

INSURANCE ACHIEVEMENT QuickSheet™

330: Fundamentals of Estate Planning

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THE ESTATE PLANNING PROCESS, HISTORY, ETHICS, AND PROPERTY RIGHTS

1.1 Estate Planning Overview

The overall purpose of estate planning is to develop a plan that will increase and maintain the financial security of the client and the client's family.

Estate planning includes accumulating, conserving, and transferring (distributing) an estate. Estate planning is concerned with the transfer tax system, which is separate from income tax and is based on English common law.

1.2 Estate Planning Process

Estate planning involves more than tax planning; it is a comprehensive process for distributing personal assets in a planned manner.

Five main steps in the estate planning process are (1) gather data, (2) evaluate the existing plan, (3) prepare the new plan and receive client approval, (4) implement the plan by executing documents and transferring property, and (5) review the plan periodically.

Although various professionals are involved in the estate planning process, the client is the ultimate director of the plan. The plan must reflect the client's goals, needs, and personality.

1.3 Types of Property Interests

The term *estate* refers to an ownership interest in property. Property is either real or personal; personal property, in turn, is either tangible or intangible.

Many laws are similar for both real and personal property, but each has different methods of inheritance and transfer.

In some cases, the legal property owner (who holds legal title) and the equitable property owner (who has the right to beneficial enjoyment of the property) are different parties. An example of this type of ownership division is when property is held

in trust: the trustee holds legal title and the trust beneficiaries hold equitable title.

1.4 Two Factors Affecting Property Ownership

Two factors affecting property ownership are situs (where the property is physically located or kept) and domicile (a person's permanent residence); property may be taxed by the state of location, domicile, or both.

Situs is important because state and local authorities tax and regulate all real and tangible personal property located in their jurisdictions.

Domicile is important because there is great variation in state death tax laws, and a person's estate is usually distributed, probated, and taxed under the laws where they are domiciled.

1.5 Community Property

Nine states have community property laws (two of these call it marital property), but there is no uniform community property system.

Community property presumes that property owned by a husband and wife belongs to both equally, unless property is proven to belong to one separately.

1.6 Co-Ownership of Property

The most common forms of co-ownership of real property are tenancy in common; joint tenancy with right of survivorship; and tenancy by the entirety, which applies only to husband and wife.

Main advantages of joint tenancy with right of survivorship and tenancy by the entirety: avoids probate delay and possibly state death taxes; limits access by creditors of one tenant by the entirety; reduces transfer costs; promotes convenience, privacy, and feeling of security.

Main disadvantages of joint tenancy with right of survivorship and tenancy by the entirety: permits access by creditors of one joint tenant with right of survivorship, more potential estate and gift tax, and full control by survivor (will or trust has no impact on joint property).

1.7 Ethics for the Estate Planner

Common areas where ethical issues arise relate to compensation, confidentiality, and conflicts of interest.

An ethical temptation exists where there is a conflict between the planner's and the client's interests. An ethical dilemma does not involve a conflict between the two parties' interests but exists when there are good reasons on both sides either for or against a certain action.

One way to resolve an ethical dilemma is to ask whether the proposed action is fair and honest and whether it meets the agent's responsibilities or would harm any stakeholders.

How to Use This QuickSheet

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- Reference in daily work

LIFETIME GIFTS/FIDUCIARY POWERS AND DUTIES/TRUSTS

2.1 Gift Giving Basics

A living gift can be a means of reducing estate shrinkage and estate transfer costs, but the transaction must be absolute, bona fide, and complete.

The five essential criteria of a gift, along with the federal annual exclusion amount (\$12,000 in 2008), are used to determine whether a gift is taxable. If the five criteria are met and the value exceeds the annual exclusion amount, the gift is taxable.

Although the gift tax and estate tax laws on valuation are similar, one big difference is that for gift tax purposes, property transferred during the donor's lifetime is valued when the gift is made. No alternate valuation date is allowed.

2.2 Nongift Gratuitous Transfers

Some common transactions are not considered gifts for tax purposes, including (1) property or an interest in property that has not been transferred, (2) sham gifts, and (3) some transfers in the ordinary course of business.

Qualified disclaimers of gifted property are exempt from gift tax provided the refusal of the gift is in writing and the transferor receives it within a specified time, the person disclaiming must not have accepted the interest or any benefits of the property, and someone besides the disclaimant must receive the property.

2.3 Two Types of Gifts: Direct and Indirect

The form of a living gift may be important for both the donor and the donee, but both direct and indirect gifts are subject to gift tax. Before making any substantial lifetime gifts, the donor should examine the potential tax consequences at her own death as well as the donee's.

2.4 Nontax Benefits of Lifetime Gifts

Lifetime gifting has many nontax advantages; the main ones are privacy, reduced probate costs, protection from creditors, and vicarious enjoyment of seeing the donee enjoy the gift.

2.5 Fiduciaries

A fiduciary holds or manages property for another party's benefit and is held to strict standards.

Trustees, guardians, and estate executors are all types of fiduciary relationships.

2.6 How to Choose a Fiduciary

Selecting a fiduciary must be done with great care and attention.

A trustee must exercise the same care and skill that a prudent person would exercise when dealing with his own property. Professional trustees are held to higher standards than lay persons because the professional trustee is considered an expert.

2.7 Guardians and Executors

Unlike a trustee, a guardian or executor does not take legal title to property.

Trusts offer more flexibility than guardianships in providing for a financially inexperienced or spendthrift person because guardianships end when an individual reaches the age of majority (18 or 21).

2.8 Appointing Property

A testamentary power of appointment may be either general or special and is exercisable only at the donee's death through the donee's will.

Exercising the power of appointment is the act of designating the property; a lapse of the power of appointment is the failure to exercise the power.

2.9 Trusts

The trust is one of the most important legal devices by which a person can dispose of property, either during lifetime (with an inter vivos trust) or after death (with a testamentary trust). People use trusts for tax savings, professional asset management, post-death asset control, and privacy.

The main advantage of a trust is that it can operate over time. Unlike a will, a trust can operate for years, and property transfers can be sequenced according to anticipated needs of recipients.

Living (inter vivos) trusts can be either revocable or irrevocable. Revocable trusts are used when the grantor wants or needs to retain some control over assets; irrevocable trusts are used when the grantor wants tax savings.

TRANSFERS AT DEATH, ADMINISTERING THE ESTATE, AND THE FEDERAL GIFT TAX

3.1 Property Transfers at Death

The three main methods for transferring assets at death are wills, trusts, and life insurance.

3.2 Testate Succession (i.e., Transfer by Will)

A will must be executed in compliance with formal state rules.

A spouse has a right to elect against the will regardless of what the will says.

3.3 Administering the Estate

Seven steps in the estate settlement process:

1. Fulfill initial responsibilities (e.g., funeral arrangements).
2. Probate the will.
3. Appoint administrator or executor.
4. Assemble property.
5. Provide interim management.
6. Pay debts and expenses.
7. Distribute net estate.

3.4 Gift Tax: An Overview

The main purpose of the gift tax is to prevent avoidance of the estate tax through lifetime gifts.

3.5 Gift Selection Factors and Determining the Income Tax Basis of Gifted Property

Gifting assets today that have high growth potential can significantly reduce future estate tax.

The recipient of a gift takes the donor's income tax basis in the property, meaning that if the property is sold, the recipient will be taxed on pregift appreciation.

Capital gains tax rates are significantly lower than estate tax rates.

3.6 Permissible Gift Tax Reductions and Lifetime Gift Tax Advantages

Present-interest gifts of \$12,000 (2008 figure) per donee per year are excluded from the gift tax—double that if spouses join in the gift.

Gifts to spouses or charities are not subject to gift tax (because they are deductible).

Special trusts are used so that gifts to children qualify as present-interest gifts eligible for the annual exclusion.

3.7 Paying and Reporting the Gift Tax

Filing gift tax returns are essential for obvious reasons, but also because the gift tax (and estate tax) are based on cumulative lifetime transfers (and transfers at death).

BUY-SELL AGREEMENTS/ ASSET VALUATION

4.1 Buy-Sell Agreements

The advantages of buy-sell agreements as estate planning tools are that they

(1) provide for the continuation of small business interests by guaranteeing a market, (2) help heirs and surviving co-owners avoid probate difficulties, and (3) make businesses more attractive to creditors.

Life insurance funds most buy-sell agreements and is uniquely suited for this purpose because the same event that creates the need for cash (death of a small business owner) provides the cash.

The elements of a buy-sell agreement that are binding on the IRS are a commitment by a seller to sell and a buyer to buy, a living option of the seller to sell to the buyer before any other third party, and a price that has been negotiated in an arm's-length transaction.

4.2 Asset Valuation for Gross Estate and Gift Tax Purposes

Tax laws are strict concerning proper accounting and documentation of gifts due to past abuses of gifts being used to evade estate taxes.

While the gift tax is a transfer tax, it is measured by the value of the property transferred, which for gift tax purposes is the fair market value of the property on the date the gift is made.

The IRS does not automatically accept the executor's valuation of closely held stock for gift or estate tax purposes. The IRS values the stock according to a variety of factors; the two methods most often used as starting points are adjusted book value and capitalization of adjusted earnings.

4.3 Valuation of Lifetime Transfers with Retained Interests

The IRS expects as high a business valuation as possible, while businessowners try to keep valuations low for estate settlement purposes.

Some asset freeze techniques used to control estate tax liability are preferred stock recapitalizations, family holding companies, family partnerships, and grantor retained income trusts (GRATs and GRUTs).

The tax code specifies a minimum valuation for any junior equity interest transferred by gift or sale to a family member; examples of such junior equity interest are common stock or partnership interests with rights to capital and profits junior to other partnership interests.

THE GROSS ESTATE: INCLUSIONS AND DEDUCTIONS

5.1 What is the Federal Estate Tax (FET)?

The federal estate tax (FET) is not a tax on the actual property; rather, the FET is a tax on the privilege of transferring property and is calculated on the entire estate.

The federal gift tax exclusion is \$1 million until 2010, and the federal estate tax exclusion is \$2 million from 2006 through 2008 until it is repealed in 2010.

5.2 The Gross Estate: An Overview

Under the general inclusion rule of IRC Section 2033, the gross estate includes the value of all beneficial property interests, intangible or tangible, personal or real, of a person at his death to the extent of his interest in the property.

There are 15 property interests specifically included in a decedent's gross estate under Section 2033; however, interests in which the decedent did not have the right to transfer the property at death (life estates given by another) are specifically not included in the gross estate.

5.3 Inclusion of Certain Transfers and Gifts Made and Gift Taxes Paid Within Three Years of Death (IRC section 2035)

As a general rule, gifts made by the decedent within three years before his death are not included in his gross estate.

The five exceptions to the general rule (i.e., items included in the gross estate) are transfers effective at death, transfers in which an interest is retained for life, transfers by the insured of life insurance policies, gift taxes already paid, and transfers in which the decedent reserved a right in the transfer.

5.4 Curtesy and Dower Interests (IRC Section 2034) and Transfers Effective at Death (IRC Section 2037)

The existence of a dower or curtesy right does not lower the amount of the property interest included in the decedent's gross estate.

Under Section 2037, the gross estate includes the value of property transferred by the decedent for less than full and adequate consideration if possession or enjoyment of transferred property can be obtained only by the surviving beneficiary and the decedent kept a reversionary interest worth over 5% of the value of the transferred property immediately before death.

5.5 Transfers with a Retained Life Interest (IRC Section 2036)

Under Section 2036, the gross estate includes all property transferred by gift by the

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decedent during the lifetime in which the decedent reserved or retained (1) the right to possess, use, or enjoy the property or receive its income or (2) the right to designate who should use the property or its income.

The amount included in the gross estate under Section 2036 is the value of the entire property transferred as of the date of death, not just the value of the interest retained or controlled; however, property subject to retained rights that are limited by a definite external standard is not included.

5.6 The Power to Revoke, Amend, Change, or Terminate or to Affect Beneficial Enjoyment (IRC Section 2038)

Under Section 2038, if any of seven powers exists at a decedent's death, the value of the property subject to the power is included in the decedent's gross estate whether the power is exercisable by the decedent alone or with another.

5.7 Annuities (IRC Section 2039)

Under Section 2039, the decedent's gross estate includes the value of an annuity receivable by a beneficiary in proportion to the purchase price paid by the decedent or his employer.

An annuity is excluded from the gross estate if the annuity ends at the decedent's death and payments to a beneficiary are not provided afterward.

Although all amounts paid as insurance on the decedent's life are specifically excluded under Section 2039, the amounts are usually included under Section 2041.

5.8 Power of Appointment and Jointly Held Property

The three occasions when a general power of appointment is subject to gift tax during the general powerholder's life are when a taker by default acquires the general power of appointment because the powerholder surrenders his right to (1) exercise the power (release) or (2) simply does not exercise the power (lapse) or (3) the powerholder exercises the power to benefit another.

The consideration furnished rule applies to all joint tenancies with right of survivorship other than those held between spouses; the test is who paid for the asset, not who owned the asset.

5.9 Life Insurance and the Gross Estate

Twelve types of life insurance proceeds are included in the decedent's gross estate for tax purposes when the estate receives the proceeds, the decedent had incidents of ownership in the policy, or the proceeds are received by another for the benefit of the estate.

5.(10) Items that Can Be Deducted from the Gross Estate

The adjusted gross estate is equal to the gross estate less three types of charges: casualty and theft losses, administration and funeral expenses, and taxes and debts.

The adjusted gross estate minus three deductions (marital deduction, charitable deduction, and state death taxes paid) equals the taxable estate.

THE ESTATE TAX MARITAL DEDUCTION

6.1 Background and Rules of the Marital Deduction

The marital deduction is not a device to avoid taxation but merely defers taxation until the death of the second spouse.

The five requirements that must be met for property to qualify for the marital deduction are (1) the passing of property, (2) receipt of property by a US citizen surviving spouse, (3) the inclusion of property in the decedent's gross estate, (4) the nondivorced status, and (5) the terminable interest rule.

The five exceptions to the terminable interest rule that allow an interest to qualify for the marital deduction are (1) bequests contingent upon the surviving spouse's survival, (2) power of appointment trusts, (3) estate trusts, (4) certain life insurance policies, and (5) QTIP trusts.

6.2 Four Forms of Marital Bequests

The four forms of marital bequests are (1) outright bequests, (2) estate trusts, (3) QTIP trusts, and (4) power of appointment trusts.

A spendthrift spouse may consume assets under an outright bequest; however, the spendthrift spouse is precluded from consuming assets under an estate trust, QTIP trust, and power of appointment trust.

6.3 Underqualification and Overqualification for the Marital Deduction

A possible solution to overqualification for the marital deduction (i.e., more property than necessary to eliminate the estate tax goes to the surviving spouse) is using a properly funded CEBT, in which assets equal the applicable exclusion amount.

The two types of formula bequests that make the most efficient use of the estate owner's applicable credit amount are the pecuniary (dollar) amount bequest and the fractional-share bequest.

6.4 Using the Marital Deduction to Accomplish the Decedent's Objectives

The financial status of the surviving spouse is a key consideration in using the marital deduction to accomplish the decedent's objectives; marital assets should be transferred to the surviving spouse until the size of the survivor's estate equals the exemption equivalent of the federal credit.

6.5 Ethics Case Study: Financial Professional's Duty of Confidentiality

Financial and estate planners have an ethical and legal duty to keep their clients' information confidential

STATE DEATH TAXES AND THE ESTATE TAX CHARITABLE DEDUCTION

7.1 State Death Taxation

The state death tax credit was repealed in 2005 and, for federal estate tax purposes, was replaced with the state death tax deduction equal to the amount of state death taxes paid.

The state death tax deduction does not apply if a decedent's estate is not required to file a federal estate tax return.

Tangible, intangible, and real property are subject to state death taxes.

7.2 The Estate Tax Charitable Deduction

The estate tax charitable deduction applies to the full value of property includable in the donor's gross estate and transferred to a qualified charity.

7.3 Valuation of Charitable Gifts

The value of a future interest given to charity is generally equal to the fair market value of the property today minus the present value of annuities, life estates, or other present interests retained by the grantor or given to noncharitable beneficiaries.

The present value of an annuity, life estate, unitrust interest, remainder, reversion, or term of years is the fair market value.

7.4 Nine Types of Charitable Bequests Qualifying for the Estate Tax Charitable Deduction

A charitable remainder unitrust offers a fixed percentage of the FMV of trust property, resulting in a payout that changes based on the trust property's value. A charitable remainder annuity trust offers a fixed annuity worth at least 5% of the original net FMV of property contributed to the trust, resulting in a reliable, fixed payout.

Charitable lead trusts (CLTs) are the reverse of charitable remainder trusts (CRTs); the charity takes the "lead" and is the income beneficiary in CLTs, while the charity receives the remainder in CRTs.

Federal estate tax liability can be completely avoided by creating a charitable remainder trust with a QTIP trust to the surviving spouse's benefit.

CALCULATING THE FEDERAL ESTATE TAX/ UNDERSTANDING BASIS

8.1 Finding the Tentative Tax Base

The tentative tax base is the sum of the taxable estate and adjusted taxable gifts.

Adjusted taxable gifts are those gifts made during life, after 1976, which are not included in the decedent's gross estate.

The five exclusions from treatment as adjusted taxable gifts are the (1) marital deduction, (2) the charitable deduction, (3) already included gifts in the decedent's gross estate, (4) medical and education expense exclusion amounts, and (5) post-1976 gifts that are completely covered by the annual exclusion.

8.2 Finding the Estate Tax Before Credits

The four steps to calculating the estate tax before credits are (1) adding up all post-1976 taxable gifts, (2) calculating the gift tax,

(3) reducing the gift tax by the applicable credit amount, and (4) subtracting the amount of the gift tax greater than the applicable credit amount from the tentative tax.

The applicable exclusion for federal estate tax and generation-skipping transfer tax (not gift taxes) is \$2 million for 2008, \$3.5 million in 2009; to be repealed in 2010.

8.3 Federal Estate Tax Credits

The four federal estate tax credits are (1) foreign death taxes, (2) the applicable credit amount (\$780,800 in 2008), (3) transfers of property made within 10 years before or two years after the transferee's death (prior transfers), and (4) the existence of gift taxes paid on pre-1977 gifts.

Up until 2005, a state death tax credit was allowed on the federal estate tax return and was used to offset state death taxes paid; however, this credit has now been replaced by the state death tax deduction, which is taken from the adjusted gross estate.

8.4 Personal Representative's Role in Paying Estate Taxes

The federal estate tax must be paid nine months after the decedent's death.

A federal estate tax return (Form 706) must be filed by the personal representative of the estate of every US citizen or resident if the gross estate plus adjusted taxable gifts is worth more than the credit equivalent amount (\$2 million in 2008).

8.5 Determining the Basis of Property

The basis of property transferred at death is stepped up from the original cost of the asset to the fair market value on the date of death or on the alternate valuation date (six months after the date of death) if the estate

qualifies and the personal representative selects that date.

The basis of property transferred at death may also be stepped down if the fair market value at the date of death is less than the decedent's original cost.

The four exceptions to the stepped-up basis rule are (1) community property, (2) appreciated property acquired by gift within one year of death, (3) receipt of property in kind, and (4) decedent's income to which he was entitled but did not receive while alive.

8.6 Extensions of Time for Paying the Federal Estate Tax

A federal estate tax payment (not filing) may be initially extended for up to 12 months from the due date of the estate tax return if the IRS finds reasonable cause; such a finding could further defer payment for up to 10 years.

Stock qualifies for a Section 303 redemption if it satisfies two requirements: (1) the decedent's stock must represent more than 35% of adjusted gross estate, and (2) the person who redeems the shares must be the person who is obligated to pay the expenses or death taxes.

8.7 Planning for the Elimination of the Estate Tax

Income tax on inherited property will most likely be owed by more individuals in 2010 and after (if the repeal is made permanent) to offset the lack of estate tax and GSTT generated for the US government starting in 2010.

Property will receive a modified carryover basis if the estate tax repeal is made permanent; property will get a full step-up basis up to no more than \$1.3 million for nonspouse beneficiaries and \$3 million for spouse beneficiaries.

Test-Taking Tips

- Read the full question (RTFQ).
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- Review **Test-Taking Tips** in your account on our website.

GENERATION-SKIPPING TRANSFER TAX/TRUST AND ESTATE INCOME TAXATION

9.1 The Generation-Skipping Transfer Tax

The generation-skipping transfer tax (GSTT) is designed to ensure that estates are exposed to transfer tax (estate or gift or GSTT) at least once per generation.

GSTT liability, therefore, arises when a transfer passes from a grandparent to a grandchild, skipping the child (or similar transfers that skip a generation); learn the type of events that are considered as transfers that skip a generation.

Generation-skipping transfers (GSTs) are generally exempt from GSTT up to the estate tax exemption amount (\$2 million in 2008), and the gift tax annual exclusion amount (\$12,000 in 2008) applies as well.

9.2 Overview of Trusts and Estates

An estate is a temporary entity created at the death of an individual for the purpose of winding up her affairs.

A trust is a flexible entity created to manage property for long or short term.

9.3 Estates and Trusts: Impact of Federal Income Taxation

Beneficiaries are generally taxed on trust or estate income distributed to them in the year earned.

When income is not distributed, the trust or the estate generally pays the tax at special estate and trust rates.

When the grantor of a trust retains the right to revoke it or other rights of control, the trust is termed a grantor trust and the grantor is subject to tax on all trust income.

9.4 Trust Income Taxation

A simple trust pays out all its income, and a complex trust does not.

Distributable net income (DNI) is the measure of income (and consequent tax liability) transferred from a trust to beneficiaries.

9.5 Estate Income Taxation

The personal representative of an estate is obliged to file (and pay) income tax returns in addition to estate tax.

Two types of income tax returns are required: (1) a return for the decedent's last

tax year and (2) a return for the estate itself.

9.6 Grantor Trusts and Taxation

A grantor is subject to tax on the income of any trust she sets up if the trust is revocable or if she retains rights to control the trust—that is, if strings are attached.

9.7 Multiple Trusts and the Kiddie Tax

A technique for reducing income taxes is to transfer income-producing property to lower-bracket taxpayers and to divide the income among multiple beneficiaries.

One restriction on this technique is the kiddie tax, which imposes a parent's tax rate on income of children under age 19 (24 if the child is a full-time student).

ESTATE PLANNING METHODS FOR INDIVIDUALS AND SPECIAL GROUPS

10.1 Installment Sales of Properties

An individual can remove property from his estate by sale to an heir with payments deferred so that the payments do not end up in the estate.

If payments are for a fixed period or amount, the transaction is generally considered an installment sale.

If payments are to be paid for the life of the seller, the transaction is generally considered a private annuity.

10.2 Freezing Estate Assets Using Trusts

Assets may be removed from the estate by transferring them to an irrevocable trust.

These transactions are subject to gift tax, but the current gift tax is significantly less than what the later estate tax would be.

The grantor may retain use of all or part of the trust property, in which case a GRAT or GRUT can be used to give the grantor access to cash, or a QPRT can be used to let the grantor continue to live in his home.

10.3 Using Life Insurance in the Estate Planning Process

Life insurance can be used to provide estate liquidity or to create an estate.

Life insurance should be owned by someone other than the insured, with no retained incidents of ownership, to ensure that proceeds are not subject to estate tax. Gift taxes on transfers of life insurance policies are significantly less than estate taxes because the cash value of a policy (today) is usually significantly less than the face amount (that will be paid at death).

10.4 Planning After Death

Executors and heirs have a variety of choices that can minimize estate tax after the estate owner's death.

10.5 Planning for Incapacity

The risk that an individual will become incapacitated increases with age.

Advance planning is needed to allow others to make decisions for an incapacitated individual regarding health care and the management of assets.

10.6 Special Estate Planning Considerations

Estate plans are not "one size fits all"; different considerations apply depending on the age of the client, whether the client is married or in a committed nonmarital relationship, or single.

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