ADVANCED ESTATE PLANNING
(For Beginners)

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I. INTRODUCTION TO ESTATE PLANNING.

A. Wealth Transfer Planning.

1. Tax-oriented estate planning primarily involves structuring a client's affairs so as to pass assets to his or her intended beneficiaries -- usually members of younger generations such as children and grandchildren -- with minimum liability for estate, gift, generation-skipping and income taxes. This is often referred to as wealth transfer planning.

2. Effective wealth transfer planning typically involves making irrevocable gifts or other lifetime transfers, thereby increasing the amount of property ***not*** subject to estate tax at the client's death. Relatively common examples of wealth transfer planning include making $11,000/$22,000 annual gifts to children and/or grandchildren, paying tuition for grandchildren, creating irrevocable life insurance trusts, and using all or part of the client's $1,000,000 gift tax exemption sooner rather than later. These planning opportunities, together with other more sophisticated and/or aggressive ideas, will be discussed in greater detail below.

3. Contrary to popular belief, for most people the Economic Growth and Tax Relief Reconciliation Act of 2001 (fondly known as EGTRRA) should not dramatically alter their estate plans. Although EGTRRA provides for eventual repeal of the estate tax (but not the gift tax), there is no assurance whatsoever that this will actually come to pass, and it would be foolish for a high net worth individual to do his or her estate planning on that basis. The only short-term consequence of EGTRRA is the increase of the lifetime exemption ($1,000,000 for gift tax purposes and $1,500,000 for estate tax purposes in 2004). Many of the provisions of EGTRRA are phased in over years, making the amounts subject to gift and estate tax and the rates of tax change from year to year. EGTRRA is discussed in more detail in E. below.

B. Basic Estate and Gift Tax Structure.

1. Each individual can make unlimited transfers to a spouse without any estate or gift tax consequences (provided the spouse is a U.S. citizen). This is referred to as the unlimited marital deduction. Gifts and bequests to charity also get similar special treatment and generally are not subject to gift and estate tax.

2. Each individual has a credit that protects $1,500,000 of transfers from federal tax, $1,000,000 of which can be made during life. This means an individual can transfer up to $1,000,000 worth of assets to children and grandchildren (or anyone else) during life without federal gift tax. If an individual does not make such large gifts during life, the unused amount can be added to the extra $500,000 available at death to protect bequests to children and grandchildren (or others) from estate tax. The $1,500,000 is often referred to as the credit shelter amount or the exclusion amount.

3. Lifetime gifts totaling over $1,000,000 require that gift tax be paid, beginning at a rate of 41% and climbing to a maximum rate of 48% for total gifts of $2,000,000 or more. Federal estate tax is required to be paid when an individual makes lifetime gifts and bequests under his Will that total more than $1,500,000 (unless they are to the spouse or to charity). The federal estate tax rate begins at 45% and increases to a maximum rate of 48% on amounts greater than $2,000,000. In addition, many states impose a separate state estate tax, which may be due even if no federal estate tax is required.

4. Gifts or bequests to grandchildren are subject not only to gift and estate taxes, but also to the separate tax on generation-skipping transfers ("GST"). Each individual has a $1,500,000 exemption from this extra GST tax which is imposed at the highest estate tax rate (48% this year). The amount of the GST exemption tracks the exclusion amount as it changes from year to year.

5. Each individual can make gifts of $11,000 each year to any number of different recipients free of gift, estate and GST taxes, without having the gifts charged against the lifetime exclusion amount. Similarly, the direct payment of tuition or medical expenses for another person is completely outside the estate, gift and GST tax structure.

6. Although the federal estate tax and gift tax rates are superficially the same, the estate tax is imposed on the entire value of the estate without reduction for the tax liability, whereas the gift tax is imposed only on the amount received by the recipient, net of tax. For example, the gift tax (assuming for simplicity a 50% rate and disregarding exemptions) on a $2,000,000 gift would be $1,000,000, for a total cash expenditure by the donor of $3,000,000. However, if instead the donor *bequeathed* the same $3,000,000 fund to the beneficiary, the estate tax would be $1,500,000, leaving only $1,500,000 after tax rather than $2,000,000. In order to bequeath a net amount of $2,000,000 to the beneficiary, the donor would need a total fund of $4,000,000. Note that this advantageous treatment of gifts does not apply if the donor dies within three years of the gift.

7. In evaluating the estate planning benefits of making lifetime gifts, it is important to bear in mind that assets passed to a beneficiary at death (rather than by gift) receive a new tax basis equal to their estate tax value, thus eliminating capital gains on appreciated property. (Note that EGTRRA takes away this basis step-up when and if the estate tax is repealed in 2010.) On the other hand, appreciated property given away during lifetime will keep the donor's tax basis for capital gain purposes, and of course any appreciation in the property after the gift will also be subject to capital gains tax if the property is sold. Although the inability to get a basis step-up is a drawback to lifetime gifts, the fact that the estate tax rate is normally substantially higher than the capital gains rate will in most cases make the gifts nonetheless worthwhile for estate planning purposes.

C. Annual Giving and Tuition Payments.

1. Remember that the donor is getting out of his estate for estate tax purposes not only the $11,000 gifts, but also all of the future income and appreciation on the gifts.

2. Maximize the number of tax-free gifts. If appropriate, include all children and grandchildren (using custodianships or specially designed trusts for minors) and their spouses, and pay private school and college tuition costs for grandchildren. Assuming normal life expectancies and an 8% average after-tax investment return compounded annually, if a wealthy husband and wife both 62 years old make $22,000 gifts each year to three children, two spouses and three grandchildren -- eight gifts each year -- **the value of the gifted funds at the death of the surviving spouse will be about $12,000,000, resulting in an estate tax saving at that time of about $6,000,000**! To put this in terms of today's dollars, the discounted present value of the future projected tax benefit is approximately $875,000. For clients who are unable or unwilling to give away as much as $176,000 each year, a more modest gift program will generate proportionately lower tax benefits.

3. Do not wait until next year to start an annual giving program. Based on the same assumptions, for a couple both age 35 with one child, a current gift of $22,000 will result in a future estate tax saving of over $500,000! In other words, delaying the start of the gift program until next year could result in losing a future estate tax benefit of $500,000.

4. Don't assume it is too late for an annual giving program to be effective. An 80 year old individual giving $11,000 each year to ten individuals can generate a tax-excluded total fund of about $1,200,000 based on normal life expectancy, resulting in an estate tax saving of about $600,000.

D. Lifetime Use of Exclusion Amount.

1. To the extent it is economically feasible, use the $1,000,000 gift tax exemption now rather than waiting for death. This will permit the $1,000,000 (or $2,000,000 for a married couple) to earn income and appreciate outside the donor's estate, for the benefit of the lower generations.

2. Again using an 8% after-tax yield assumption, a gift of $2,000,000 will grow to roughly $8,000,000 in 18 years (the joint life expectancy of a couple both age 70). The income/appreciation of $6,000,000 is not subject to estate tax on the parents' deaths, whereas if the parents had kept the $2,000,000 the $6,000,000 of income and growth would be subject to an estate tax of about $3,000,000 (plus GST tax if grandchildren are involved).

3. As with an annual giving program, it is never too early and never too late to use the exclusion amount. For example, if a husband and wife both age 60 decide to make a $2,000,000 gift to their children, each **month** that they delay actually making the gift will sacrifice a potential future estate tax saving of about **$50,000**.

E. The Economic Growth and Tax Relief Reconciliation Act of 2001

1. EGTRRA includes several dramatic changes in the federal estate and gift tax structure. Many practitioners doubt whether all these changes, in some cases not scheduled to become effective until 2010, will actually take place.

2. The most immediately usable change was the increase in the exclusion amount from $675,000 to $1,000,000 effective on January 1, 2002.

> a. The exclusion amount for federal estate tax and GST purposes increased to $1,500,000 at the beginning of 2004 and is scheduled to increase to $2,000,000 at the beginning of 2006, and to $3,500,000 at the beginning of 2009.

> b. These additional increases do **not** apply to the federal gift tax. The gift tax exclusion amount is capped at $1,000,000, and even when the estate tax is repealed in 2010 the gift tax will remain.

3. The maximum tax rate for federal estate and gift tax dropped from 55% in 2001 to 50% in 2002, 49% in 2003, 48% in 2004, and gradually drops to 45% by 2007.

> a. When the estate tax is repealed, the maximum gift tax rate will be 35%.

> b. Because of a cutback in the credit that the IRS allows against estate tax for estate taxes paid to the states, the total maximum estate tax rate for residents of some states, such as New York, actually dropped from 55% to 54% in 2002, and then **increased** to 57% in 2003 and to 60% in 2004.

4. Under the provisions of EGTRRA, the federal estate tax is repealed as of January 1, 2010. Several other provisions, however, tend to undercut this provision.

> a. Because of the standing rule in the Senate that a tax reduction having an negative revenue impact beyond ten years must be approved by a 60% vote, all the provisions of EGTRRA are scheduled to "sunset" on January 1, 2011, restoring the tax law to its status before EGTRRA was passed. Because this would be a

disastrous and politically unacceptable result, it is clear that, either the provisions of EGTRRA will have to be reapproved at some point with a 60% vote in the Senate, or a compromise bill will have to be enacted, which may or may not include estate tax repeal.

b. Even if estate tax repeal stays in effect, the benefits are significantly offset by a provision eliminating the "step-up" in income tax basis that applies to all appreciated assets included in an estate prior to repeal. Under the proposed carryover basis regime, all assets received from a decedent will keep the same basis that the decedent had, except that a basis step-up of $3,000,000 will be allowed for assets passing to a surviving spouse, and another $1,300,000 for other assets.

c. EGTRRA's decrease in federal estate tax rates was "paid for" by decreasing the share of the tax that was paid over to the states. As a result, many states have "decoupled" their state estate tax law from the federal law and now impose a separate state estate tax. Some states impose a state estate tax even where the value of the estate does not cause any federal estate tax.

5. Estate planning under EGTRRA generally includes taking advantage of each increase in the exclusion amount as it becomes effective, and also requires flexibility in drafting wills, to take into account not only the increasing exclusion amount, but also the uncertainty as to what will happen in 2010 (and 2011).

II. ESTATE PLANNING BY ACRONYM AND BUZZWORD.

A. The Family Limited Partnership (FLP).

1. The FLP is undoubtedly the hottest, most controversial and potentially most powerful wealth transfer weapon in the estate planner's arsenal. Aggressive use of this technique can permit the client to pass business interests, real estate or marketable securities to lower generation beneficiaries at substantially discounted values.

2. In a typical example, Mr. & Mrs. Client will create a limited partnership funded with $4,000,000 of marketable securities. Initially, they will be both the general partners and the limited partners, with the limited partnership interests constituting 98% of the value of the partnership. The mere creation and funding of the partnership is not a gift or a taxable event.

a. The Clients make a gift to each of their three children of a 20% limited partnership interest, with an underlying net asset value of $800,000. However, they obtain an opinion from a business valuation expert that the fair market value of each 20% interest is only $500,000, taking account of the minority nature of the interests and their lack of marketability. Thus, the three gifts total only $1,500,000, and can be sheltered by Mr. & Mrs. Client's gift tax exclusion amount.

b. The Clients can use their remaining 40% of the FLP to fund future annual exclusion (or larger) gifts on a similar discounted basis, and with the right planning whatever portion of the FLP they hold at the time of their death will also be valued on a discounted basis for estate tax purposes.

c. The net result of the use of the FLP is that Mr. & Mrs. Client can pass assets with an underlying value of $4,000,000 to their children (or grandchildren) for a transfer tax value of only $2,500,000, for potential estate tax savings of about $750,000.

3. Although the use of these discounts appears to involve sleight of hand, the underlying rationale is relatively simple and persuasive.

a. Although the gifts are within the family, valuation for estate and gift tax purposes is premised upon a hypothetical sale to a hypothetical unrelated purchaser.

b. If the hypothetical purchaser wants to invest in marketable securities, he can purchase them directly, or by purchasing shares of a mutual fund he can acquire an interest in a large, diversified, professionally managed portfolio of securities.

c. Acquiring a limited partnership interest in the Client Family Partnership would not be an attractive alternative, because the purchaser would have no management or redemption rights, there would be severe limitations on sale or transfer, he would be taxed on his share of partnership income even if not distributed, and he would be getting the investment expertise of Mr. & Mrs. Client, who are not investment professionals.

d. Nonetheless, the hypothetical purchaser would still be willing to buy the FLP interest if the discount were large enough to offset the disadvantages. Frankly, under these circumstances a discount of 30-50% seems very reasonable if not low.

4. It is very important to obtain an appraisal from a professional specializing in valuing interests in business enterprises. Such an expert will have a current database of market information which will allow him or her to compare the FLP to publicly traded companies with similar holdings. For example, where the FLP assets are real estate interests, the discount may be as high as 70% (using publicly traded REIT's for comparison), compared to perhaps 30-40% for marketable securities.

5. Naturally, the minority and lack of marketability discounts also apply to gifts of minority interests in operating businesses. Such gifts can be very effective in passing the business to lower generations with reduced estate tax consequences. Furthermore, in some cases interests in the operating business can be placed in a family partnership, and to some extent two layers of discounts may be available when gifts are then made of FLP interests.

6. Although the IRS has conceded that minority and lack of marketability discounts are available even in the context of family gifts, there is understandably a great deal of opposition to the allowance of substantial discounts where it appears that the primary purpose of creating the FLP is to make discounted gifts for wealth transfer purposes.

a. In many cases the primary issue is the amount of the discount. If the FLP agreement has been carefully drafted, a good quality appraisal obtained and the client has not transferred his or her entire estate to the FLP, there is a strong likelihood of sustaining a substantial discount upon audit.

b. The IRS is using every argument it can think of to reduce or in some cases eliminate the discount, and all of the legal issues have not yet been resolved by the courts.

c. A client should not use the FLP technique to make gifts if the possible loss of the discount is an unacceptable risk. In other words, if a lifetime gift at full value would be desirable for estate planning, the potential FLP discounts are an additional sweetener to the extent they are upheld.

B. The Intentionally Defective Grantor Trust (IDGT).

1. The IDGT (pronounced "I dig it," which is what you say when you understand the concept) is a technique for enhancing the wealth transfer benefits of gifts otherwise made for estate planning purposes.

2. The Internal Revenue Code contains a series of provisions, known as the grantor trust rules, which were originally designed to prevent taxpayers from artificially splitting their taxable income among family members -- particularly children -- through the use of trusts. Under these rules, if a trust contains any of various prohibited "strings", the trust's income will be taxed to the grantor even though he does not actually receive it or benefit from it.

3. Under the current lower and compressed income tax rate structure, coupled with the "kiddie tax" on young children's investment income, there is often little or no advantage in splitting income within the family, but the grantor trust rules provide an outstanding opportunity for wealth transfer planning.

4. In short, a parent can place assets in an irrevocable trust for children which contains a string which causes it to be "defective" by "flunking" the grantor trust rules (but does not cause inclusion in the grantor's taxable estate). Although all the trust's income is either accumulated for the children (or grandchildren) or paid out to them currently, the Internal Revenue Code mandates that the grantor report all the income (including capital gains) on his own 1040 and pay the resulting income tax. This payment by the grantor of

the income tax on the children's income is effectively a gift to the children, totally outside the gift and estate tax structure.

a. The potential benefits from an IDGT can be enormous. Using round numbers, if a $1,000,000 IDGT generates $48,000 of taxable income each year, the resulting income tax will be in the range of $18,000. Because the grantor is paying that tax rather than the trust, he or she is removing $18,000 per year from his or her future taxable estate. Compounded over 20 years, the aggregate potential estate tax savings grow to more than $400,000.

b. In recent years the IRS has grown increasingly antagonistic to the use of an IDGT to have the grantor pay the tax on income in which he or she has no economic interest, and from an equity and tax policy standpoint their antagonism is justified. However, it appears that the IRS has no supportable basis on which to challenge this result without a change in the law by Congress. Nevertheless, clients should be aware that the aggressive use of an IDGT may lead to a dispute with the IRS.

5. The IDGT (or simply "DGT") can be used as a vehicle for making annual exclusion gifts or for utilizing all or a portion of a client's lifetime exemption. It may be particularly useful for making gifts of stock in family businesses because, unlike many trusts, it will automatically be a permitted shareholder in a Subchapter S corporation.

6. Another desirable attribute of a DGT is that, under a 1985 IRS revenue ruling, sales and other transactions between the grantor and the trust are not taxable events for income tax purposes. This permits the grantor to purchase appreciated assets from the trust without causing a capital gain.

7. The ability of the grantor to purchase assets from the trust without causing a capital gain can be particularly useful where a DGT has highly appreciated assets and the grantor is elderly or for other reasons has a short life expectancy. In this case if the grantor purchases the appreciated assets at their current market value for cash or a promissory note, upon his or her subsequent death the assets will receive a "stepped-up" basis and the potential capital gain will be eliminated.

8. Another method of using the favorable attributes of a DGT is for the grantor to fund the trust through a gift, and then to lend additional funds to the trust, charging the lowest interest rate permitted under the tax law without being deemed to be an additional gift. Because of the grantor trust status, the payment of interest by the DGT to the grantor will not have any income tax consequences to either party.

9. Although we have no guarantee that the advantages of using a defective grantor trust will not be restricted or eliminated by legislation, court cases or IRS rulings, at present the opportunity is available and compelling for clients who are attempting to maximize the tax free transfer of wealth.

C. The Irrevocable Life Insurance Trust (ILIT).

1. The ILIT is designed to own life insurance on the grantor's life under a structure which will prevent the insurance from being subject to estate tax upon the grantor's death.

2. In the case of a second-to-die life insurance policy, the beneficiaries will normally be the grantor's children and/or their descendants. The proceeds can either be paid out to the beneficiaries at the death of the second spouse, or held in further trust for their benefit. In the case of a single life policy, the surviving spouse (if any) will ordinarily be a beneficiary for the balance of his or her life, but with limited rights so as to keep the trust out of his or her taxable estate.

3. For a second-to-die policy (or a single life policy where there is no surviving spouse), the insurance proceeds can provide the necessary liquidity for the payment of estate taxes where the estate is short on cash. This is accomplished by the ILIT either lending money to the estate or buying assets from the estate at their fair market value.

4. The funding for the payment of the life insurance premiums is typically accomplished by the grantor making annual gifts to the ILIT. Ordinarily, gifts to a trust do not qualify for the $11,000/$22,000 annual gift tax exclusion, but there is a special technique known as a "Crummey" withdrawal power which permits the use of the annual exclusion.

a. The technique is named after the taxpayer in a 1968 Ninth Circuit Court of Appeals case. It consists of giving each trust beneficiary the power (for a limited time) to withdraw from the trust a pro rata share of any gifts made by the grantor. If the beneficiary does not exercise his or her withdrawal power within the stated period, the power lapses. Because each beneficiary has an unrestricted right to withdraw trust funds during that window period, the grantor's gift is treated as having been made pro rata to each of the beneficiaries, thus permitting use of the annual exclusion.

b. Although the IRS acknowledges the validity of using Crummey powers, they frown on their use where the Crummey beneficiaries do not otherwise have a substantial interest in the trust, and the IRS also challenges the use of Crummey powers where the beneficiaries (or the parents of minor children) are not notified by the trustee each time a withdrawal right is created on account of a gift to the trust by the grantor.

c. In short, Crummey powers have many technical and IRS-sensitive aspects to them, and care must be taken in drafting and administering the trust to comply with the rules to the extent possible.

5. In order to ensure that the insurance proceeds are kept out of the grantor's taxable estate, it is critical that the grantor not have any direct or indirect control over the trust or the insurance policy, or any economic interest in the policy or its proceeds.

6. If a new insurance policy is being purchased, the applicant should be the trustee of the ILIT and not the grantor; in other words, the ILIT should be created in advance of the issuance of the policy. If the ILIT is to hold insurance policies already in existence, they must be assigned absolutely to the trust, and the insured/grantor must live at least three years for the insurance proceeds to be excluded from his or her estate.

7. A trust which fits the description of an ILIT can also hold investments other than life insurance, and the use of Crummey powers will still facilitate tax free annual gifts to the trust. An ILIT may also fit the description of a dynasty or safety-valve trust as described below.

D. The Qualified Personal Residence Trust (QPRT or House GRIT).

1. The grantor retained income trust (GRIT) became a popular estate planning tool in the early 1980's. In short, the grantor transfers property to a trust for a designated term of years, during which time he is entitled to the trust income (interest & dividends) or the use of the property in the case of non-financial assets. At the end of the trust term all the property in the trust is distributed to the designated "remaindermen" -- usually the grantor's children or a continuing trust for their benefit. If the grantor dies during the trust term the trust property reverts back to his estate.

2. The creation of a GRIT is a taxable gift, but for qualifying GRIT's under the current law (see below) the amount of the taxable gift is the total value of the property transferred, less the actuarial value of the income interest retained by the grantor. Stated differently, the taxable gift is the present value of the remaindermen's expectation of receiving the trust property at the end of the trust term.

3. For purposes of computing present values and other actuarial factors, the IRS requires the use of a published discount rate which is changed monthly. The rate, which has recently been in the neighborhood of 4.0%, is determined by taking 120% of the average yield over the prior month on mid-term U.S. Treasury securities.

4. If the grantor survives the term of the GRIT, the trust property passes to the remaindermen without any further estate or gift tax consequences. If he dies during the term the property is included in his gross estate for estate tax purposes, leaving him in essentially the same position as if the GRIT had never been created.

5. The GRIT is an especially effective estate planning technique where significant growth is expected in the trust principal, and in particular where the trust generates little or no ordinary income. This is because the actuarial valuation of the gift anticipates that the grantor will receive income at the published rate and the principal value will stay flat.

6. Under tax legislation enacted in 1990, a GRIT within the immediate family can hold no assets other than a personal residence (principal residence or vacation home) used by the grantor. (A GRIT for nephews or nieces or more remote relatives can still contain non-residential assets. We call this a "True GRIT.") A residential GRIT, sometimes called a house GRIT, is technically known as a Qualified Personal Residence Trust, or QPRT.

7. Using the discount rate of 4.0% and assuming a personal residence with an appraised value of $1,000,000, the following table illustrates the taxable gift component of QPRT's for various terms and ages:

Term (years)

Age	2	4	6	8	10	15	20
40	$920,240	$846,360	$777,740	$713,840	$654,290	$521,990	$409,320
50	$915,090	$835,620	$761,180	$691,350	$625,590	$478,010	$352,560
60	$901,110	$808,330	$721,290	$639,880	$563,570	$392,410	$251,220
70	$872,560	$752,920	$641,880	$539,680	$445,760	$247,220	$109,020
75	$846,920	$706,240	$576,950	$459,260	$355,050	$156,580	$47,430
80	$806,880	$633,170	$481,520	$351,630	$244,580	$74,080	$13,800

8. An attempt to include in the QPRT adjacent land or buildings "in excess of that which is reasonably appropriate for residential purposes (taking into account the residence's size and location)" may disqualify the QPRT entirely and should be avoided.

9. There is no prohibition against using mortgaged property in a QPRT (although the IRS will likely take the position that the original gift is based only on the net equity in the house, with each future mortgage payment by the grantor constituting in part a further gift to the QPRT). The grantor of the QPRT will also continue to pay taxes, insurance and routine maintenance expenses, and will continue to benefit from all applicable income tax deductions. He will also be subject to capital gains tax on a sale of the residence, but will retain the right to roll over or exclude capital gains upon a sale of the home.

10. In the case of a residence held jointly by husband and wife, the ownership can be restructured as a tenancy in common so that each can create a QPRT with his or her undivided interest in the home. Their QPRT's can be for the same term or for different terms. Because each spouse is making a gift of a minority interest in the home, there is authority for valuing each 50% interest at less than one-half of the total appraised value of the home.

11. The question of what will happen to the home at the end of the QPRT term can be handled in several ways. In the simplest situation the home will then be owned by the grantor's children, and the grantor can arrange at that time to rent the home for a fair market rental from the children. Alternatively, the home can continue in a further trust for the children's benefit for the life of the grantor and spouse after the QPRT term, and the grantor can enter into a rental arrangement with the trustee, which will also under current law avoid the children recognizing taxable rental income because it will be a DGT. Lastly, until recently the grantor could buy the home back from the QPRT for its then fair market value shortly before the end of the term, without causing a capital gain to be realized. However, under recent regulations, every QPRT is required to contain a provision explicitly prohibiting the repurchase of the residence by the grantor.

12. If the residence is sold during the term of the trust, the trustee may or may not purchase a replacement residence. Any net proceeds not reinvested in a replacement residence will be returned to the grantor or automatically be converted into a grantor retained annuity trust ("GRAT") of equivalent actuarial value to pay an annuity to the grantor as discussed below.

13. The QPRT is an excellent opportunity to partially utilize a client's lifetime exemption painlessly and effectively. It is painless because it does not involve the use of cash or liquid assets and because the transfer of the home to the QPRT will have little outward effect on the grantor. It will be effective because the actuarial discounting will result in an eventual transfer of the home to children at a gift tax value only a fraction of the actual value of the home. Note, however, that if the house is not repurchased and passes to the children at the end of the QPRT term, their tax basis will be the same as the grantor's; consider whether the estate tax saving in such a case outweighs the potential basis step-up which occurs if the house is held until death.

E. The Grantor Retained Annuity Trust (GRAT).

1. When the use of a GRIT for financial assets was restricted in 1990, the same tax legislation created the concept of a GRAT, which is similar but requires that a designated fixed annuity be paid each year to the grantor whether or not the trust has any income. There is thus less opportunity for abuse because the trust investments cannot be manipulated to divest the grantor of his annuity payments in favor of the remaindermen.

2. If the grantor dies during the term of a GRAT, there will be at least partial inclusion of the trust assets in his gross estate for estate tax purposes. In general, if there has been net appreciation in the trust principal a portion of that appreciation will be excluded from estate tax.

3. Regardless of the GRAT term and the annuity payout, if the actual performance yield of the trust is greater than the IRS discount rate -- recently around 4.0% -- the remaindermen will receive a benefit greater than the taxable gift component of the GRAT. However, if the taxable gift component of the GRAT is substantial, the GRAT may

not be a particularly effective way of utilizing one's lifetime exemption, especially because of the possibility that the assets may decline in value. On the other hand, if the GRAT is structured so that the taxable gift component is small or negligible -- for example, a 9% annuity for 15 years, a 12% annuity for 10 years, a 19% annuity for 6 years, a 36% annuity for 3 years, or a 53% annuity for 2 years -- the transaction will not use up any significant portion of the lifetime exemption. This is commonly known as a "zeroed-out GRAT."

4. With a "zeroed-out GRAT" it is not necessary to actually earn the annuity amount in order to achieve a tax benefit -- so long as the investment performance exceeds the IRS discount rate there will be some residual value in the trust at the end of the term, which is passed virtually gift tax free to the remainder beneficiaries. And if the investment performance does not meet the IRS discount rate, all of the assets will be returned to the grantor in satisfaction (or partial satisfaction) of his retained annuity, but with no adverse gift tax results because there was no substantial taxable gift at the outset. **In other words, placing assets in a zeroed-out GRAT has upside potential but no downside risk from an estate planning standpoint.**

5. This characteristic of a zeroed-out GRAT can be further exploited by creating multiple GRATs and placing different assets in each GRAT, particularly where the assets are speculative in nature. For example, if one GRAT achieves an annual return of 14% and another GRAT goes bust, the family unit in the aggregate will have a 7% investment return, of which approximately half will pass to the remainder beneficiaries free of any estate or gift tax. On the other hand, if both investments were in one GRAT, the combined 7% return would be used in its entirety to help make up the annuity payment to the grantor, with no residual value at the end of the term, and thus no estate planning benefit.

6. In summary, a GRAT with a substantial taxable gift component is usually not the most desirable form of estate planning, but a zeroed-out GRAT, or multiple zeroed-out GRATs where appropriate, can provide a no-lose estate planning opportunity.

F. Safety-Valve and Dynasty Trusts.

1. It is often the case that a client wishes to do aggressive wealth transfer planning through gifts in trust, but is concerned that unforeseen future events might result in a situation where he or she would like to get some of the property back. To give the trustee the power to distribute assets to the grantor would make the trust ineffective for estate planning purposes, but it is permissible to make the grantor's spouse a discretionary beneficiary of the trust. Therein lies the concept of the safety valve.

2. A typical safety-valve trust would name as discretionary beneficiaries the grantor's spouse and all the grantor's descendants, and upon the death of the survivor of the grantor and spouse the trust would divide into separate shares for each child and either distribute the shares outright or hold them in further trust. There would have to be a non-beneficiary trustee to make the discretionary distribution decisions. The trustee would be

someone who would be expected to be reasonably receptive to the wishes of the grantor consistent with the trustee's fiduciary obligations.

3. Although any distribution to the spouse pursuant to the safety valve would represent negative estate planning, such a distribution could be made if the grantor or the spouse determined that it was warranted. Alternatively, the trustee could lend funds to the spouse and thus avoid sending value back upstream into the estates of the grantor and spouse. One drawback to the safety valve trust is that it normally should not be used where the grantor and the spouse intend to elect gift-splitting for gift tax purposes.

4. In the event of divorce or death of the spouse, followed by the grantor's remarriage, the subsequent spouse could fulfill the same safety valve role.

5. Because naming a spouse as a discretionary beneficiary will automatically cause the trust to be a DGT, the safety valve can also have the effect of reimbursing the grantor (indirectly through the spouse) for the income taxes paid by the grantor on account of trust income. In other words, if the grantor determines that paying income taxes on trust income is more wealth transfer planning than he or she wants, the burden can effectively be lessened or eliminated by a discretionary distribution from the trustee to the spouse.

6. The dynasty trust is simply an irrevocable estate planning motivated trust which is designed to utilize the clients' $1,500,000 exemptions from generation-skipping transfer ("GST") tax to pass property through multiple generations without the imposition of any wealth transfer tax other than that potentially arising from the initial transfer.

7. Under the traditional common law and the laws of most states, the duration of a dynasty trust is limited by an archaic principle known as the rule against perpetuities, which provides that a trust must terminate no later than 21 years after the death of the last surviving member of a group of persons named in the trust indenture. This will ordinarily permit a trust to continue for close to a hundred years or more.

8. South Dakota and Delaware led the way in abolishing their rule against perpetuities limitations, and many other states have followed suit. Trusts in these states can continue for an unlimited duration. However, most clients are satisfied with a dynasty trust that is expected to last a century, and feel no need to embrace perpetuity.

9. A dynasty trust is not really a special kind of trust, and almost any kind of estate planning trust, such as an ILIT, can be set up as a dynasty trust if it is sheltered from the GST tax by the allocation of GST exemption.

G. Charitable Split Interest Trusts (CLAT, CLUT, CRAT & CRUT).

1. What Are Split Interest Trusts and How Do They Work?

a. A charitable split interest trust is a trust where charity is the beneficiary of either the current cash flow from the trust or the remainder interest upon the termination of the trust, but not both.

b. In a charitable lead trust, charity is the recipient of the current cash flow as specified in the instrument, and at the termination of the trust the trust remainder passes to an individual or individuals. In a charitable remainder trust, the grantor or some other person designated in the instrument receives the cash flow during the trust term, after which the trust principal is paid to the designated charity or charities.

c. Both charitable lead trusts and charitable remainder trusts are required to be either annuity trusts or unitrusts. An annuity trust pays a fixed periodic sum to the current cash flow recipient for the full term of the trust, whether or not the principal of the trust goes up or down. A unitrust pays out on a periodic basis a fixed percentage of the trust principal, which is revalued each year for purposes of computing the payout amount.

d. A gift to a charitable remainder trust will generate a charitable deduction for income tax purposes equal to the actuarial value of the remainder interest, computed using standard actuarial principles and the standard IRS discount rate.

e. A gift to a charitable lead trust will not normally generate an income tax deduction, but if the remainder interest is given to someone other than the grantor, the actuarial value of the charitable lead interest will be a gift tax charitable deduction, reducing the amount of taxable gift to the remaindermen.

2. A charitable lead trust in a will can benefit charity but at the same time maximize the wealth being passed to children and/or grandchildren. This concept was used effectively as an important component of the Jacqueline Onassis will.

a. The estate will get an estate tax charitable deduction for the actuarial value of the charitable lead interest, meaning that in effect only the actuarial value of the remainder interest passing eventually to children or grandchildren is subject to tax.

b. If in fact the trustee can earn an overall yield on the trust assets which exceeds the IRS discount rate used in computing the charitable deduction, then the remainder passing to the beneficiaries will be larger than "expected," and the excess will pass to them essentially free of estate tax.

3. Much of the attraction of charitable remainder trusts results from the fact that the trust itself is exempt from paying income tax. Accordingly, highly appreciated property of any nature can be contributed to a charitable remainder trust and then sold without incurring a trust level capital gains tax, although the capital gains will be taxed over time to the grantor/annuitant if the annuity amount in any given year exceeds the taxable income earned by the trust.

a. Note that this deferral or possible elimination of capital gains tax is totally independent from the income tax deduction resulting from the creation of the trust. In fact, the trust may contain a relatively high annuity or unitrust payout so that the actuarial value of the charitable remainder interest (and thus the charitable deduction) is relatively small, so long as the actuarial present value of the charitable remainder interest is at least 10% of the total value of the trust.

b. This technique can be particularly attractive where a client has highly appreciated, non-income producing property, such as undeveloped land. If the client sells the property and invests the net proceeds to generate cash flow, the investable amount will be reduced by the capital gains tax. If instead the client contributes the property to a charitable remainder trust, which then sells the property, the entire proceeds can be invested to generate cash flow, with the usual result that the client's cash flow is increased by the use of the remainder trust.

4. There is a special type of charitable remainder unitrust which pays out in each year the computed unitrust payment or the actual income, i.e., interest and dividends, earned in the trust, whichever is less, but with a "make-up" provision that if the grantor/annuitant received less than the unitrust amount because of a shortage of income, in later years if income exceeds the unitrust amount, the shortfall can be made up. This is known as a net income with make-up charitable remainder unitrust, or NIM-CRUT for short.

a. The NIM-CRUT can function very much like an IRA under some circumstances. By investing in the early years in non-income producing growth assets or zero-coupon bonds, the trust can grow dramatically because the growth is not being currently taxed.

b. Then in the later years the investments are shifted into specialized assets, such as deferred annuities or partnership interests, which are designed to produce artificially high ordinary income.

c. In many cases both the ultimate charitable remainderman and the grantor/annuitant will end up ahead of the game from the use of the NIM-CRUT.

5. An alternative to the charitable remainder trust, particularly for relatively small gifts, is the charitable gift annuity, or CGA. With the CGA the donor transfers to the charity the full principal amount of the gift, and the charity enters into a contractual agreement to pay a fixed sum each year to the donor in return for the gift. As with a

charitable remainder trust, the donor gets an income tax deduction for the principal value of the gift, reduced by the actuarial value of annuity payments to be made by the charity. Because the donor must rely on the credit-worthiness of the charity, most states regulate the use of charitable gift annuities and require the charity to maintain reserves like those of an insurance company.

6. Another alternative to the charitable remainder trust is the pooled income fund, which is generally only used by large charities because of the administrative cost of creating and maintaining the fund. With a pooled income fund the donor transfers the principal of the gift to the fund to be commingled with gifts from many other donors, in return for a proportionate share of the income actually earned by the fund. Thus it is much like investing in a mutual fund, except that upon the donor's death the principal of the gift is turned over to the charity. In general, the donor's income tax deduction is based on the actual rate of return achieved by the pooled income fund, rather than the IRS discount rate.

III. CONCLUSION.

This outline describes the substantial tax benefits that may be available through the utilization of some sophisticated estate planning strategies. However, there is no guarantee that a QPRT or a GRAT or a DGT or a FLP or a NIM-CRUT created today will be able to reap all of the more sophisticated tax benefits under the applicable laws at some time in the future. In some cases there is not even a guarantee that the benefits are necessarily available today. Not all of the techniques are appropriate for every client, and it is important to develop an estate plan which is consistent with a particular client’s financial situation, temperament, risk-tolerance and other relevant factors.