**To learn more about the definitions of the underlined terms, click each heading.**

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| **Overview** | A trust is a ***fiduciary*** ***relationship*** whereby one ***party***, the trustee, takes ***title*** to ***property*** for the sole purpose of managing it for the benefit of a designated party, the beneficiary(ies). |
| **Fiduciary** | The term “fiduciary” is derived from Roman law, and applies to a person or entity that has accepted a responsibility that must be performed in the best interests of another person or entity. In other words, action cannot be based on self-interest; the interest of another must come first. |
| **Relationship** | As a “relationship,” it must be freely entered into. Just because someone is named to assume this obligation (as trustee), does not obligate him or her to act in this capacity. It is always possible to “disclaim the appointment.” But once accepted, the responsibility is legally binding. |
| **Party** | The parties to the relationship may be individuals or institutions. |
| **Title** | The party acting in this fiduciary capacity is called a **Trustee**. Unlike someone who has a power of attorney or someone who is acting as an agent or custodian, the trustee actually takes legal title to all property held in the trust. |
| **Property** | Trusts are created for the purpose of managing property and utilizing it for specific purposes. Without property, there is no effective trust. All too frequently people create trust documents, only to fail to properly fund them. |

While trusts can be created verbally, this course will only deal with trusts that are created by written agreement. Under such agreements, property is transferred only when the receiving party agrees to abide by the terms of the agreement.

In drafting trust agreements, care must be taken to make sure there is no conflict with the will. This is important because assets owned by the trust will be administered by the terms of the trust. Unless the trust is required to distribute assets to the estate, the will has no authority over trust assets. For this reason, wills and trust agreements are customarily treated as complementary tools in estate planning.

## Types of Trusts

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| **Trust Types:**   * Revocable * Irrevocable * Living * Testamentary * Non-discretionary * Discretionary |

Trust agreements are extraordinarily flexible, and can be tailored for virtually any purpose. They may be **revocable,** meaning the person who created the trust can alter or cancel it at any time. Or they may be **irrevocable,** meaning they cannot be altered or canceled after their creation.

They may be created during life, which is known as a ***living trust,*** or by a person's will, which is known as a ***testamentary trust.***  Since the person who created the will is dead when a testamentary trust is funded, it is by its very nature irrevocable.

They may bind the trustee to do only what the trustee is explicitly directed to do by the grantor or the terms of the trust, which is called a ***non-discretionary trust.*** Or they may allow the trustee to use his or her own discretion in deciding what investment changes to make and/or how to distribute income or principal to the beneficiaries, which is known as a ***discretionary trust.***

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| Trustee  The trustee is the person or institution that administers the trust per the terms of the trust document. |

## Three Key Roles

The specific terms and purposes of the agreements are infinite in their variety. But despite these differences, all trusts consist of three parties, as diagramed below:

**Click each named party for more information.**

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| **Grantor** |
| This is the person who creates the trust. Alternatively, this person is referred to as the trustor or settlor. Any legally competent adult can create a trust by having a trust agreement drafted and transferring assets into the trust.  The grantor can be distinct from the beneficiary and trustee, but can simultaneously be either the beneficiary or trustee, or both. For example, it is quite common for people to establish a living trust in which the grantor acts as the trustee and receives all the benefits while alive. |
| **Trustee** |
| This is the person or institution that takes title to the property, agrees to be governed by the trust document, and agrees to act on behalf of the beneficiary. If there is more than one trustee, they are referred to as ***co-trustees***.  In fulfilling the duties, the Trustee may have as much or as little power as the grantor chose to relinquish, as stated in the terms of the agreement. Any legally competent adult can be a Trustee. |
| **Beneficiary** |
| The beneficiary is the person(s) or entity(ies) for whom the benefit of the trust is intended. Some beneficiaries may be **current beneficiaries**, meaning they receive a current benefit, such as income, from the trust. Others may be **future beneficiaries**, meaning they will not receive any benefit until some future point in time. Quite often, the future beneficiaries are to receive the assets of the trust upon the death of the current beneficiaries. For example, a trust may exist to pay income for the lifetime of a surviving spouse (the current beneficiary), but terminate upon the surviving spouse's death and distribute the assets to the surviving children (future beneficiaries). |

## Protection Benefits of Trusts

Trusts can be written to provide a number of protection benefits, such as the following. **Click each benefit below to learn more.**

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| **Protection against Incapacity** |
| Unlike brokerage accounts and investment management accounts, which may terminate upon being notified of the incapacity of the account owner, trusts continue. This enables the trustee to continue managing the assets for the benefit of a grantor, following the grantor's dictates, while avoiding the need to involve the court in a guardianship.   |  | | --- | | **Sarah’s Story**  Sarah Henderson is an 80-year-old widow who lives in South Florida, which is almost a thousand miles away from her children. She is currently in good health and is fiercely independent. She is adamant that she never wants to be placed in a nursing home, preferring to be cared for at home so long as her assets make this possible. She is equally insistent that she never wants to be a burden to her children. Therefore, Sarah appointed a corporate bank to act as the trustee of a revocable living trust. As a revocable trust, Sarah retains full control over the assets while she is alive and competent, directing the trustee to make distributions to her as she needs them. In case she becomes unable to handle her own affairs, the trust document instructs the trustee to apply the funds toward maintaining her in her home, so long as there are sufficient assets to make this possible. Upon her death, the trust terminates and the remaining assets are distributed to her children. | |
| **Protection for Adult Beneficiaries** |
| For those who cannot properly handle money, a trust provides the ability to give beneficiaries the benefit of money without turning control over to them. This is advisable protection for those who lack investment expertise, who might be subject to outside influence, or who are spendthrifts.   |  | | --- | | **The Stephens**  Tom and Elizabeth Stephens are both in their seventies. Tom has always handled the investments and Elizabeth feels uncomfortable handling any financial matters beyond her checking account and credit cards. Knowing that men typically have shorter life spans than women, Tom decided to put a plan in place to provide security and peace of mind for his wife in the event that he predeceases her. Tom accomplished this by transferring his assets into a living trust and appointing a corporate trustee. This gives Tom an opportunity to evaluate the skills of the trustee while he is alive and thereby to reassure his wife that she will be in good hands if he should die before her. | |
| **Protection for Minor Beneficiaries** |
| The use of a trust should be considered whenever a minor child is involved. Without a trust, a child will receive access to an inheritance upon reaching the age of majority, which is age eighteen in most states. Since no one can predict the child's level of maturity at that age, there is inherent risk in having a plan that leaves everything to a child at such a young age. Will the newfound funds be squandered on a spending spree? Will the child feel empowered by the funds to skip college? Will the child be involved in experimentation with drugs and use the funds for that purpose?  By using a trust, it becomes possible to defer some or all of the funds until the child is older. Typically, this is done in installments, thereby giving the child a chance to grow in responsibility. If the child fails to properly manage the money after the first distribution from trust, then at least there is a chance that the child will learn from that mistake and do better with the next one.   |  | | --- | | **Joseph and Ruth**  Joseph and Ruth Abrams are in their late twenties, with twin sons who are five years old. Their estate is approximately $800,000. They went to an attorney to have wills drawn so that they could name guardians in case they were to die in a common accident. The attorney suggested that their estate plan should include the funding of a trust for their minor children.  The attorney explained that the trust, which would be created by their will, would direct the trustee to provide funds for the care and education of the children. Upon reaching age 18, the children would begin to receive the income from the trust. At age 21, they would receive 1/3 of the assets, at age 25 they would receive ½ of the balance, and at age 30 the trusts would terminate and the children would receive the remaining balance. | |
| **Protection for Persons with Special Needs** |
| People with "special needs," such as a physical or mental disability, are often eligible for government assistance, e.g., through Social Security and/or Medicaid. Leaving an inheritance to someone who has such a need can jeopardize the person's government assistance. Therefore, instead of transferring the funds directly to the person, a "special needs" trust can be established that names the special needs person as the beneficiary. This trust can provide assistance that goes beyond the government assistance, providing for supplemental living expenses and paying for medical assistance that might be beyond that provided by government programs.   |  | | --- | | **Jane’s Situation**  Jane has an adult daughter who, because of a fall, suffers partial paralysis. The daughter currently receives government assistance. Jane would like to leave her home to her daughter so that she will always have a place to live, but fears that giving it to her daughter will jeopardize her daughter's government assistance. Instead, upon Jane's death the home will be placed in trust and the daughter will be allowed to live in the home free of rent. Additional funds will be placed in the trust to provide for its maintenance and to pay utilities. Upon the daughter's death, the home will be sold and the assets will be distributed to Jane's two other children. | |
| **Privacy** |
| When property is transferred via the will, the disposition of the property becomes a matter of public record. Anyone who desires to see a copy of the will can go to the courthouse and obtain one. This is often undesirable, particularly when someone is a public figure or where there is concern that there can be family strife if certain relatives learn the particulars of one's estate. One virtue of a living trust is that it is not generally covered by the will. Only those persons who are named as beneficiaries will be entitled to any specific information regarding the terms of the trust.   |  | | --- | | **Mr. Williamson**  Phillip Williamson has been mayor of a small country town for over twenty years. He has three grown children and over twenty close relatives who all live in the same community. He is concerned that upon his death the local newspaper might reveal information regarding his estate, particularly how he decides to divide his assets among his children and relatives.  To prevent this, his attorney created a revocable trust, which Phillip funded with one dollar. His attorney also created a "pour-over will," which "pours" Mr. Williamson's entire estate over into the trust upon his death. The trust will contain all the information as to how assets are to be used for or distributed to his three children. All anyone will be able to learn by going to the courthouse is that his will distributed everything to his trust, the terms of which remain private. | |

## Helping Clients See the Need for Protection

In working with a client or prospect, any number of factors may lead you to identify that protection is a relevant need. For example, the person may be elderly and in poor health, with no nearby relatives; the person may reveal concern regarding a special needs child; or the person may have minor children. Once you identify that a need for protection may exist, it is not sufficient that *you* see it; you must help your *client* see the need. Until the client sees the need and feels some sense of urgency to resolve the need, no action will be made.

The best way to help the client identify the need and feel motivated to action is to ask open-ended questions that deal with the repercussions of failing to adequately plan for the need. For example, to help your clients/prospects see a need to plan to provide greater protection for themselves and their loved ones, you might ask them the following questions.

DocumentationIcon_32px**Click the icon to view example questions.**

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| **Example Questions**  How have you protected yourself and your family against the possibility of your incapacity?  How have you prepared your spouse to take over management of your financial assets upon your death?  How have you planned to protect your children from possibly being harmed by a large inheritance when they are too young to handle it? |

## Review Exercise

Before proceeding, check your familiarity with trust terminology by answering the following True-False questions. **For each question, indicate your response by clicking the appropriate button.**

1. **The grantor, trustee, and beneficiary must be three distinct persons.**

* True

**Incorrect.** One person can fulfill all three roles, naming in the trust document a remainder beneficiary (or beneficiaries) to receive the trust proceeds after the grantor’s death, if the trust is to terminate upon the grantor’s death; or, if the trust is to continue after the grantor’s death, naming a beneficiary (or beneficiaries) to be the successor beneficiaries of the trust.

* **False**

**Correct.** One person can fulfill all three roles.

1. **To fund a trust with real estate, the property must be retitled.**

* **True**

**Correct**. To fund the trust, it is necessary to re-title real estate into the trust.

* False

**Incorrect**. To fund the trust, it is necessary to re-title real estate into the trust.

1. **A discretionary trust is one where the trustee is empowered to use his/her discretion, subject to the terms of the trust, in deciding how to make investment changes and/or how to make distributions to the beneficiaries.**

* **True**

**Correct.** This is the definition of a discretionary trust.

* False

**Incorrect**. This is the definition of a discretionary trust.

1. **Testamentary trusts are typically revocable.**

* True

**Incorrect.** Since the creator of the trust is deceased, they are irrevocable.

* **False**

**Correct.** Since the creator of the trust is deceased, they are irrevocable.

## Need #3 - Maintaining Control

The primary instrument for providing control over ***who*** receives assets upon death is the will. By complementing the will with one or more trusts, created either while alive or at death, it also becomes possible to control ***when*** people receive assets. Together, these form the core of an effective estate plan. We've already discussed trusts and illustrated how they can provide control over the timing of transfers. Let's now examine the will.

Most people do not have wills. They either assume their estates are too small to bother or they procrastinate planning for their own demise. Yet a will is the most basic of estate planning documents.

A will is an instrument by which a persondeclares instructions for the disposition of his or her property at death. While some property may transfer by virtue of its title (e.g., property held in joint tenancy), by virtue of being held in a trust, or by contract (e.g., life insurance proceeds), the remaining property must be transferred through the will and be administered (probated) through the court. The most common form of will is the Simple Will, also known as an “I Love You Will.” Here, all assets owned by the first spouse pass free of income and estate taxes to the surviving spouse using the unlimited marital deduction.

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| --- |
| **person**  **testator *- male***  **testatrix *- female*** |

|  |  |
| --- | --- |
| **Overview** | Wills also have uses beyond the transfer of property. **To learn more about these uses, click each heading.** |
| **Establishing domicile** | A will helps establish the testator's state of residency, also referred to as the testator's domicile. While moving to another state does not invalidate a will, it is usually desirable for the will to reflect the current domicile. This clarifies where the estate will be administered and what laws will govern. It also helps to establish residence for state income tax purposes. |
| **Naming guardians** | A will is frequently used to nominate guardians for minor children. Unless it is a surviving parent, this will probably require approval of the court after the death of the testator. |
| **Creation of Trusts** | Wills are useful in establishing trusts (testamentary trusts) that continue after the lifetime of the testator. |

## Intestacy

What happens when a person dies [intestate](http://www.greeneconsults.com/topclass/)? Essentially, state law will decide how assets are distributed. These statutes vary from state to state, but there is typically some split of assets between the spouse and the children. If there is no surviving spouse or children, then the assets typically go to the parents, then brothers and sisters, then cousins and nephews, etc.

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| --- |
| **intestate**  **Intestate** - Having died without a will. |

Note: In community property states (e.g., Alaska (optional), Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), community propertygoes to the surviving spouse, with the remaining separate property owned by the deceased passing by state law in a manner similar to all other states.

|  |
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| **Community property**  Generally, **separate property** is:   * Property that an individual acquired prior to marriage * A gift or inheritance specifically given to an individual spouse * Compensation for personal injuries of an individual spouse * Individually owned property acquired prior to moving to a community property state |

|  |
| --- |
| **Separate property**  Generally, **community property** consists of income earned while married and property purchased with such earnings. Upon death, 50% of community property is included in the deceased spouse’s estate. |

While these statutes are equitable, taking into consideration the interests of both the spouse and children, they rarely accomplish what the decedent would have preferred.

DocumentationIcon_32px**lick the icon to view more information.**

|  |  |
| --- | --- |
| The diagram on the right illustrates what happens in most states when a person dies without a will and is survived by a spouse and children.  If survived by a spouse and children, most states split the assets between the surviving spouse and the children, with the spouse receiving 1/3 or 1/2 of the assets. This is true regardless of the age of the children.  Note: In community property states, such distributions would only pertain to separately owned property, since all community property would go to the surviving spouse. |  |

The example above may not be what the client wants to happen. However, the pitfalls of intestacy are quite significant: **Click each pitfall below to learn more.**

|  |
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| **Reduced funds for surviving spouse** |
| Under any number of scenarios, the surviving spouse is left with only part of the assets. This conflicts with the desire of most spouses for the surviving spouse to have the full benefit of all the assets for his or her lifetime. |
| **Minor children** |
| Because children cannot own property, their inheritance may require the appointment of a guardian to handle the property. While the property is administered in a guardianship, accountings to the court may be required and court approval may be needed for the sale of assets or their use on behalf of the children. Therefore, alternative planning that does not involve a court-monitored guardianship is typically preferred.  For example, a trust could be created to hold the funds for the children and a trustee could be empowered to use his or her own discretion (not the court’s) in making distributions for their health, education, maintenance, and support. The trust might further direct that the children start receiving the trust income at age 18, receive one-third of the principal at age 21, one-half of the balance of the principal at age 25, and the balance of the funds at age 30. |
| **Early inheritance** |
| As previously discussed, allowing a child to receive his or her inheritance upon reaching the age of majority is not necessarily a desirable strategy. Under intestacy laws, however, this result is inevitable. |
| **Inability to provide unequal distribution** |
| There may be variations in need among the beneficiaries that the decedent would want considered. For example, one child may be physically handicapped, with a higher anticipated need for financial assistance throughout the child's life. But the rules of intestacy are blind to such differences, and each child would be treated the same. |
| **Escheat to the state** |
| While this rarely happens, if the decedent left behind no living relatives, the assets would escheat to the state. It is highly doubtful that anyone would want the government to be the sole heir.   |  | | --- | | **escheat**  A reversion of property to the state if there is no heir to inherit | |
| **No distributions outside the family** |
| Most people have friends and charities to whom they would like to leave something behind. Intestacy does not recognize any beneficiaries outside the decedent's family. |

## Naming Someone to Settle Your Estate

A will also allows you to select the person or institution that will be empowered by the court to settle your estate. Depending upon the state, the person who is designated to settle the estate is referred to as the executoror **personal representative**, and the court that has jurisdiction over the proceeding is referred to as the **probate *(adj.)* court** (in some jurisdictions, it may be referred to as the **surrogate court**).

|  |
| --- |
| **executor**  **executor** *- male*  **executrix** *- female* |

The process of settling an estate through the court is referred to as **probate *(n.)***, and to go through that process is to **probate *(v.)*** the estate. That this is done as a court-monitored process reflects the fact that the will is viewed as a legally enforceable document, the instructions of which are binding upon the personal representative. Being a legal document, it should be drafted by an attorney.

## Helping Clients Achieve the Control Benefits of Wills and Trusts

Now that you have the context of wills and the probate process, it should be apparent that everyone needs a will. Failure to have a will is to allow state laws to settle your estate for you, rather than you determining who receives your estate. When one or more trusts are coupled with the will, the combination can actually give control that extends beyond the grave. Such a plan makes it possible to provide directions that will govern the management and use of the funds long after death of the testator/grantor.

|  |
| --- |
| When you encounter clients or prospects who have not done proper planning or do not review their plans periodically to ensure they are appropriate, ask them an open-ended question that leads them to face the consequences of inaction:   * **What process have you used to construct an effective estate plan that serves your needs and goals?** * **How have you made sure your estate plan remains current with your present needs and goals?** * How have you made plans to name guardians for your minor children if you and your spouse die in a common accident? * How have you planned your estate to make sure your assets continue to accomplish your goals after your death? |

## Need #4 – Deciding Who Will Act as Executor/Trustee

Although common, it is often a mistake to name an individual to serve as trustee or executor. Since the trustee/executor is responsible for handling all of the affairs of the estate after one’s death, most people choose a family member or close friend to serve in this capacity. While it may be viewed as an honor to be named as someone's executor or trustee, it can be a difficult and time-consuming task. There is the further potential that the executor may be placed in the middle of a family squabble over the estate, which is particularly troubling if the executor is a family member. The same is true for a trustee, whom the beneficiaries may resent as standing between them and “their money.” There is much to consider in both the selection of an executor/trustee and in accepting such an appointment.  **Click each of the links below to review a list of considerations each individual should consider when making such an important decision.**

|  |  |
| --- | --- |
| [Criteria for Choosing a Trustee/Executor](javascript:void(0)) | |
| * A professional money manager * Totally impartial when making decisions on behalf of beneficiaries * Someone who will manage the day-to-day activities of the trust or estate, keep good records, and provide periodic accountings to beneficiaries * Knowledgeable about fiduciary law * Possesses deep resources to make the account or beneficiaries whole if there is a loss due to error or negligence * Capable of not acting in a self-interested manner * Someone who is never sick and will not die during the course of administration | |
| [Considerations for the Individual Chosen](javascript:void(0)) |
| * Do you desire to be in a position to decide how a beneficiary will or will not be cared for? * Do you want to be in a position where beneficiaries who are friends or relatives can become angry and take sides because of your actions? * Do you consider it a privilege to have responsibility for all investment decisions, bill payments, tracking activity, and making periodic reports to beneficiaries? * Do you want the responsibility of dealing with legal documents and taxes? * Do you want to be in a position where every decision you make will be second-guessed by the beneficiaries? * Do you want to be personally liable if ever accused by beneficiaries and judged by a court as having been negligent or having not acted in the best interest of the beneficiaries? |

## Benefits of a Corporate Executor/Trustee

The considerations on the prior page make a strong case for considering the appointment of a corporate trustee or executor. The benefits of a corporate trustee or executor are quite significant:

* Experience
* Expertise
* Impartiality
* Continuity

|  |
| --- |
| If you work for an institution that offers estate settlement or trust services, you may be in a position to guide your client to a more appropriate solution. Therefore, if a client/prospect has selected an individual as trustee or executor, help him or her assess the appropriateness of such a selection by asking questions such as the following:   * How have you determined that your current executor (or trustee) has the expertise necessary to settle your estate (or administer your trust)? * How have you protected against your estate becoming a source of division in your family after your death? |

## Review Exercise

**Select the correct answer to the following questions**

1. **In addition to transferring assets, a will is useful in accomplishing all the following EXCEPT:**

* Establishing domicile

**Incorrect**. Try again.

* Creating a trust

**Incorrect**. Try again.

* **Establishing intestacy**

**Correct**. Intestacy refers to dying without a will. A will helps avoid intestacy.

* Naming guardians

**Incorrect**. Try again.

1. **If a client dies intestate (without a will), ALL of the following are possible EXCEPT::**

* Assets may be split between the surviving spouse and children.

**Incorrect.** Try again.

* **Distributions from the estate to non-family members with close ties to the deceased will be considered.**

**Correct.** If a person dies intestate, state laws of intestacy will preside and non-family members will receive nothing from the probate estate, regardless of how close their ties to the deceased were.

* Charities will be excluded from receiving part of the estate.

**Incorrect.** Try again.

* Minors will receive full control of assets upon reaching the age of majority (18 in most states).

**Incorrect.** Try again.

1. **In some states, the executor is called the:**

* Estator

**Incorrect**. Try again.

* Trustee

**Incorrect.** Try again.

* Probator

**Incorrect.** Try again.

* **Personal Representative**

**Correct.**

* Surrogate

**Incorrect**. Try again.

1. **In selecting an executor or trustee, you should look for all of the following EXCEPT:**

* Knowledge of fiduciary law

**Incorrect**. Try again.

* Impartiality

**Incorrect**. Try again.

* Professional money management expertise

**Incorrect**. Try again.

* Someone who will maintain absolute privacy and only provide an accounting upon termination of the estate/trust

**Correct**. The trustee/executor should provide periodic accountings.

## Need #5 - Minimizing the Impact of Gift and Estate Taxes

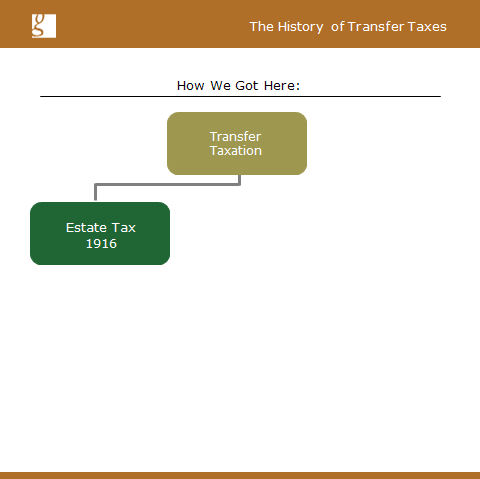
To understand how to minimize the effects of federal gift and estate taxes, you need to first understand some of the fundamentals regarding this form of taxation. The Federal Estate and Gift Tax System is commonly referred to as the federal "Transfer Tax System" because it deals with the taxation applied to the “transfer” of assets. Although there are exceptions, some of which will be addressed in this training, any transfer of assets from one party to another is potentially a taxable event. Knowing when these taxes apply is crucial.

There is also a federal Generation Skipping Transfer Tax for very large cumulative transfers to lineal descendents that skip a generation or go to non-related individuals 37½ years younger than the donor. This, too, is part of the federal Transfer Tax System, but further details regarding this tax shall be beyond the scope of this course.

Estate and Gift Taxes Have Much In Common

At one point in our history, lifetime transfers (gift taxes) were taxed under a system that was totally separate from the taxation of transfers upon death (estate taxes). However, in 1976, the federal estate and gift tax systems were "unified" and have shared many common elements since that time, the most important of which has been a unified tax rate schedule. A short history of this development is provided on the next page and will provide you with the context for better understanding our current system of transfer taxation.

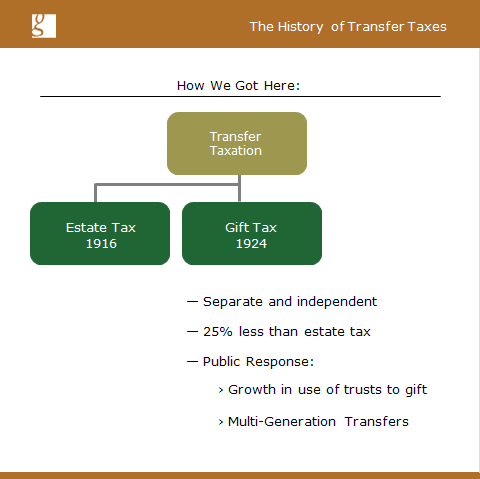
## A Short History of the Development of Transfer Taxes

Prior to the 20th century, an estate tax was implemented numerous times, always as a temporary measure of short duration. It was used to help pay for the Civil War, to help build the Navy, and to help pay for the Spanish-American War.

In the 20th century, in 1916 as the United States was nearing entry into World War I, Congress passed an estate tax as a “temporary measure”.

This tax has been with us ever since. As the public began to realize that this tax was not going away, an easy solution was to not own anything when you die; just give it away while you're alive.

This led to a rise of “death-bed-transfers.” Before you die, you call your doctor and you call your attorney.

To address the growing attempts to avoid the estate tax through lifetime gifts, in 1924 Congress passed the Gift Tax.

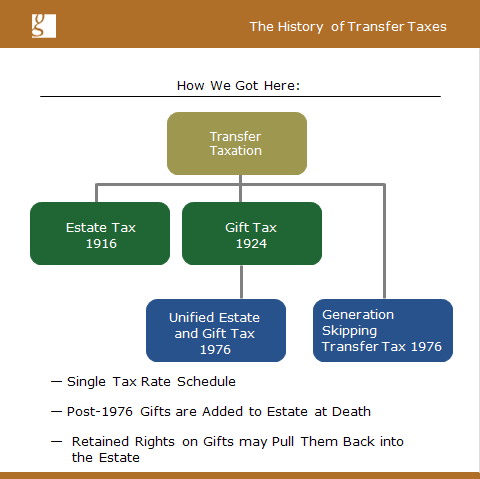
This tax was separate and independent from the estate tax. Both the estate tax and the gift tax were calculated without consideration of the other.

The gift tax rate was also 25% lower than the rate for estates, so there remained an incentive to give lifetime gifts rather than be taxed on assets at death.

In time, the public began to find ways to take advantage of this structure and became more creative with its use of lifetime gifts.

There was a growing use of trusts as a vehicle by which to transfer assets. For example, I could place an asset in trust, thereby no longer owning it, yet retain all the benefits of ownership. I might retain the right to all the income, retain the right to use the asset, or retain the right to continue voting the stock.

There was also an interest in multi-generation transfers. If the IRS was going to tax transfers in each generation, then I could achieve a considerable tax savings by transferring assets directly to my grandchildren, rather than first transferring them to my children where they would be taxed upon my children’s death.

To address these issues, in 1976 Congress implemented a Unified Estate and Gift Tax.

It was a unified system in that both the estate tax and the gift tax used the same tax rate schedule. Whether the transfer was made in life or at death, the same tax rates would be applied.

It was also unified in the sense that the estate tax and the gift tax would no longer be calculated independently. Instead, there would be consideration of lifetime gifts when computing estate taxes.

Here was the premise: the IRS would charge the same tax regardless of when the transfer occurred. To accomplish this, when you die, all post-1976 taxable gifts will be added back to your estate. The result is that you would compute your estate tax as if you had never given these amounts away.

A final thing the unified system did was address some of those transfers where people were retaining power over assets as if they still owned them outright. Essentially, the new rules said that if you made transfers in which you retained too much power, then they were considered incomplete transfers and the assets would be added back to your estate upon your death.

The final thing Congress did in 1976 was address the strategy to avoid the estate tax by skipping generations. Congress addressed this with a totally independent tax known as the “Generation Skipping Transfer Tax.” Essentially, this legislation said that sizeable transfers that skip a generation will be subject to an additional tax, assessed at the highest rate on the Unified Estate and Gift Tax Schedule.

Although there have been some reforms along the way, and we will talk about those, the 1976 legislation is essentially the tax system we have today. This course will flesh out more of the details as to how this system of taxation works.

## Deductions: Unlimited Marital and Charitable

Fortunately, we are not taxed on all transfers in life and at death. There are certain deductions that we are allowed to make ***before*** the tentative tax is calculated. Two important deductions that are available for both gift and estate taxes are:

1. **The Unlimited Marital Deduction**--Transfers of assets between spouses are non-taxable events regarding transfer taxes. This is true for lifetime gifts or for inheritances.

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| Beware, however, if a spouse is not a U.S. citizen. Non-U.S. citizen spouses are not automatically entitled to the Unlimited Marital Deduction and additional planning must be done in order to get them in a position to receive assets free of estate taxes. |

1. **Charitable Deductions--**Transfers to qualified charities, during one's lifetime or at death, are not subject to transfer taxes.

## Annual Gift Tax Exclusion

In addition to the deduction for transfers to a spouse or charity, which results in no transfer taxation, there are also three types of lifetime gifts that are excluded from consideration for transfer taxes. What is especially important to remember about these three types of excluded gifts is that they not only escape gift taxation when gifted, they also generally are never added back to the estate as post-1976 gifts when we die.

The first of these is known as the ***annual gift tax exclusion***. For 2016, lifetime gifts of a present interest in the amount of **$14,000 or less** can be made **annually (indexed for inflation in future years) to any individual,** and are **excluded** from the gift tax. Note that the gift tax exclusion is not limited to gifts to family members; it applies to gifts to ANY INDIVIDUAL.

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| **Present interest**  The recipient enjoys an immediate benefit and the unrestricted right to use, possess, and enjoy the property. |

This provides a significant ability for individuals with taxable estates to effectively transfer assets out of their estates without incurring a transfer tax. Given sufficient doneesand sufficient years to make transfers, sizeable amounts can effectively avoid taxation.

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| **donees**  Person or institution to whom a gift is made. |

|  |  |
| --- | --- |
| **Overview** | To learn more about other factors to keep in mind, **click on each heading on the left.** |
| **Gift Splitting** | A husband and wife can “elect to” or “consent to” split gifts between them for a combined $28,000 (in 2016) to any individual, and the entire amount qualifies for the annual gift tax exclusion. This is true even if the source of the funds is from one spouse. |
| **There is No Limit to the Number of Gifts in a Year** | An individual can make $14,000 annual gifts to as many people as desired. |
| **It is Not Cumulative** | In other words, it is either used or lost. If a year is skipped, the individual is not allowed to carry it forward into a subsequent year. |
| **Indexed for Inflation** | Beginning in 1999, the exclusion was set at $10,000 and indexed for inflation using 1997 as the base year. The indexing is rounded down to the next lowest multiple of $1,000, meaning it may be a number of years between changes. For 2016, it is $14,000. |

## Other Gift Tax Exclusions

The other two gift exclusions with which you should be familiar are direct payments for tuition and medical care.  **For the basic characteristics of each, click on each item below.**

|  |
| --- |
| **Direct Payment of Tuition** |
| * It is limited to tuition (books, dormitory, student fees, etc. do not qualify). * Payment must be made directly to the school (it cannot be given to the student with the intent that the student would pay the tuition). * There is **no limit** on the amount. * This is in addition to the annual gift tax exclusion. * Payment can be for anyone. |

|  |
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| **Direct Payment of Medical Care** |
| * The IRS defines specific expenses that qualify, but in general they cover the expenses of diagnosis and treatment. * It is not allowed for amounts reimbursed by insurance. * Payments must be made directly to the doctor or health care facility providing the care. * There is **no limit** on the amount. * This is in addition to the annual gift tax exclusion. * Payment can be for anyone. |

## The Gift and Estate Unified Rate Schedule

Let’s now begin a deeper exploration of the federal estate and gift tax system by exploring the Unified Rate Schedule. Listed below is the current Federal Unified Rate Schedule that is used in calculating the transfer tax on both lifetime gifts and estates. Under current law, this schedule remains constant for future years.

**Click the highlighted row to learn more.**

**CURRENT UNIFIED GIFT & ESTATE RATE SCHEDULE\***

|  |  |  |  |
| --- | --- | --- | --- |
| Column A  Taxable amount over | Column B  Taxable amount not over | Column C  Tax on amount in Column A | Column D  Rate of tax on excess over amount in Column A |
| $0 | $10,000 | $0 | 18% |
| 10,000 | 20,000 | 1,800 | 20% |
| 20,000 | 40,000 | 3,800 | 22% |
| 40,000 | 60,000 | 8,200 | 24% |
| 60,000 | 80,000 | 13,000 | 26% |
| 80,000 | 100,000 | 18,200 | 28% |
| 100,000 | 150,000 | 23,800 | 30% |
| 150,000 | 250,000 | 38,800 | 32% |
| 250,000 | 500,000 | 70,800 | 34% |
| 500,000 | 750,000 | 155,800 | 37% |
| 750,000 | 1,000,000 | 248,300 | 39% |
| 1,000,000 | ---- | 345,800 | 40% |

*\*This schedule is for 2013 and subsequent years.*

|  |
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| Let’s look at an example. Suppose you wish to calculate the transfer tax on $120,000. Here is how you do it:  **Step 1** – Find the row where $120,000 is between the number in Column A and the number in Column B. As you can see, it is the 7th row, where the range between Column A and Column B is $100,000 to $150,000.  **Step 2** – Identify the tax on the $100,000 amount given in Column A. This is provided in Column C, where we see that the tax on $100,000 is $23,800.  **Step 3** – Now calculate the tax on the amount over $100,000 using the rate found in Column D. Since our amount is $20,000 over the $100,000 for which we have already been provided the tax amount, multiply $20,000 by 30% to get $6,000.  **Step 4** – Add together the tax from Step 2 and Step 3. Thus, our tax on the first $100,000 plus the tax on the next $20,000 equals $23,800 + $6,000, for a total tax of $29,800. |

***Make note of the highest tax rate: 40%.*** This is achieved on all amounts over $1 million. This has not always been the highest rate. As previously discussed, this rate has been much higher in the past. Current legislation, however, dictates that this rate schedule remain fixed unless changed by future legislation.

## Practice – Using the Gift and Estate Rate Schedule

To develop some comfort in working with the Unified Gift And Estate Rate Schedule, use the schedule to answer the questions that follow:

**CURRENT UNIFIED GIFT & ESTATE RATE SCHEDULE\***

|  |  |  |  |
| --- | --- | --- | --- |
| Column A  Taxable amount over | Column B  Taxable amount not over | Column C  Tax on amount in Column A | Column D  Rate of tax on excess over amount in Column A |
| $0 | $10,000 | $0 | 18% |
| 10,000 | 20,000 | 1,800 | 20% |
| 20,000 | 40,000 | 3,800 | 22% |
| 40,000 | 60,000 | 8,200 | 24% |
| 60,000 | 80,000 | 13,000 | 26% |
| 80,000 | 100,000 | 18,200 | 28% |
| 100,000 | 150,000 | 23,800 | 30% |
| 150,000 | 250,000 | 38,800 | 32% |
| 250,000 | 500,000 | 70,800 | 34% |
| 500,000 | 750,000 | 155,800 | 37% |
| 750,000 | 1,000,000 | 248,300 | 39% |
| 1,000,000 | ---- | 345,800 | 40% |

*\*This schedule is for 2013 and subsequent years.*

Enter your results in the blank space provided and click the Submit button.

* Tentative Tax on a transfer of $150,000 = **$38,800**

**Correct!** The answer is $38,800

**Incorrect.** To find the correct tax, follow these steps:

**Step 1**. Locate the row where $150,000 falls within the range given in the first two columns. This occurs in the range of $150,000 to $250,000.

**Step 2.** The third and fourth columns indicate the tax would be $38,800 plus 32% of any amount over that listed in Column A ($150,000). Since our estate is exactly $150,000, there is nothing further to calculate, so the tentative tax is $38,800.

* Tentative Tax on a transfer of $350,000 =**$104,800**

**Correct!** The answer is $104,800.

**Incorrect**. To find the correct tax, follow these steps.

**Step 1**. Locate the row where $350,000 falls within the range listed in Columns A and B. The appropriate range is $250,000 to $500,000.

**Step 2.** Columns C and D indicate that the tax is $70,800 plus 34% of any amount over $250,000. That leads to the following tax calculation:

Tentative Tax = 70,800 + .34(350,000 – 250,000) = 70,800 + 34,000 = $104,800

Next, identify the marginal rates for the following amounts:

* **Marginal rate** on a transfer of $450,000 = **34%**

**Correct!** The answer is 34%.

**Incorrect**. To find the correct answer, follow these steps:

**Step 1.** Locate the row where $450,000 falls within the range given by Columns A and B. The appropriate range is $250,000 to $500,000.

**Step 2.** Column D gives the marginal rate being charged on every dollar over $250,000 as 34%. Thus, the marginal rate for $450,000 is 34%.

* **Marginal rate** on a transfer of $4,500,000 = **40%**

**Correct!** The answer is 40%.

**Incorrect.** To find the correct answer, follow these steps:

**Step 1.** Locate the row where $4,500,000 falls within the range given by Columns A and B. The appropriate range is in the last row, which includes everything from $1,000,000 and above.

**Step 2.** Column D gives the marginal rate being charged on every dollar over $1,000,000 as 40%. Thus, the marginal rate is 40%.

## Why Unify the Gift and Estate Tax?

One of the goals in creating a unified gift and estate tax system was to ultimately have everyone make the same transfer tax calculation regardless of the timing of the transfers. Just how this is accomplished is illustrated in the following example.

|  |  |
| --- | --- |
| **Mr. Jones’ Story**  Mr. Jones made taxable gifts during his lifetime (after 1976) of $800,000. He died in 2016 with an estate valued at $6,200,000. How do you take into account his lifetime gifts in computing his estate tax?  DocumentationIcon_32px  **Click the icon for the answer.**   |  | | --- | | **Answer**:  First, add together his lifetime taxable gifts (those made after 1976) and his final estate value, deriving a total of $7 million. Then compute the tax on $7 million, deriving his tentative estate tax.  If he paid any prior tax on his lifetime gifts (a likelihood if the bulk of his taxable gifts were made prior to 2002 when the cumulative amount that could be gifted without paying a tax was less than the cumulative $800,000 he gifted), then give him a credit in that amount against his estate tax.  The result is that Mr. Jones’ estate tax is calculated on $7,000,000, which is the same amount he would have used if he had never made lifetime taxable gifts (ignoring potential market value changes). This illustrates how two people with the same size estate will ultimately make the same estate tax calculation, even though one person made lifetime taxable gifts and the other did not. To be sure, there may be value in getting assets out of your estate during life because the appreciation on those assets will not be in your estate when you die; but ignoring market value changes, the tax calculation itself will be the same. | |

The concept illustrated by the example above is very important to remember. ***Lifetime taxable gifts (made after 1976) are added back whenever a Federal Gift or Estate Tax Return is filed.*** Thus, the calculation is always a cumulative calculation of all taxable transfers since 1976. A credit, which we will discuss later, is available against the calculated tax. Furthermore, if any gift taxes were previously paid on lifetime transfers, then credit against the current tax calculation will also be given for prior taxes paid.

## The Applicable Credit Amount

In addition to the deductions and exclusions we have discussed to this point, there is also a sizeable tax credit. Every U.S. citizen and **resident alien (non-citizen resident)** has a lifetime ***credit*** against gift and estate taxes; it is typically referred to as the “***Applicable Credit Amount***.” A “credit” is an amount that you get to ***subtract after a tax is calculated***. So, once we calculate a tentative transfer tax, we get to subtract the credit from the calculated tax.

The Applicable Credit Amount is “***unified***,” meaning it is shared with lifetime transfers (i.e., gifts) and estate transfers (i.e., at death); for this reason, you will sometimes see the Applicable Credit Amount referred to as the “***Unified Credit***.” Thus, the credit can be used to offset calculated gift or estate taxes; but if it is all used up by lifetime taxable gifts, there will be no credit left to protect further assets that transfer at death.

Historically, the Applicable Credit Amount has not always been fully unified between gift and estate taxes. In other words, there have been times in the past when only a portion of the Applicable Credit Amount could be used for lifetime taxable gifts; but today, there is no limit on how much of the credit can be used while alive.

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| **Resident Alien (Non-Citizen Resident)**  For transfer tax purposes, a non-citizen person is considered a resident alien and domiciled in the United States if the person lives in the United States with no present intention of leaving the United States. Various factors, such as statements of intent, length of time in the U.S., visa status, etc.) are used to determine domicile. Resident aliens are generally under the same gift and estate tax rules as U.S. citizens and are subject to taxation on their ***entire estates wherever situated***. |

## The Applicable Exclusion Amount

The amount of assets that are protected from taxation by the Applicable Credit Amount is known as the ***Applicable Exclusion Amount***. Stated another way, the Applicable Exclusion Amount is that amount of taxable transferred assets that will result in a tax bill equivalent to the Applicable Credit Amount, resulting in zero taxes owed to the IRS.

In Recent years, the Applicable Credit Amount and corresponding Applicable Exclusion Amount available to U.S. citizens and resident aliens have grown considerably. For example, in the decade between 2001 and 2011, we saw the following change:

|  |  |  |
| --- | --- | --- |
| Year | Applicable Credit Amount | Applicable Exclusion Amount\* |
| 2001 | $220,550 | $675,000 |
| 2011 | $1,945,800 | $5,000,000 |

*\*The amount of assets that are protected from taxation by the Applicable Credit Amount.*

In just 10 years, we went from being able to make $675,000 of taxable transfers to making $5,000,000 of taxable transfers without having to pay a single dollar of Federal Gift and Estate Taxes. This led to a dramatic decrease in the number of estates that owed gift and estate taxes, and an equally dramatic lowering of concern by most Americans regarding depletion of their estates by estate taxes.

For years following 2011, the growth of the Applicable Credit/Exclusion Amounts has slowed. This is because legislation fixed the Applicable Credit and Exclusion Amounts to 2011 levels, but began adjusting the amount for inflation. Today, their inflation-adjusted values are:

|  |  |  |
| --- | --- | --- |
| Year | Applicable Credit Amount | Applicable Exclusion Amount |
| 2016 | $2,125,800 | $5,450,000 |

While you need not memorize the Applicable Credit Amount, you should commit the Applicable Exclusion Amount to memory. Knowing this amount will be extremely useful in evaluating the tax exposure of any given estate.

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| ***Illustration*:**  In 2012, James made a $1,000,000 taxable gift to his children. He had made no prior taxable gifts and had no transfer tax credits other than his own Applicable Credit Amount.  Next, in 2014, he made another $1,000,000 taxable gift to his children.  Finally, he died in 2016 with a taxable estate valued at $10,000,000. How much of his estate was *NOT* protected by his Applicable Credit/Exclusion Amount?  **Try for the answer yourself and then click here for our analysis.**  ***Analysis****:*  James filed a gift tax for the 2012 gift, calculating a tax of $345,800. But his Applicable Credit Amount was more than enough to cover the tax, so no tax was due to the IRS.  When he filed the gift tax return for the 2014 gift, he ***added together the 2012 and 2014 gifts*** (remember, all post-1976 taxable gifts must be added back for both gift tax returns and estate tax returns). Thus, he reported his cumulative lifetime taxable transfers of $2,000,000, with a calculated tax of $745,800. Again, no tax was due because his Applicable Credit Amount was more than enough to cover the tax.  Upon his death, the executor added all post-1976 taxable gifts ($2,000,000) to the value of his estate ($10,000), and calculated the tax on the combined $12,000. The 2016 Applicable Credit of $2,225,800 was sufficient to protect the first $5,450,000 (in this case, the $2,000,000 of lifetime taxable gifts and $3,450,000 of his estate at death). Tax would be due, however, on the remaining $6,550,000 of his estate. Since this will be taxed at the marginal rate of 40%, James’ executor will pay the IRS: $6,550, 000 x 40% = $2,620,000. |

### What about Nonresident Aliens?

Unlike U.S. citizens and resident aliens, who have a generous unified Applicable Exclusion Amount for use with both lifetime gifts and estate transfers, **nonresident aliens** have an Applicable Exclusion Amount that can only be used for at-death transfer of their estates. Furthermore, the estate-only Applicable Exclusion Amount for nonresident aliens is limited to **$60,000**. This amount is **NOT adjusted for inflation**.

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| **Nonresident Alien**  All non-citizens who do not meet the test for being a resident alien are classified as nonresident aliens, even though they may be living in the United States for an extended period of time. They are subject to Federal Gift and Estate Tax only on their ***U.S. “situs” assets***.Unless modified by treaty, this generally includes real and tangible personal property located in the U.S., business assets located in the U.S., and stocks. |

## Portability of the Applicable Exclusion Amount

Beginning in 2011, a new concept was introduced to the Federal Gift and Estate Tax laws known as the “***portability***” of the Applicable Exclusion Amount. By “portability,” we mean that it is now possible for the unused portion of a deceased spouse’s Applicable Exclusion Amount to be transferred (or transported over) at death to the surviving spouse. For this to apply, the death had to occur after 2010.

Stated differently, when one spouse dies, the surviving spouse has their own “Basic” Exclusion Amount PLUS the ***“Deceased Spousal Unused Exclusion (DSUE) Amount.”***  If someone is predeceased by more than one spouse, then it is the ***last deceased spouse*** for whom this portability applies.

This change significantly impacts estate planning and makes it possible for a surviving spouse to have a significantly enhanced Applicable Credit/Exclusion Amount for use on the Estate Tax Return. To make use of it, the executor simply files an estate tax return and chooses to not opt out of portability on the return. Furthermore, portability is available for both U.S. citizen and resident alien spouses; it is not available to nonresident aliens.

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| **Overview** | While this sounds simple, it can actually get a bit complicated. Fortunately, this added complexity makes for some planning risks and opportunities. The best way to illustrate this is with several similar examples, going from the simple to the more complex. Study these examples carefully, as they illustrate some important planning considerations regarding portability.  **Click each example to learn more.** |
| **Example 1** | Mr. Andrews died in 2012 when his Applicable Exclusion Amount was $5,120,000. He never made any lifetime taxable gifts and passed his entire estate on to his wife, using the unlimited marital deduction so that his estate would owe no estate taxes. Therefore, his estate used none of his Applicable Exclusion Amount and $5,120,000 of DSUE was passed on to her.  Mrs. Andrews died in 2016. She, too, had never made any lifetime taxable gifts, so the Applicable Exclusion Amount available to her estate equaled her own 2016 Basic Exclusion Amount of $5,450,000 plus the $5,120,000 DSUE Amount she received from her deceased husband, for a combined total of $10,570,000. ***Please note that her Basic Exclusion Amount (i.e., her own Applicable Exclusion Amount) was increased by inflation from 2012 to 2015, while the DSUE Amount she received from her deceased husband remained fixed by the year of his death.*** |
| **Example 2** | Jane’s first husband died in 2012 when his Applicable Exclusion Amount was $5,120,000. He had never made any lifetime taxable gifts and passed his entire estate on to Jane, utilizing the unlimited marital deduction so that his estate would owe no estate taxes. Therefore, his estate used none of his Applicable Exclusion Amount and $5,120,000 of DSUE was passed on to Jane.  Jane remarried in 2014 and her second husband died in 2015. Jane’s second husband had a will that left his entire estate of $10,000,000 to his children from a prior marriage, totally using up his entire Applicable Credit/Exclusion Amount and transferring no DSUE to Jane.  Jane died in 2016. According to the rules of portability, her estate can no longer use the $5,120,000 DSUE she received from her first husband’s estate because the rules dictate that her estate can only use the DSUE from her ***last deceased spouse***. Unfortunately, her last deceased spouse’s estate left her with no DSUE. Thus, her estate is left solely with her own Basic Applicable Exclusion Amount of $5,450,000.  ***This example highlights a risk associated with DSUE and remarriage. In the next example, we will see a planning technique that can potentially address that risk.*** |
| **Example 3** | Sarah’s first husband died in 2012 when his Applicable Exclusion Amount was $5,120,000. He had never made any lifetime taxable gifts and passed his entire estate on to Jane, utilizing the unlimited marital deduction so that his estate would owe no estate taxes. Therefore, his estate used none of his Applicable Exclusion Amount and $5,120,000 of DSUE was passed on to Sarah.  Sarah remarried in 2014. Immediately upon remarriage, she made taxable gifts in the amount of $5,120,000 to her children from her prior marriage. The rules dictate that when a surviving spouse with DSUE makes lifetime taxable gifts, the DSUE is used up before the surviving spouse’s own Basic Credit. Thus, in making the gifts to the children, Sarah totally used up the DSUE from her first husband.  Sarah’s second husband died in 2015 when his Applicable Exclusion Amount was $5,430,000. He had never made any lifetime taxable gifts and passed his entire estate on to Sarah. His estate used none of his Applicable Exclusion Amount and, ***since he was now her last deceased spouse***, his estate transferred $5,430,000 of DSUE to Sarah.  Sarah died in 2016. Her Applicable Exclusion Amount equals her own Basic Exclusion Amount of $5,450,000 plus the $5,430,000 DSUE Amount she received from her second deceased husband (now the last deceased husband), for a combined total of $10,880,000.  This example highlights a planning opportunity associated with DSUE and remarriage. Realizing the risk that she could lose the DSUE from her first deceased husband if her second husband predeceased her, Sarah quickly used up the DSUE from her first deceased husband. The end result was that ***Sarah got to make use of the DSUE from both of her deceased husbands and had sufficient transfer tax credits to protect a total of $16,000,000 from taxation.*** |

## Review

**We have covered a lot of facts to this point, so let’s do a quick review of key facts.**

**Click each topic below to review key facts. Do not proceed forward until you have committed these to memory.**

|  |
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| **Deductions & Exclusions** |
| * Deductions are taken before the tax is calculated. * The amount that can be transferred between spouses without a transfer tax is unlimited(provided they are U.S. citizens)**.** * Transfers to charities are not subject to transfer taxes. * An annual gift tax exclusion is available for gifts to any person. The amount is indexed for inflation and spouses can “split” the gift, thereby doubling the amound regardless of which spouse provides the funds. In 2016, the annual gift tax exclusion is $14,000. * Tuition and medical care paid on someone’s behalf is excluded from the gfit tax so long as the payment is made directly to the provider. |
| **Unified Transfer Tax Rates** |
| * The same rate schedule is used for gifts and estates. * Lifetime taxable gifts and final estate assets are aggregated to calculate the tentative estate tax. * The maximum scheduled rate for 2016 is 40%. |
| **Applicable Credit / Exclusion Amount** |
| * Only the Applicable Credit is used in the actual tax calculation. * The Exclusion Amount illustrates the value offset by the Applicable Credit. * The Applicable Exclusion Amount for gifts AND estates = $5,450,000 for 2016. * Currently, the full Applicable Exclusion Amount can be used for lifetime gifts. * The first dollar on which a tax is actually paid to the IRS on taxable transfers in 2016 is at the 40% rate. |
| **Portabilty** |
| * Beginning in 2011, it became possible for a surviving spouse to inherit the Deceased Spousal Unused Exclusion (DSUE) Amount of the ***last*** deceased spouse. * No pre-death planning is needed for this; it merely requires the filing of an estate tax return after death. * DSUE is not adjusted for inflation. |

## Review Exercise

**For the following statements, select the correct response.**

1. **Gift taxes are computed using the same rate schedule as for estates:**

* **True**

**Correct**. The Estate and Gift tax use the same rate schedule.

* False

**Incorrect**. The Estate and Gift tax actually do use the same rate schedule.

1. **The amount that can be transferred between spouses without incurring a transfer tax is:**

* Limited

**Incorrect**. The amount that can be transferred between spouses without generating a transfer tax liability is unlimited**.**

* 50%

**Incorrect**. The amount that can be transferred between spouses without generating a transfer tax liability is unlimited**.**

* **Unlimited**

**Correct**. There is no limit to the amount spouses can transfer between each other without generating a transfer tax liability.

1. **When computing the gift tax or estate tax, lifetime taxable gifts made after 1976 are added back to the tax return before computing the tentative estate tax:**

* **True**

**Correct**. This makes it possible to have a unified estate and gift tax system.

* False

**Incorrect**. Each tax return calculation is inclusive of lifetime transfers since 1976.

1. **Transfers to charities ARE NOT excluded from estate or gift taxation:**

* True

**Incorrect**. They are, in fact, excluded from estate and gift taxes.

* **False**

**Correct**. They are, in fact, excluded from estate and gift taxes.

1. **The gift and estate Applicable Exclusion Amount for 2016 is:**

* **$10,000**

**Incorrect.** Try again.

* **$12,000**

**Incorrect.** Try again.

* **$14,000**

**Correct.**

* **$28,000**

**Incorrect.** This is the amount for a couple who are splitting their gifts. Try again.

1. **The maximum marginal rate on the current Unified Gift and Estate Tax Rate Table is:**

* **18%**

**Incorrect.** This is the minimum rate on the schedule. Try again.

* **40%**

**Correct**.

* **50%**

**Incorrect.** Try again.

* **70%**

**Incorrect**. This was true in 1977, but not today. Try again.

1. **With portability, a surviving spouse’s Applicable Exclusion Amount equals their Basic Exclusion Amount plus the:**

* **DSUE**

**Correct.** They get to add the Deceased Spousal Unused Exclusion Amount.

* DSSU

**Incorrect.** Try again.

* DESU

**Incorrect.** Try again.

* DUSE

**Incorrect.** Try again.

## Strategies for Minimizing Transfer Taxes

Now that you have an understanding of the fundamentals of estate and gift taxes, we can begin to illustrate some of the techniques available for minimizing the impact of these taxes.

### Important Compliance Issues

The following pages of this course contain case illustrations designed to help you understand the issues involved in the estate planning process. The content also identifies some practical ways you can engage your clients in effective conversations that help the client understand their need to develop or update their estate plan. While these case study examples are designed to help you develop a deeper understanding of the topic and more confidence, you must remember that **your work must not replace the advice of the client’s legal and tax advisors**. Your role is to help your clients ***realize*** the need for proper planning and identify ***potential*** solutions; not to offer legal or tax advice.

## Planning to Minimize Estate Taxes has Gotten Much Simpler

Legislation in recent years has made the estate planning process much simpler for most people. This is due to two key changes: **Click each change to learn more.**

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| **Growth of the Applicable Credit/Exclusion Amount** |
| In 2000, each individual received a credit against the gift and estate tax that protected the first $675,000 from the transfer tax. At the time, that was the largest credit in history, and it had taken 15 years for it to go from protecting $400,000 to protecting $675,000.  But since 2000, the Applicable Credit/Exclusion Amount has risen rapidly to protect the first $5,450,000 from taxation. This has virtually eliminated the federal transfer tax from being a planning issue for the vast majority of Americans. |
| **The Introduction of Portability** |
| In 2016, a married couple’s combined Applical Exclusion Amounts can protect $10,900,000 of assets from transfer taxation. Even if everything is left to the surviving spouse, the executor merely files an estate tax return “porting” over the Deceased Spousal Unused Exclusion Amount; no further planning is required. This combined amount is more than sufficient to protect the vast majority of married couples from having to worry about paying a federal estate tax.  Prior to 2011, it was not possible for a deceased spouse to pass on his or her Unused Exclusion Amount to a surviving spouse. This meant that any Unused Exclusion Amount in the first estate would be forever lost as an opportunity for protecting assets from the transfer tax. This resulted in the need for significant planning to optimize the use of both spouses’ Applicable Exclusion Amounts whenever their combined estates exceeded a single Applicable Exclusion Amount, as illustrated in the following example:   |  | | --- | | Example:  In 2009, Joe and Martha Average, a married couple who were both U.S. citizens, had a combined estate of $3.7 million. They had very simple wills whereby they left everything to the survivior.\*  The Applicable Exclusion Amount in 2009 was $3.5 million. Together, they had a combined Applicable Exclusion Amount of $7 million – more than enough to protect their combined estate. However, this is what would have happened if both spouses died in 2009 when portability was not available:  Unlimited Marital Deduction Flowchart  Because the assets passed by way of the unlimited marital deduction, the first spouse’s Applicable Exclusion amount goes unused and the surviving spouse’s estate is left with all the assets and only a single Applicable Exclusion Amount to protect them from taxation. The result is that $200,000 of assets go unprotected, resulting in a tax bill of $90,000.  Clearly, in the days before portability, which allows the surviving spouse to inherit the Deceased Spousal Unused Exclusion (DSUE) amount, this simple plan could be quite costly.  *\* The characters and scenarios in this case study are fictitious and purely for purposes of illustration.* | |

## Preserving the Applicable Exclusion Amount in the First Estate Prior to Portability

On the previous page, we provided the example of Joe and Martha Average, who needed additional planning to optimally utilize both spouses’ Applicable Exclusion Amounts in the days before the advent of portability. On this page and the next few that follow, we introduce you to planning techniques that were developed in the pre-portability years to accomplish this.

It is important that you become familiar with these planning techniques since they continue to have application in today’s environment, as we shall later explain. It is also important that you be familiar with these concepts because many clients you will encounter established their estate plans pror to 2011 (and some since) when portability went into effect, and these plans will likely reflect these techniques.

### The Credit Shelter Trust

Continuing with the the example of Joe and Martha Average from the previous page, they had a combined estate of $3.7 million in 2009 and each spouse had an Applicable Exclusion Amount of $3.5 million. How could they make use of both Exclusion Amounts to fully protect their combined estates?

This was typically accomplished by NOT leaving everything to the surviving spouse! One option was to leave the assets that are covered by the Applicable Credit/Exclusion Amount to other heirs, but then the assets would not be available to provide for the needs of the suriving spouse. Instead, most people preffered to utilize a Credit Shelter Trust.

The ***Credit Shelter Trust*** (sometimes referred to as the “Applicable Exclusion Trust,” "By-Pass Trust," or "Family Trust”) became very popular as a means of utilizing the Applicable Credit/Exclusion Amount when the first spouse died. Here is how it works:

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| * When the first spouse dies, the Applicable Credit Amount is generally applied against as much of the deceased spouse’s estate as possible. * These "sheltered" assets are transferred into a "Credit Shelter Trust." Since the surviving spouse cannot control these assets, his will keeps them out of the surviving spouse’s estate and protects them from being taxed when the second spouse dies. * Any remaining assets, which are not covered by the deceased spouse’s Applicable Credit Amount, are transferred to the surviving spouse (or, as we shall explore on the following page, into a trust for the surviving spouse that will be included in the surviving spoue’s estate). These remaining assets will be protected from taxation upon transfer due to the unlimited marital deduction. * The surviving spouse generally receives income from the Credit Shelter Trust and, if the document allows, can receive principal at the trustee's discretion. * The Credit Shelter Trust can also be used for the children. For this reason, it is often referred to as a "family trust." In fact, after the death of the surviving spouse, the trust can continue for the benefit of the children. * The end result is that both Applicable Credit Amounts are utilized and the surviving spouse does not have to forego benefit of all the assets. * **Important Note** – For this strategy to work, both spouses need to have assets in their individual names. This is because it is impossible to know which spouse will die first. For example, if the first spouse dies not owning assets, then there is nothing with which to fund the trust. For this reason, most couples adopting this strategy will split assets to the degree necessary for the strategy to be optimized for either death. |

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| **Credit Shelter Trust Example**  If Joe and Martha Andrews had divided their assets equally (since they couldn’t predict which of them would die first)and utilized the credit shelter trust technique in their estate planning documents, the end result would have been no estate taxes, at a savings of $90,000 (if they both died in 2009). This is because half of the assets would have been “sheltered” from taxation upon the first death and excluded from the estate of the surviving spouse, as illustrated in the diagram to the right.  Credit Shelter Trust Flowchart  For many years, this was one of the most powerful estate planning techniques available for couples, and its features became second nature to planners. |

## Planning for Larger Estates of Married Couples Before the Advent of Portability

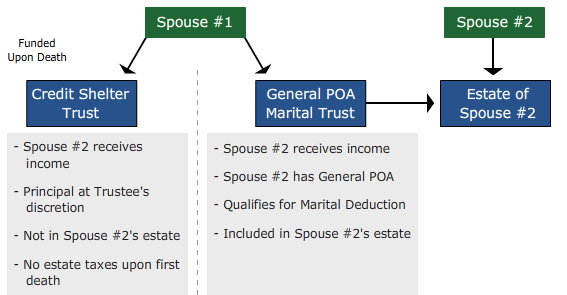
Let’s now examine a pre-portability example of a larger estate to learn some additional techniques that were widely utilized in conjunction with the Credit Shelter Trust prior to the advent of portability, but which have continued utility for today.

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| **Example of** Mr. and Mrs. Dollar (2009)  In 2009, John and Susan Dollar, both U.S. citizens, were both in their 70's. John was in poor health and was concerned that he might predecease Susan, who has never handled any of the financial affairs, and he feared she would be overwhelmed by having to handle things herself. They had four grown children, all of whom were married with children of their own. Their youngest son had recently been diagnosed with Amyotrophic Lateral Sclerosis (Lou Gehrig's Disease), and John and Susan Dollar were providing financial assistance to him and his family.  John and Susan's combined estate was currently valued at $9.5 million. Each had an Applicable Exclusion Amount in 2009 of $3.5 million. How might they plan to minimize their estate tax exposure?\* The following is how this was typically done:  **1. Split Assets**  Since they could not predict which would die first, they would typically divide up assets, making sure that each spouse could use as much of their Applicable Exclusion Amount as possible upon the first death. In our example, let’s assume that John and Susan divide assets equally, with each spouse owning $4.75 million each.  **2. Create a Credit Shelter Trust Upon the First Death**  Assuming the first spouse died in 2009 when the Applicable Exclusion Amount was $3.5 million,, then $3.5 million would go into the Credit Shelter Trust upon the first death.  **3. Transfer Remaining Assets to the Surviving Spouse**  After funding the Credit Shelter Trust, the first estate has a taxable balance of $1.25 million. Rather than pay taxes in the first estate, the taxes could be deferred by passing them on to the surviving spouse through use of the unlimited marital deduction. This would provide the surviving spouse time to do additional tax planning to reduce the size of the taxable estate, which we shall discuss, prior to the assets being taxed upon the second spouse’s death.  While transferring the remaining assets to the surviving spouse would defer taxation, many clients preferred not to transfer assets outright in the hands of a surviving spouse. This could be because the surviving spouse was not familiar with handling assets and the client did not want to burden the surviving spouse. Alternatively, this might be a second marriage and, while the client wished to adequately support the surviving spouse, there was also the desire to assure that the assets went to the deceased’s own children from a prior marriage. So, how does one defer taxation of assets that exceed what can placed in the Credit Shelter Trust by utilizing the unlimited marital deduction, yet not make an outright transfer to the surviving spouse?  **3. (Alternative) – Transfer Assets to a Marital Trust**  The answer that was commonly deployed was to utilize a ***Marital Trust***. This was typically referred to as A-B Trust planning, whereby a Credit Shelter Trust was set up for the Family (the A Trust) and a Marital Trust (the B Trust) would be set up for the benefit of the surviving spouse.  The terms of the marital trust would be such that the assets would be included in the surviving spouse’s estate, thereby qualifying the trust for the unlimited marital deduction. In this manner, taxation of the marital trust would be deferred until the second death, just as occurred with an outright transfer to the surviving spouse.  Two types of marital trusts were commonly used: the **General Power of Appointment (POA) Marital Trust** and the **Qualified Terminal Interest Property (QTIP) Marital Trust**. Both continue to have utility today for those situations where the preference is NOT to leave assets outright to the surviving spouse. We will discuss each type on the following pages.  *\* The characters and scenarios in this case study are fictitious and purely for purposes of illustration.* |

## 

## The General Power of Appointment (POA) Marital Trust

The oldest type of marital trust is the ***General Power of Appointment (POA) Marital Trust***.



In this arrangement, the surviving spouse receives the income from the trust and also has a “General Power of Appointment”over the assets in the marital trust. What that means is that the surviving spouse can appoint those assets to whomever he/she chooses, even to himself/herself.

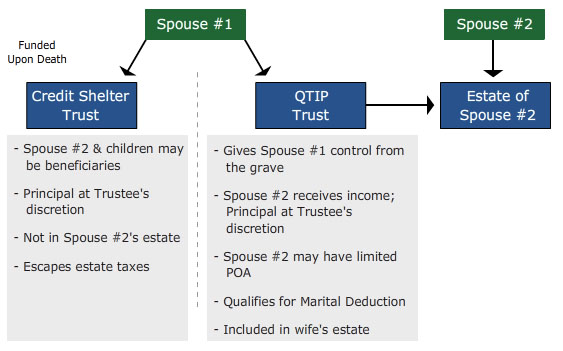
This arrangement would certainly address Mr. Dollar’s concern that his wife be protected from the burden of handling the finances, since the assets can be handled by a competent trustee. The terms of the trust (as well as the terms of the Credit Shelter Trust) could also read that upon the death of the surviving spouse, provided the General Power of Appointment is not exercised, the trust is to continue for benefit of the son who has Lou Gehrig's disease until his death, then terminating and being distributed to the children or their surviving families.

## Introducing the QTIP Marital Trust

One problem with the General Power of Appointment Marital Trust is that it may leave too much power with the surviving spouse.  For example, Mr. Dollar’s desire for the ongoing support of the ill son could be defeated if Mr. Dollar dies first and the surviving spouse exercises her power of appointment otherwise.  While this may seem unlikely, it is conceivable that another family member might influence her to do exactly that.  The fact is that there are many situations where a surviving spouse might alter the intent of a deceased spouse.  For example, a surviving spouse might remarry, and there might be children involved from both marriages.  The ultimate result might be that children unrelated to the deceased spouse would ultimately receive some or all of the assets left by the deceased spouse.  For reasons such as this, the **QTIP (Qualified Terminable Interest Property) marital trust** became increasingly popular.

A **terminable interest** in property is one that will terminate upon death.  For example, if a person receives income from a trust during life, but at death the assets are distributed to other beneficiaries according to the terms of the trust, then that person has an interest that terminates upon his death.  Such "terminable interests" are not ordinarily included in a person's estate.  But as long as certain technicalities are met, a marital trust can be constructed with a terminable interest, yet be included in the surviving spouse's estate and thereby qualify for the marital deduction.

In other words, it is possible for John Dollar to plan for a marital trust that will direct the ultimate disposition of the assets to his children, prevent the surviving spouse from changing the distribution, and still qualify the trust for the marital deduction. That is truly control from the grave and accounts for the fact that such trusts continue to be popular today! That is why this continues to be a very popular planning technique today, especially in cases of second marriages.



Among the technicalities is the requirement that the surviving spouse **must** receive income from the trust.  But unless the donor desires to give the surviving spouse a **limited power of appointment** (for example, limiting the ultimate distribution to the children, but allowing the surviving spouse to decide how it is to be prorated among them), **it is the donor who will decide how the assets ultimately transfer, not the surviving spouse**.

## When NOT to Rely on Portability

Certainly, things have become simpler since 2011 when portability of the DSUE was introduced. This in no way negates the use of the Credit Shelter Trust or Marital Trust in today’s environment. In fact, there are situations when they are still preferred to relying solely on portability of the DSUE. The following is a list of some common situations where one should not overly rely upon portability. **Click each situation to learn more.**

|  |
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| **Second Marriages Involving Children of a Prior Marriage** |
| When this is the case, it will typically be desirable to create a Credit Shelter Trust or an A-B Trust arrangement where a Credit Shelter Trust is coupled with a QTIP Marital Trust. In this manner, all the assets can be available to support the surviving spouse, but each spouse will be able to ultimately preserve their own assets for children of a prior marriage. |
| **States with an Estate Tax and No Portability** |
| Many states have an estate or inheritance tax. They generally provide a credit against the tax, similar to the Federal Applicable Credit Amount, but the size of the credit is typically much smaller (e.g., protecting $1 million) and states have been slow to adopt the concept of portability of the credit between spouses.  For situations where there is a state tax but no portability of the state tax credit, a Credit Shelter Trust should be considered. This trust would be funded up to the limit that can be protected by the state credit. Part of the Federal Applicable Credit/Exclusion Amount would also be applied to the Credit Shelter Trust, thereby protecting the Trust from both state and federal taxes. The balance of the DSUE can then be “ported” over to the surviving spouse or placed in a marital trust for the surviving spouse’s benefit. |
| **Accomplishing Personal Goals** |
| There may be times when it is desirable to fund trusts at death to support personal goals, such as the care of a handicapped child or the establishment of a trust for grandchildren. In such situations, it may be preferred to use the Applicable Credit/Exclusion Amount (either in total or in part) to protect these trusts from transfer taxation, allowing the balance to be deferred through the unlimited marital deduction. |
| **A Non-Citizen Spouse** |
| While it is beyond the scope of this course, portability is not available when the surviving spouse is not a U.S. citizen. In this situation, special planning is needed. |

## Why Should Older Estate Plans be Reviewed to Consider Utilizing Portability?

On the previous page, we discussed the fact that there is still a role to be played by Credit Shelter Trusts and Marital Trusts. That is not to say, however, that all pre-2011 plans that made use of these techniques are still optimal now that we have the option of utilizing portability of the DSUE. These older plans should be reviewed for a number of reasons to make sure they are still optimally meeting client goals. **Click each reason to learn more.**

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| **Freedom in Planning** |
| In past years, planning to minimize taxes often led to estate plans that were a compromise between what the client might prefer and what a client felt he/she needed to do to save on taxes. With the elevated Applicable Exclusion Amount, clients should re-examine their estate plans to see if they might want to do things differently in a world where estate taxes are not as much of a concern.  For example, a client who previously established an Irrevocable Life Insurance Trust to provide liquidity for estate taxes may no longer have a taxable estate. In that case, the Life Insurance Trust should be reviewed to see what options are available under the terms of the trust. |
| **Potentially Adverse Effect of Credit Shelter Trusts** |
| Many clients have pre-existing estate plans that will fund a Credit Shelter Trust upon death. Many of these were set up primarily for tax reasons and should be reviewed to make sure the plan continues to meet the goals of the client AND to make sure there are no unanticipated or adverse consequences of leaving them in place.  One potential problem is the funding formulas that were commonly used to fund the Credit Shelter Trust. These formulas typically instructed the executor to fund the Credit Shelter Trust with the maximum amount that could be protected by the Federal Estate Tax Credit. If, for example, the estate plan had been put together in 1997, Credit Shelter Trust funding for deaths in that year would have been $600,000. In 2016, it could be as much as $5,450,000. A client adopting an estate plan in 1997 would never have anticipated that the Credit Shelter Trust could be funded with so large an amount. This could result in an unanticipated and undesirable shift in allocation of funds going to various beneficiaries.  For example, the client may have felt comfortable at the time with a portion of the estate going into the Credit Shelter Trust to minimize taxes, knowing that the largest share would go to the surviving spouse. However, in 2016, if the estate is under $5,450,000, the entire estate will go to the Credit Shelter Trust and none to the surviving spouse. This may no longer represent the client’s preferences.  Another potential problem with leaving a Credit Shelter Trust in place in an older estate plan is that the assets of a Credit Shelter Trust will not get a step-up in tax basis upon the second spouse’s death. With portability of the Applicable Exclusion Amount, some clients may prefer to not utilize a Credit Shelter Trust and instead have everything included in the surviving spouse’s estate to receive the step-up in tax basis on the combined estate upon the second death.  For reasons such as these, clients would do well to review their existing estate plans with an estate planning attorney to see if changes need to be made in light of the new rules. |
| **Enhanced Gifting Opportunities** |
| For clients who have taxable estates, lifetime gifting continues to be an excellent means for reducing the size of the taxable estate and for keeping future appreciation out of the estate.  Given that the Generation-Skipping Transfer (GST) Tax Exemption has also risen to $5,450,000 in 2016, it may be especially attractive to set up trusts for grandchildren. In this regard, it is important to note that there is no portability of the Generation-Skipping Transfer Tax Exemption. If the desire is to use both spouse’s exemption for this purpose, it will be important to make plans for utilization of the exemption in each spouse’s estate, since the surviving spouse cannot inherit the GST exemption from the deceased spouse. |
| **Disparity Between Federal and State Taxes** |
| While we now have a federal estate tax exclusion of $5,450,000 in 2016, many states have a much smaller exclusion amount, e.g., $1,000,000. Thus, state transfer taxes have received renewed attention and clients may need to pursue planning strategies with their estate planning attorneys to minimize those taxes. These plans might still make use of the Credit Shelter Trust, which might have to be balanced against the potential cost of not receiving a step-up in basis on the trust assets upon the second spouse’s death. |
| **Asset Protection Trusts** |
| While testamentary trusts may no longer be needed for minimization of estate taxes, they might nonetheless continue to be useful vehicles for asset protection, e.g., to protect the assets from the creditors of a surviving spouse. This might be a good reason, for example, for leaving a previous estate plan that funds a Credit Shelter Trust in place. |

Given the amount of change that has taken place in recent years, clients should be encouraged to review their estate plans with their estate planning attorney. The good news in all of this is that they will have more freedom to make plans that best suit their personal goals than they have ever had before.

## What to Do if You Have a Taxable Estate

As you have seen, the sizeable Applicable Exclusion Amount, coupled with deductions and exclusions, means that most affluent clients do not have to worry today about paying a federal estate tax. But it has only been in recent years that the Applicable Exclusion Amount has gotten so large, so many clients will have state plans that were structured at a time when they had estate tax exposure; and many still have exposure when considering state taxes. So, what do clients do when after all we have discussed to this point still leaves them with an estate that, if they died today, would owe an estate tax?

The answer is, they could consider taking steps to reduce the size of their taxable estates while still alive. There are numerous techniques for doing this, but most are beyond the scope of this course; but there are two techniques with which you should be aware. **Click each technique to learn more.**

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| [**Lifetime Gifting**](javascript:void(0)) |
| The first technique is to make lifetime gfits. This can be either in the form of annual exclusion gifts, or direct payments of tuition or medical care on behalf of others. |
| [**Irrevocable Life Insurance Trust**](javascript:void(0)) |
| The second technique applies to to clients with taxable estates who either own life insurance or plan to own life insurance. For them, it would be preferable to not own policies on their own lives. This is because ***the death benefit of*** ***any life insurance policy they own on their own life will be included in their estate.*** For example, if a client who owns a $500,000 term life insurance policy, which has no current cash falue, the full $500,000 would be included in the client’s estate if the client died today. This would be true even though the policy typically names a beneficiary other than the estate who will receive the money, while the estate is left with any tax liability.  Obviously, one way around this is to have someone else own the policy. However, that produces its own set of problems, such as giving them control over the policy and potentially subjecting them to tax implications in their own estates if the policy has cash value.  The more popular option has been to create an Irrevocable Trust, which will be treated as a separate tax entity, and have the policy be owned by the trust. This is known as an ***Irrevocable Life Insurance Trust***, and we shall explore this in more detail on the next page. |

## The Irrevocable Life Insurance Trust

An ***Irrevocable Life Insurance Trust*** is an irrevocable trust with language that makes it possible for the trustee to buy and hold life insurance. The trust is named the owner and beneficiary of life insurance for purposes of keeping life insurance outside of the grantor's estate. Alternatively, such trusts are often referred to as ***Wealth Replacement Trusts*** or ***Asset Replacement Trusts*** because they are used to replace some of the wealth or assets that are eroded by estate taxes or charitable transfers.

### How it works

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| **Overview** | The process of establishing, funding, and administering an Irrevocable Life Insurance Trust is as follows: **Click each step to learn more.** |
| **1 – Create the trust and transfer or purchase the policy.** | The grantor creates an Irrevocable Trust, typically naming family members as the trust beneficiaries. Next, the grantor either transfers a life insurance policy(ies) or contributes funds that may be used to purchase life insurance. The trust is named as the owner and beneficiary of the insurance policy. So long as the grantor avoids all incidents of ownership, e.g., is not named as the trustee, has no power to direct the trustee, and has no beneficial interest in the trust, then the insurance policy will not be included in the grantor's estate upon the grantor's death.  **Be aware of the “3-year rule.”** If the policy is transferred by the grantor, the grantor must live three years after the transfer to avoid the three-year rule, which will return the policy back to the grantor's estate if the transfer is made within three years of death. Furthermore, there may be gift tax implications with transferring an existing policy. For these reasons, as long as the grantor is currently insurable, it is generally preferable to have the trust purchase a new policy with contributed cash. |
| **2 – Make contributions to pay the premiums.** | Typically, the sole asset of the trust is the insurance policy. Therefore, the grantor needs to make periodic contributions to the trust, thereby providing the trust with the funds to pay the premiums.  This presents a potential problem because the beneficiaries of the trust receive no benefits until the grantor dies; in other words, they have a “future interest.” Only gifts of a “present interest,” meaning they must have the right to presently use and enjoy the funds, will qualify for the annual gift tax exclusion.  Unless we can find a way to give the beneficiaries a “present interest” in the contributed funds, the contributions will be taxable gifts, requiring the grantor to file a gift tax return and use up part of the Applicable Credit Amount. In the next step, we show how we give them a “present” interest, thereby making the contributions annual exclusion gifts and therefore nontaxable. |
| **3 – Send Crummey letters to the trust beneficiaries after each contribution.** | To qualify the contributions for the annual gift tax exclusion, a **"Crummey Power"** is provided to the beneficiaries in the trust document, which gives them a “present interest” for a limited time (typically 30 days) following each contribution, during which the beneficiaries may remove the funds for their own use. Note - the term “Crummey” comes from the last name of the person whom the IRS took to court seeking to outlaw this procedure; the IRS lost the case and the court ruling set the precedent for utilizing this technique.  Therefore, upon receipt of the contributed funds, the trustee writes "***Crummey Letters***" to the beneficiaries, notifying them of the contribution and their temporary right to remove their portion of the contribution. Provided they do not remove the funds, their current interest lapses at the end of the time period, and the trustee can use the funds to pay the premiums.  **Note:** To qualify the entire contribution as one or more annual exclusion gifts, you need to have sufficient beneficiaries named in the trust to fully cover the amount of the contribution. In other words, the number of beneficiaries multiplied by the amount of the current annual gift tax exclusion amount must total greater than the amount being contributed. |
| **4 – Trust receives death benefits when grantor dies.** | Upon the death of the grantor, the trust receives the insurance proceeds and the trustee will administer or distribute the funds as directed by the terms of the trust. |

## Review Exercise

Before proceeding, check your familiarity with some of the most frequently used planning techniques, some of which have been utilized for decades. **For each question, select the appropriate answer.**

1. For Credit Shelter Trusts to be an effective strategy in estate planning for couples, it is generally important that:

* Assets should be held in joint name with right of survivorship.

Incorrect. Try again.

* Each spouse needs to own assets in their own name (typically equalized up to the amount that can be protected by each spouse’s Applicable Credit Amount)

Correct! The trust cannot be funded if the decedant does not own assets in their own name.

* All assets be left to the surviving spouse when the first spouse dies.

Incorrect. A Credit Shelter Trust will be established upon the first death with assets that do not pass to the surviving spouse. Try again.

1. A Credit Shelter Trust can provide benefits for:

* The spouse only

Incorrect. Try again.

* The children only

Incorrect. Try again.

* The entire family (spouse and children)

Correct! The Credit Shelter Trust is unrestricted regarding the beneficiaries who can be named in it

1. A General Power of Appointment Trust will be included in the surviving spouse’s estate, thereby qualifying for the unlimited marital deduction, because:

* The trust document declares that assets are to be included.

Incorrect. Try again.

* The surviving spouse can appoint (i.e., distribute) the assets to whomever desired, even to himself/herself

Correct! This is essentially unrestrained control over the assets by the beneficiary. Such control causes the assets to be included in the beneficary’s estate.

* Because the trust assets are titled in the name of the surviving spouse.

Incorrect. Trust assets are never titled in the beneficiary’s name. Try again.

* Because the surving spouse receives benefits from the trust.

Incorrect. Receipt of benefits from a trust is insufficient reason for the trust assets to be included in the beneficiary’s estate. Try again.

1. The primary distinguishing characteristic of the QTIP Marital Trust vs. a non-QTIP Marital Trust is:

* It gives the first spouse to die the ability to name ultimate beneficiaries, while utilizing the marital deduction.

Correct! The distinguishing feature is that the trust can defer taxes by use of the marital deduction even though the deceased spouse retains "power from the grave" to direct the ultimate distribution of the assets.

* It provides additional estate tax savings.

Incorrect. It provides no more tax savings than a General Power of Appointment Marital Trust; both allow for deferral of estate taxes. Try again

* It provides income for the surviving spouse.

Incorrect. While it does provide income for the surviving spouse, so does a General Power of Appointment Marital Trust. Try again.

* It provides income for the children.

Incorrect. A QTIP Marital trust cannot provide income for the children. Try again.

* It provides discretionary principal distributions for the entire family.

Incorrect. Only the surviving spouse can receive principal distributions from a QTIP Marital Trust. Try again.

1. QTIP stands for:

* Qualified Transitional Interest Property

Incorrect. Try again.

* Qualified Terminal Interest Property

Correct!

* Qualified Trust Income Property

Incorrect. Try again.

* Qualified Taxable Income Property

Incorrect. Try again.

1. The simplest way to keep life insurance out of your estate is to:

* Not own it

Correct!

* Not be named as a beneficiary

Incorrect.

* Not be able to name a beneficiary

Incorrect.

* Not be able to borrow against the policy

Incorrect.

1. The three-year rule states that insurance must be transferred within three years of purchase if it is to be excluded from the owner's estate.

* True

Incorrect. The three-year rule has nothing to do with when a policy was purchased. Rather, it is relative to when the policy was transferred to another owner.

* False

Correct! The three-year rule has nothing to do with when a policy was purchased. Rather, it is relative to when the policy was transferred to another owner.

## 

## Need #6 – Maximizing Charitable Intent

A sizeable portion of charitable gifts are made at death rather than during life because many people, while desiring to support charities, fear that making gifts to a charity during their lifetime may result in them outliving their assets. However, in many situations, that fear is unfounded. In fact, making lifetime gifts, as mentioned in the last case study, can be a far superior means of realizing their charitable intent, while increasing their lifetime income. This is illustrated in the following situation.

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| |  |  | | --- | --- | | **Situation*:*** Suppose an elderly client has $4.5 million, of which $1 million is in an asset with a basis of $30,000. The client receives a dividend yield on the asset of approximately 1.5%, or $15,000 per year. The client would like more income, but doesn’t want to pay the capital gains tax for selling the asset. The client plans to give $1 million to a university upon his death.  DocumentationIcon_32px**Click the icon to view the solution.**   |  | | --- | | **Solution**  A solution is to create a ***Charitable Remainder Trust*** and fund it with the $1 million appreciated asset. A Charitable Remainder Trust is a trust where the grantor receives an income benefit during life, with the asset going to the charity upon death. Here is a possible result for taking this step:   * The client receives an immediate income tax deduction for the charitable gift. This deduction can be spread over 5 years of income tax returns. * The trust is structured to provide an annuity to the grantor for life, or for a specific number of years (up to 20). In this case, let’s suppose it is a 6% annuity, or $60,000 per year, significantly increasing his income. * The charity will be free to liquidate the asset to reinvest in income-producing securities, without suffering the impact of capital gains taxes. The asset can then be reinvested to generate higher income, thereby minimizing or totally eliminating (depending upon market conditions) the need to use principal to make the annuity payments. * No capital gains are paid when making the gift. * Upon his death (or at the end of the designated number of years), the trust terminates and the university receives the principal outright.   Through use of a Charitable Remainder Trust, or a ***Pooled Income Fund*** which operates similarly but is designed for smaller accounts, people can not only reduce their estate tax exposure, if any, but often improve their current income situation by making the charitable transfer while alive rather than waiting until they are dead. | | |

**Awareness Questions**

To help a client/prospect understand the immediate benefits of a charitable gifting strategy, ask them the following questions.

DocumentationIcon_32px**Click the icon to view example questions.**

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| **Example Questions**   * How have you assessed the benefits of gifting to charities while alive rather than waiting until your death? * How have you structured your estate plan to maximize the impact of your charitable intent? |

## 

## Review Exercise

**Select the correct answer for each of the following questions.**

1. **For insurance to be removed from your estate, how long must you live after transferring ownership to a trust?**

* One year

**Incorrect**. Try again.

* Two years

**Incorrect.** Try again.

* Three years

**Correct.**

* Five years

**Incorrect.** Try again.

1. **Which of the following transfers can be made without gift tax liability?**

**A. Annual exclusion Gifts**

**B. Direct payment of tuition or medical expenses**

**C. Gifts to a spouse**

**D. Gifts to charities**

* A only

**Incorrect**. Try again.

* A and D only

**Incorrect.** Try again.

* A, B, and C only

**Incorrect.** Try again.

* A, C, and D only

**Incorrect.** Try again.

* **A, B, C, and D**

**Correct.**

1. **There is no capital gains impact to the grantor upon funding a Charitable Remainder Trust.**

* **True**

**Correct.**

* False

**Incorrect.**

## Conclusion

This concludes the material for this subject. At this time you may return to any sections for which you feel the need for further study. At the start of this course, we introduced you to six common estate planning needs. The following is a summary of the primary solutions that were offered for each need.

**Click each need to review the solution.**

|  |
| --- |
| **The Need for a Plan** |
| * Development of a planning strategy * Execution of appropriate documents, such as wills and trusts |
| **Providing Protection** |
| * Living trust to protect against incapacity * Trust to protect adult beneficiaries (e.g., financially unsophisticated, easily influenced, spendthrifts, etc.) * Trust for minors (to prevent them from inheriting at too young an age) * Special needs trust for persons whose private or government assistance might be jeopardized by an outright inheritance * Trust with a "pour-over-will" to provide privacy regarding dispositions |
| **Maintaining Control** |
| * A will to direct disposition of probate assets and avoid intestacy * A will in conjunction with a trust to provide "control from the grave" |
| **Deciding Who Will Act as Executor/ Trustee** |
| * A corporate executor/trustee to provide professional expertise and avoid the possibility of family conflict that can be caused by decisions of a family member acting in such a role |
| **Minimizing the Impact of Estate and Gift Taxes** |
| * Federal gift and estate taxes are no longer a consideration for most affluent clients today because of the size of the Applicable Exclusion Amount and the advent of portability, which makes it possible for married couples to use both spouses’ Applicable Exclusion Amounts without having to develop estate plans that include trusts. * For most affluent clients living in states with an estate or inheritance tax, the focus of planning to minimize estate taxes has shifted from federal transfer taxes to state transfer taxes. * While Credit Shelter trusts are no longer required to preserve the Federal Applicable Exclusion Amount for both spouses, they still might have many non-tax uses for controlled distribution of assets to family members, anticipated inheritances of surviving spouse, etc. * There is also a continued need for Credit Shelter/Marital Trust (A-B Trust) planning in the case of second marriages, with children of a prior marriage are involved, of when thre is likelihood of remarriage of a surviving spouse. * Irrevocable Life Insurance Trusts continue to be viable means of reducing the size of one’s taxable estate, especialy in states where there is a state estate tax with a credit that is much lower than the federal Applicable Credit Amount. * Pre-existing plans should be re-examined in light of current law, as the techniques utilized (such as funding clauses) may no longer be consistent with the preferences of the client. * The higher exclusion amounts mean that most affluent clients can focus on personal estate planning goals rather than being overly concerned with minimization of estate taxes. |
| **Maximizing Charitable Intent** |
| * Charitable remainder trust to remove assets from the estate, help the charity, and provide current income and tax benefits to the grantor. |