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RE: Basic, Intermediate and Advanced Estate Planning and Asset Protection Techniques

Dear [SALUTATION]:

This letter is being sent pursuant to our phone conversation and at your request. The primary purpose of this letter is to give you a brief synopsis of some of the more common estate planning techniques, along with the approximate cost involved in implementing an estate plan. Regarding cost, I am enclosing an "Approximate Fee Schedule" (unless I have sent you one already) that may be of some help to you, but be advised that word "approximate" means just that.

So long as your combined estate (and the estates of your beneficiaries) will **always** remain under $675,000 (the applicable exclusion amount in the year 2000[1]), there may be no need to worry about estate taxes. However, in determining the size of an estate for estate tax purposes, one must consider life insurance proceeds, employee plan benefits, IRAs, and the possibility that one of you will inherit property in the future, including inheriting property from each other.

If there is a possibility of estate taxes being imposed in the estate of your primary beneficiary or beneficiaries, then a will with a credit shelter trust is the minimum recommended procedure. **In addition, there are a number of ancillary forms that we recommend everyone have, even if estate tax is not a concern.** Furthermore, I can say to you unequivocally that you should have a Will, even if only a *simple Will*, whether or not your estate is subject to estate taxes and whether or not you have a Living Trust that is intended to bypass probate.

"Estate Planning" is a broad term that can encompass many things. I have listed below some of the techniques that we consider basic, intermediate and advanced, including an approximate break down of the anticipated costs. After reviewing this simple list, you can let me know how much or how little you would like for us to do, how simple or how complex a plan you feel comfortable with, and how much money you can afford to spend.

BASIC ESTATE PLANNING DOCUMENTS

- **Durable Powers of Attorney.** A durable power of attorney is used to invest someone whom you trust with the authority to act on your behalf.[2] A durable power of attorney could be indispensable should you become incapacitated. Since this form is likely to be readily recognized and accepted, more so as time goes by, we recommend that this form be used, and for this reason recommend that you sign a new Power of Attorney even if you have one already, if the one you have now was signed before the change in law.

- **Health Care Powers of Attorney.** There is a special statutory form that allows you to appoint a person to make health care decisions for you should you be unable to make such decisions for yourself. My recommendation is that whoever has your durable power of attorney have this power also.

- **Appointment of Guardian For Yourself Before the Need Arises.** This document is designed to give you some say so over who will be your guardian should the need ever arise. This is a matter that is otherwise determined by the Courts in accordance with a statutory preference order predetermined by the legislature. My recommendation is that whoever has your durable power of attorney have this power also.

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[1] The applicable exclusion amount is scheduled to increase to $1 million in 2006.

[2] The holder of a power of attorney is a "fiduciary." A fiduciary is someone holding a special relationship of trust and confidence with another person. A fiduciary duty is the highest duty the law recognizes, and it would be a breach of that duty to use this fiduciary office in a manner that is adverse to the person to whom the duty is owed.

- **Appointment of Guardian For Minor Children.** Texas Probate Code §117 gives the surviving parent of a minor child the right to designate the person who will serve as guardian of his or her children after the death of the parent. This designation is required to be in writing. If you have a minor child or children, I strongly recommend that you consider who you would prefer to be the child's guardian in the event there is no surviving parent. In the absence of the appropriate written designation, the Courts will appoint a guardian in accordance with a statutory order of preference.

- **Directive To Physician** (Living Will). Under the Texas Natural Death Act, you have the right to express your desire not to have your life artificially prolonged where your attending physician determines that death is imminent or will result within a relatively short time without application of life-sustaining procedures. Many of my clients have asked to sign this form.

- **Anatomical Gifts.** Some people are inclined to make anatomical gifts of "any needed organs and tissues" or of certain specified organs. If this is something that interests you, please let me know and I will prepare the necessary forms free of charge.

- **Standby Living Trust.** If you have a living trust in place, it may be that there will be no need for a guardianship in the event of incapacity. A living trust can be either presently funded or unfunded. However, if unfunded (a "standby trust"), the person holding the power of attorney can be authorized to fund the trust. A living trust is typically freely revocable and amendable by you during life. The trust can contain explicit instructions to take care of you during life, and can also be drafted to continue after death. In fact, the trust can contain within it most of the estate planning provisions normally found in a will. Your trust should appoint a trustee. My recommendation is that whoever has your durable power of attorney serve as trustee in the event of your incapacity. So long as you are alive and well, you may serve as your own trustee.

- **Pour Over Will**. A Pour Over Will simply provides that the portion of your estate not already in the trust will simply "pour over" into the trust at death. Unlike a Will, the provisions of a living trust are not a part of the public record. Your Will should appoint an executor. My recommendation is that whoever has your durable power of attorney serve as your executor.

- **Division of Trust Estate at Death.** If the combined value of your estate (including life insurance, IRA benefits, etc.) could exceed $675,000 (the applicable exclusion amount in 2000, scheduled to increase to $1 million by 2006), then I recommend that the living trust divide your estate into two or more shares. My general recommendation is that the trust make a **Marital Deduction Gift** and a **Credit Shelter Gift, usually in trust.**

- **The Credit Shelter Gift.** The Credit Shelter Gift is designed to shelter an amount equal to the available estate tax exemption equivalent (which can be as much as $675,000 in 2000 and $1 million in 2006) so that no federal estate or generation skipping tax is ever paid at your generational level. The idea is that an amount equal to the exemption equivalent is either left to your descendants (outright or in trust), or, it can be placed in trust for the life of your spouse and then transferred to your descendants (either outright or in further trust), where, in either case, it will escape taxation in the estate of the surviving spouse.

This technique can be utilized during life or at death. Of course, if utilized during lifetime, the tax leverage can be many times greater, but there is a price: you have to be in a position to afford to part with the money, since you lose the right to use it after the gift is made. (If your spouse is a beneficiary, however, you may obtain some indirect benefits from a lifetime gift.)

The use of this technique can be expected to save at least $250,000 in estate taxes in a taxable estate exceeding $1.35 million. Of course, if the sheltered $675,000 (or such larger amount as is then applicable) appreciates over the lifetime of the surviving spouse, the estate tax savings will be commensurately greater. This amount ($675,000 this year, plus post death appreciation), is not subject to estate tax in the estate of the person creating the trust, because it is less than the estate tax exemption equivalent, and it is not ever subject to estate tax again, so long as it is held in trust. It can be held in trust for a long time: as much as 21 years after the death of some person living at the death of the person creating the trust. This means estate tax can be skipped in your estate, your spouse's estate, your children's estates, and maybe even your grandchildren's estates, particularly if you have grandchildren living at your death. If any of these people need access to the trust in the interim, then it will be there for them. If not, it will be available to the next generation free of estate tax.

- **The Marital Deduction Gift.** An estate tax deduction is available for certain gifts made outright or in trust to a spouse. The Marital Gift soaks up any assets not needed to fund the Credit Shelter Trust. This means that there will be no estate tax due in the estate of the first spouse to die. The marital deduction gift is frequently held in trust in order to give the spouse protection from creditors and to assure that the amount remaining in the trust will eventually pass to the children, or as otherwise directed by the first spouse to die.

- **Generation Skipping Transfer Tax Planning**. In an estate that might exceed $1 million, the Marital Deduction Trust should further be divided into a **Generation Skipping Exempt Trust** and a **Nonexempt Trust**, if necessary. You and your spouse are each entitled to shelter $1 million from the generation skipping penalty tax, and this division of the estate would preserve this benefit. A Generation Skipping Exempt Trust operates on the same principal as the Credit Shelter Trust, and is designed to skip estate taxes in lower generations.

This amount (up to $1,000,000 plus post death appreciation), is not subject to estate tax or GST tax in the estate of the person creating the trust, to the extent it is less than the estate tax applicable exclusion ($675,000 in 2000), and it is not ever subject to estate tax again (or to GST tax at all), so long as it is held in trust. It can be held in trust for a long time: as much as 21 years after the death of some person living at the death of the person creating the trust. This means estate tax can be skipped in your estate, your children's estates, and maybe even your grandchildren's estates, particularly if you have grandchildren living at your death. If any of these people need access to the trust in the interim, then it will be there for them. If not it will be available to the next generation free of estate tax. The reason for the GST tax is to limit the use of this technique to trusts under $1 million.

- **Trusts For Children For Life.** Instead of leaving your property outright to your children or other beneficiaries on the death of the surviving spouse, consider leaving it to them in trust for life. Each child can be appointed trustee of his or her own trust at whatever age you think appropriate; so the fact that the property is in trust will not mean that your children will not be able to enjoy the use of the property. **There are a number of advantages to this plan.** The separate property character of the estate can be preserved during the children's lifetimes and this can be an important advantage in the event of divorce. In addition, the property may very well be exempt from creditor's claims should a child fall on hard times. Finally, careful use of the generation skipping exemption may allow all or a part of the property to pass to your great-grandchildren someday, without being subjected to estate taxes in your children's estates.

- **Coordination of Nonprobate Assets with Overall Estate Plan.** It is important that nonprobate assets such as life insurance, joint tenancy bank accounts, IRAs and qualified plan death benefits pass in a manner that does not disrupt the estate plan. This can be a thorny and time-consuming task. Suffice it to say that simply designating the surviving spouse as the beneficiary of all nonprobate assets can be disastrous.

In the case of life insurance, the best solution is often to name the trustee of a living trust as the death beneficiary. This solves most all of the problems.

In the case of IRAs and qualified plan death benefits, designating the surviving spouse as the death beneficiary is usually preferable for income tax planning purposes and may be the only alternative that avoids unnecessary complexity, but it may mean that the full credit shelter amount ($675,000 in 2000) is not available to fund the credit shelter trust, unless other assets are sufficient. (The completion of the designation should be carefully supervised by us, but it will be up to you to get us the necessary information, and to make clear to us the extent to which you want us to be involved in the beneficiary designation process.)

Large bank accounts, stock brokerage accounts, and certificates of deposit should seldom, if ever, be held in joint tenancy with right of survivorship or otherwise be payable to a third party at death.

- **Cost of Basic Estate Planning Documents.** The cost of a basic estate plan that contains the above documents, including an unfunded living trust with generation skipping provisions and a marital deduction trust, will vary depending on individual circumstances from between $2200 and $3700 for a married couple, plus the cost, if any, of attending to the coordination of nonprobate asset beneficiary designations, if this is desired. Whether the fee is at the high end or at the low end depends on whether the property is all community property, or is part community and part separate (and if the latter whether this property is to be identified), and whether or not much work is required in coordinating the nonprobate assets.

If the generation skipping tax will not be involved (combined estates *that are certain to be* less than $1 million), the fee will be several hundred dollars less. If the marital deduction gift will not be in trust, the fee will also be lower.

The cost of a basic estate plan that contains the above ancillary documents, but no living trust and a simple will with no estate or generation skipping tax planning is generally around $1200 for a married couple, plus the cost, if any, of attending to the coordination of nonprobate asset beneficiary designations, if this is desired. This plan is not recommended if your combined estate *could possibly* exceed $500,000.

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BUSINESS ESTATE PLANNING DOCUMENTS

As the owner of a closely held business, there are a number of concerns that must be addressed in any good estate plan.

- **Buy-Sell Agreement.** If you wish to keep the business in the family, it may be necessary to prepare a buy-sell agreement between the owners. This is not a simple matter. Recent changes in the law have made it difficult if not impossible to peg the price of a closely held business that will be recognized for estate tax purposes.

It may be that all you really need is an option to purchase the stock of the other owners on their deaths, since you can control the disposition of your stock under your will. On the other hand, a funded buy-sell agreement could provide your estate with necessary liquidity.

- **Funding the Buy-Sell Agreement.** Each owner must be assured that the funds will be available to fund the buy-sell agreement. Life insurance is the most effective vehicle for accomplishing this task.

- **Cost of Funding and Preparing a Buy-Sell Agreement.** This is hard to estimate since it could be very involved or fairly simple, depending on your concerns. It might be done for as little as $1500, but it could be considerably more. To adequately collateralize and secure a cross-purchase agreement, I think you should be prepared to expend between $5,000 and $10,000.

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INTERMEDIATE ESTATE PLANNING DOCUMENTS

Intermediate estate planning primarily involves the use of irrevocable trusts and life insurance.

- **Annual Exclusion Gifts/Educational Gifts/Gifts For Medical Care.** Under IRC §2503(b), each donor is allowed to make gifts, free of gift or other transfer tax, including generation skipping tax, each calendar year, to one or more persons, in an amount not exceeding $10,000 with respect to each person. This limit applies separately with respect to a husband and wife, and there is no limit on the number of donees. The gift must ordinarily be of a present interest, which means it cannot be a gift in trust or a gift of any other future interest. There is an important exception to this rule in the case of annual withdrawal trusts discussed below.

IRC §2503(e) contains a separate exemption from the transfer tax, including generation skipping tax, for any amounts paid on behalf of an individual as tuition to certain educational organizations or to a person who provides medical care (within the meaning of the statute). This exception has a lot of potential for avoiding transfer tax, particularly in the case of grandchildren.

- **Crummey Trusts/Annual Withdrawal Trusts.** In order for the annual exclusion to apply ($10,000 per donor/per donee) a gift is supposed to be made immediately and not in the future. For this reason an ordinary irrevocable trust will not qualify. However, the trust can contain a feature known as a withdrawal right that can cause gifts to the trust to qualify. As simple as this sounds, the tax effects of such a feature are very complex. With care, a trust can be drafted to qualify for the annual exclusion without attracting gift, estate or generation skipping taxes, but some drawbacks will have to be accepted as the price.

- **Annual Exclusion Gifts of Undivided Interests in Real Estate.** Making annual gifts of undivided interests in real estate is often a very effective technique. Because the gifts would be in undivided interests, a valuation discount should be available. If this technique is utilized it is extremely important to have a good appraisal of the value.

- **Annual Exclusion Gifts of Undivided Interests in a Family Business.** Making annual gifts of stock in your corporation to your children is another technique that should be considered. Because the gifts would represent a minority interest, a minority discount should be available. I would strongly recommend having an appraisal done before making such gifts.

- **Irrevocable Trust.** An irrevocable trust allows you to exercise some control over property that you give to your loved ones during life. By making a present gift during lifetime, all of the income and appreciation on the property from the time of the gift to the date of your death is effectively transferred tax free. In addition, the gift tax rates are substantially less than the estate tax rates (33% vs. 50% for example). Up to $10,000 per donor/per donee can be transferred tax-free each year.

By making the gift to a trust instead of outright, you can exercise some control over the use to which the property will be put (for example, by keeping it in the family), and in addition, you can give the beneficiary the added benefit of receiving a gift that can be protected to some extent from the beneficiary's creditors (including a spouse). If the gift is within the available generation skipping transfer tax exemption, another advantage is that it may pass to the donee's children (for example) without being subject to estate tax in the donee's estate.

As an aside, it should be noted that by making irrevocable gifts in trust for your spouse and (or) children, you can provide for such things as their education and a modicum of support in advance, so that should your financial situation change, your family will have some asset protection. Financial reversals can come about as a result of adverse business conditions, lawsuits against you, or other similarly unforeseeable events that could happen to anybody even though not anticipated now.

• **Life Insurance.** Life insurance is a perfect asset for an irrevocable trust, although an irrevocable trust will usually be funded with other types of property as well. The reason life insurance is so suitable is that it performs the function of providing the liquidity needed by an estate at death, and because the difference between the value of life insurance during life and at the moment of death is dramatic, meaning that the difference between the gift tax paid (if any) and the estate tax that would be paid is equally dramatic.

There is no good reason that I have ever been able to think of for a person whose estate will be subject to estate tax to hold term life insurance outside of an irrevocable trust.

If life insurance is transferred by the insured and the insured dies within three years, the proceeds of the policy will be includible in the insured's estate. If an irrevocable trust purchases a life insurance policy in the first instance (so that there is no transfer), the three-year rule may be avoided.

• **Funding the Living Trust**. You may wish to transfer your property to the revocable living trust during life and while you are not incapacitated. This might save some probate costs, and is certainly advisable if you are at all concerned about becoming incapacitated for any extended length of time. The living trust need not be funded unless a need to do so is perceived. It may not be worthwhile to prefund a living trust in the case of the very young, but as you get older, it is an option to be taken seriously. It is also a good idea, no matter what your age, if you want to earmark and preserve your separate property.

• **Cost of Intermediate Estate Planning.** The cost of funding a living trust is similar to the cost of probating an estate. The process mainly concerns the transfer of legal title to your assets to yourself as trustee. Title to most assets can be transferred very easily without much legal expense. The record ownership of bank accounts and brokerage accounts are easily changed. Other assets are more troubling. The beneficiary of the property insurance may have to be changed too. These sorts of matters take time but must be attended to. However, to some extent they can be handled without a lawyer.

An irrevocable trust suitable to hold life insurance and containing sophisticated Crummey withdrawal powers, specimen withdrawal right notices, partition agreements to assure that trust is not funded with community property (if a spouse is to be a beneficiary), detailed instructions to the trustee, sophisticated techniques such as "hanging powers" and special powers of appointment, will usually cost around $3200, but will be considerably less if a spouse is not a beneficiary.

Assisting in stock transfers and preparing deeds to real estate can be done for $400 to $500. If appraisals are done by a third party there is that cost to consider.

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ADVANCED ESTATE PLANNING DOCUMENTS

- **Lifetime Funding of Bypass Trust.** By far the best advanced estate planning technique for persons who have a stable marriage and who can afford it, is to make a gift in trust now, for the benefit of the other spouse, remainder to the children, using the available unified credit exemption equivalent, which can be as much as $675,000 in 2000. All of the income and appreciation in the trust is removed from both spouse's estates. Ideally, the spouse would not invade the trust at all, but the option would be there. Although the property has been given away, if the marriage survives, the property is still available to at least one party to the marriage.

The trust must be funded with separate property, so what is really required if the donor spouse has no separate property, is to partition $1.35 million of community property. The donor spouse gives away his or her half of this amount to the trust, and the donee spouse retains his or her half. The donee spouse now owns $675,000 outright as separate property, and in addition is the beneficiary of a $675,000 trust. The down side is that the donor spouse is now $675,000 poorer in fact, and has lost control over the donee spouse's interest in an additional $675,000.

It would be tempting to have the donee spouse transfer the other half of the $1.35 million to a trust for the other spouse, but this is likely to cause the whole transaction to fail in its intended purpose, since the IRS will employ the reciprocal trust doctrine to uncross the trusts. Nevertheless, the donee spouse might make a similar gift years later under different terms, and this might be upheld if it is not part of a prearranged plan.

Consider what the $675,000 (or $1 million beginning in 2006) trust might be worth at death, as a result of appreciation. In a large estate the appreciation factor would have been subject to a 50% or more estate tax if the gift was made at death rather than during life, as the following admittedly dramatic examples illustrate. If the trust quadrupled in value over the next 18 years (doubling every nine years), the $675,000 gift would be worth $2.6 million and the tax savings would be close to $1 million. In nine more years the gift could be worth $5.2 million and the tax savings would be over $2 million.

(I suppose that if the donee spouse were given a power of appointment, it would be theoretically possible for the donee spouse to exercise it in favor of the spouse that established the trust, in the event the donor spouse outlived the donee. Of course, there could be no prearranged plan to this effect.)

- **Marital Agreements/Partitioning Community Property/Identifying Separate Property.** A marital agreement can be very important if it is desired to preserve and identify separate property. Separate and community property will have to be identified at death in any event; however, at that time it could be very difficult (if not impossible) to do. I charge a minimum of $5000 to undertake a marital property agreement and I insist that each party be represented by separate counsel.

Since both halves of community property are liable for the torts committed by or malpractice judgments against either spouse, **an agreement to convert community property into separate property is often employed as a simple asset preservation technique to protect the innocent spouse**. At the death of either party to a marriage, the basis in both halves of the community property gets stepped up (or down) to the fair market value of the property at date of death. The cost of an arrangement under which community property is converted into separate property is that the surviving spouse will lose the basis step up that might otherwise have been available had the property not been converted.

- **Grantor Trusts Where the Grantor In Effect Pays the Donee's Income Taxes.** The tax law requires that income on a trust established by a grantor be taxed to the grantor under certain conditions. That type of trust is called a "grantor trust." The grantor of a grantor trust has no choice but to pay the income tax on that trust for at least as long as the trust is in existence and the grantor is still living. Historically, the IRS has never treated this incident of the tax law as a gift. Lately the IRS has indicated that the grantor may be making a taxable gift when the grantor is forced by the IRS to pay the income taxes on the grantor trust, but most practitioners think that the IRS argument in favor of a gift is weak. It is possible that Congress may act to close this loophole in the future, but it has not done so to date.

By placing property in trust, and paying the income tax outside the trust, the trust becomes like an IRA: it grows at a compounded rate, as if tax free. If **$2 million** is given to a trust on which someone else pays the taxes, earning approximately **10%** per annum, the trust will be worth close to $15 million 20 years later, and will be **worth $42 million in 30 years**. Astounding is the effect of tax free compounding of interest. The transfer tax cost to the donor could be around $240,000 for a $2 million gift by a married couple (or zero for a $1.35 million gift by husband and wife), but the $15 million to $42 million in the trust can be sheltered from generation skipping and estate taxes for 100 years or more. Okay, I realize this all sounds so fantastic as to border on the ridiculous, but even accounting for the many vicissitudes that could affect the assumptions, you still get the point.

- **Grantor Retained Income Trusts/Gift of Remainder Interest.** A grantor retained income trust, or GRIT, is a technique under which you transfer a remainder interest in property and retain the income for a term of years. The gift of the remainder is valued for gift tax purposes at a substantial discount. **This technique is not permitted unless the beneficiary is someone other than a spouse or a descendant,** and even then only works well if the asset returns income at a rate less than the assumed rate of return. The idea is that by giving away the remainder interest in land or growth stock that has a low rate of return, the appreciation is, in effect, shifted to the remaindermen.

In order for this technique to be of any benefit, the grantor must survive the term of the trust, else the trust will be includable in the grantor's gross estate for estate tax purposes based upon the value of the trust at date of death.

- **Grantor Retained Annuity Trusts and Unitrusts/Gift of Remainder Interest.** If a gift of a remainder interest in a trust is made to a beneficiary who is a descendant, the asset must pay you a market rate of return during the term of the trust. In many cases, this takes most of the leverage out of the gift of the remainder. The retained interest must be an annuity interest based upon the original value (a grantor retained annuity trust, or GRAT), or a unitrust interest based upon the market value each year (a grantor retained unitrust, or GRUT).

As was the case with the GRIT, we are here valuing the gift based upon the value of the remainder interest discounted to present value. This value is based upon the length of the term of the GRAT, current interest rates (the adjusted Federal Mid-Term Rate), and the size of the annuity percentage. **Under the right circumstances, the value of the gift for transfer tax purposes can be close to zero.**

In this case, the strategy is the opposite of that of a GRIT. **Here, what is desired is a high rate of return that exceeds the assumed market rate.** Occasionally, a gift of a remainder interest in heavily discounted stock may yield striking tax savings, if the stock pays dividends in excess of the assumed rate of return. A GRAT is particularly attractive if it can be funded with stock in a pass through entity (S-corporation, limited liability partnership, etc.) with an historically low rate of dividends or distributions, that is expected to generate higher rates of return in the future.

A GRAT will be a grantor trust, which means that the grantor must pay income taxes on all of the income of the trust, not just the income used to pay the annuity. (See the discussion of grantor trusts above.) Consider this graphic example:

Closely held stock having a book value of $2 million, but a fair market value of $1 million (because of the minority interest discount), is transferred to a GRAT paying a guaranteed 8% annuity to the grantor for 20 years. The stock pays 8% of the book value as a dividend. 8% of book value is $160,000 on the stock transferred to the GRAT (i.e., 16% of fair market value). If the income tax rate were 50% (which it has been in recent memory), then the donor would owe $80,000 in tax. The GRAT is required to pay the donor 8% of $1 million, or $80,000, which the donor, in turn, uses to pay the income tax. As you can see, 20 years later, when the GRAT terminates, (a) the GRAT would have accumulated $8 million if the stock in the GRAT consistently paid 8% of book (16% of fair market value), (b) the donor has paid virtually no transfer tax, (c) the donor's estate has not really been augmented at all by the annuity (since it went to pay income taxes), and (d) even if the stock appreciated not at all during this 20 years, the trust would still be worth $10 million. **In effect, the donor will have transferred $10 million dollars paying no transfer tax.** If the underlying value of the stock increases during this period, the results are even more striking. Perhaps this technique can be made even more attractive if the property continues to be held in trust (as a grantor trust) following the termination of the retained interest. (In that case, the $10 million could become $31 million in another 15 years, if it continues to grow tax free at 8%, *and you pay the income tax*— which (the income tax) could admittedly become quite a burden by that time.)

In the example just given, if the donor had done nothing, the donor could have simply transferred $10 million to the children, and paid $5 million in tax instead of nothing. So, even if the savings would have been substantially less than $5 million, the potential savings may still be significant enough to make the game worth playing. It depends on the facts. You have to analyze the situation yourself. Obviously, the assumptions govern the outcome. **If the stock pays only 4% of book value or 8% of fair market value, then the donor will not have accomplished anything.** If it pays less, the donor will have accomplished worse than nothing. Further, it may only be a matter of time before the IRS and the courts begin to take into account other factors in the valuation process, such as the fact that the grantor is paying income taxes on property given away. Any time you see a tax result that looks like it is too good to be true, it just might be. You must be willing to take the risk. Some areas of the tax law are more certain than others. This technique is not in the more certain category.

Caution: As was the case with a GRIT, a GRAT will be of no benefit unless the grantor survives the term of the trust; otherwise, the trust will be includable in the grantor's gross estate for estate tax purposes based upon the value of the trust at date of death. However, by using a series of short term GRATs, the early death contingency can be mitigated.

- **Making Gifts Less Likely to be Attacked On the Basis of Valuation Issues.** There are a number of techniques that can be employed to make it less likely that the IRS will challenge the value of a gift placed in trust. For example, one might give the children a pecuniary interest, expressed as a fraction, the numerator of which is 99.9% of the value you believe the gift to be worth, and the denominator of which is the value of the gift for gift tax purposes. The remainder goes to charity. If the value is challenged, it simply increases the size of the gift to charity rather than the tax.

- **Making Gifts Less Likely to be Scrutinized.** There are a number of techniques that can be employed to make it less likely that the IRS will scrutinize a gift to a trust. If the gift to the trust is cash, rather than property, then the cash gift is what is reported on the gift tax return. If the cash is then used to purchase, say, a minority interest in a closely held business, then perhaps there is less of a red flag effect. Of course, the purchase price would still need to be at fair market value, backed up by a thorough appraisal.

- **Additional Leverage Through Borrowing.** Further leverage can sometimes be obtained by having the trust for children (or GRAT) purchase property from the grantor (such as closely held stock) on an installment note secured by the property purchased.

- **Gift of Remainder Interest in Home Following a Term of Years.** This technique is known as a grantor retained income trust, or House GRIT. The technique contemplates that you will give your home away after a period of time, say 15 years. The gift takes place in the present, so that the value of the gift is only a fraction of the full value of the home, since the value is discounted by the value of your right to use the property during the term. There are significant downsides to this technique. For instance, what if at the end of the 15-year period you want to stay in the home? One solution would be to buy the house back at the end of the term.

- **Charitable Remainder Trusts.** Appreciated property can be transferred to charity without recognizing capital gain. In return, the charity can give you the right to annual payments of income based on the fair market value of the property, either as initially valued (a charitable remainder annuity trust) or as revalued annually (a charitable remainder unitrust). To the extent that the value of your right to the income is less than the value of the transferred property, you can get a charitable income tax deduction. **The grantor can serve as trustee of the trust!** Believe it or not, in addition to benefiting charity, this technique can sometimes be of economic advantage regardless of charitable intent, particularly if the property has a very low basis and does not produce much income.

- **Family Limited Partnerships.** This is a technique for investing and managing family wealth in a way that limits the ability of a third party creditor to disrupt the business. This technique can be very useful in preserving a business and other investments of the partnership, but is not intended and is ineffective to put the *value* of the business outside the reach of creditors of the individual partners. One significant feature of a family partnership is that it may very well have a transfer tax value that is much less than the value of the underlying assets!

- **Cost of Advanced Estate Planning.** Advanced estate planning can get expensive. If you are serious about advanced estate planning please let me know, at which time, the costs can be estimated.

* * * *

BASIC ASSET PROTECTION ISSUES

- **Liability of Marital Property In a Nutshell.** The rules of marital property liability can be briefly summarized as follows:

A person is personally liable for the acts of the person's spouse only if the spouse acts as an agent for the other spouse, or the spouse incurs a debt for necessaries under the duty of support described in Family Code §4.02.[3] Except as provided by §5.61 of the Family Code, community property is not subject to a liability that arises from an act of a spouse.[4] A spouse does not act as agent for the other spouse solely because of the marriage relationship.[5]

A spouse's separate property is not subject to liabilities of the other spouse unless both spouses are personally liable "by other rules of law."[6] The spouse's separate property and special community property may be liable under Family Code §4.031 for necessaries or if the spouse is acting as agent for the other.[7] Each spouse owes a duty of support to the other spouse and to his or her minor children.[8]

Unless both spouses are liable under Family Code §4.031 (for necessaries or as agent), the community property subject to a spouse's sole management, control and disposition (the spouse's "special community") is not subject to any liabilities of the other spouse incurred before marriage, nor for any nontortious liabilities that the other spouse incurs during marriage.[9]

The community property subject to a spouse's sole or joint management, control and disposition is liable for that spouse's liabilities, whether incurred before or during the marriage.[10]

All community property is liable for torts committed during marriage by either spouse.[11]

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[3]Tex. Fam. Code §4.031(a).

[4]Tex. Fam. Code §4.031(b).

[5]Tex. Fam. Code §4.031(c).

[6]Tex. Fam. Code §5.61(a).

[7]For an example of a case illustrating that the law is not always what it seems to say, see *Cockerham v. Cockerham,* 527 S.W.2d 162 (Tex. 1975). It is believed that the rule now found in Fam. Code §4.031 to the effect that a person is liable for the acts of the person's spouse only if acting as agent for the spouse, and that a spouse does not act as agent for the other spouse solely because of the marriage relationship, was passed, in part, in response to *Cockerham*. If the *Cockerham* fact pattern were to arise today, the application of this rule might very well alter the outcome.

[8]Family Code §4.02.

[9]Tex. Fam. Code §5.61(b).

[10]Tex. Fam. Code §5.61(c).

[11]Tex. Fam. Code §5.61(d).

A spouse's separate property is basically liable to the same extent as a spouse's special community, except with respect to torts committed by the other spouse. A spouse's special community is liable for the torts of the other spouse. **A spouse's separate property is not liable for the torts of the other spouse.**

Assuming the spouses agree, can one spouse's special community be made subject to the sole control and management of the other spouse? Must the property be "mixed" first? Apparently spouses may simply agree, either orally or in writing, that any community property will be subject to the sole control and management of one spouse or the other,[12] in which event, it follows that such property will ordinarily not be subject to the nontortious debts of the noncontrolling spouse.[13] Third parties are, however, entitled to rely upon certain presumptions as to who has control and management.

"During marriage, property is presumed to be subject to the sole management, control, and disposition of a spouse if it is held in his or her name, as shown by muniment, contract, deposit of funds, or other evidence of ownership, or if it is in his or her possession and is not subject to such evidence of ownership." [14] A third party is entitled to rely on the presumption in the absence of fraud or actual or constructive notice to the contrary.[15]

- **What Assets Are Exempt From Creditor Claims in Texas.**

Homestead. Art. §51 of The Texas Constitution defines the homestead:

§51. Amount and value of homestead; uses

> "Sec. 51. The homestead, not in a town or city, shall consist of not more than **two hundred acres** of land, which may be in one or more parcels, with the improvements thereon; the homestead in a city, town or village, shall consist of lot or lots amounting to not more than **one acre** of land, together with any improvements on the land; provided, that the same shall be used for the purposes of a home, or as a place to exercise the calling or business of the homestead claimant, whether a single adult person, or the head of a family; provided also, that any temporary renting of the homestead shall not change the character of the same, when no other homestead has been acquired.

The Constitution recognizes the existence of a business homestead as well as a residential homestead. The two are not mutually exclusive, and it should be possible to claim both.

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[12]Tex. Fam. Code §5.22(b) and (c).

[13]See *LeBlanc v. Waller,* 603 S.W.2d 265, 267 (Tex. Civ. App.-Houston [14th Dist.] 1980, no writ.)

[14]Tex. Fam. Code §5.24(a).

[15]Tex. Fam. Code §5.24(b).

An urban homestead need not consist of contiguous lots, and both residential and business properties are entitled to the exemption.[16] There are some very interesting possibilities in connection with the business homestead exemption that are sometimes overlooked.

Exempt Personal Property. Pursuant to Article 16, §49, of the Texas Constitution, the Legislature has enacted Texas Property Code §42.001 and §42.002. These sections exempt a wide range of personal property (household furnishings, vehicles, etc.) not to exceed $60,000 in the case of a family or $30,000 in the case of a single adult.

IRAs and Qualified Plans. In Texas, rollover and deductible IRAs are exempt from creditor claims.[17] Qualified plans are generally exempt from creditor claims under both Texas[18] and federal law.[19]

Life Insurance and Annuities Are Exempt in Texas. Article 21.22 of the Insurance Code provides an apparently unlimited exemption for life insurance and annuity benefits.

> Art. 21.22. *Unlimited* Exemption of Insurance Benefits *and Certain Annuity Proceeds* From Seizure Under Process.
>
> Sec. 1 Notwithstanding any provision of this code other than this article, all money or benefits of any kind, **including policy proceeds and cash values**, to be paid or rendered to the **insured** or any **beneficiary** under any policy of insurance *or annuity contract* issued by a life, health or accident insurance company, **including** mutual and fraternal insurance, **or** under any plan or program of **annuities** and benefits in use by any **employer** *or individual*, shall:
>
> > (1) inure exclusively to the benefit of **the person for whose use and benefit the insurance *or annuity* is designated in the policy *or contract***;
> >
> > (2) **be fully exempt from execution**, attachment, garnishment or other process;
> >
> > (3) be fully exempt from being seized, taken or appropriated or applied by any legal or equitable process or operation of law to pay any debt or liability **of the insured or of any beneficiary**, either before or after said money or benefits is or are paid or rendered, and

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[16]*Miller v. Menke,* 56 Tex. 539 (1882); *Ford v. Aetna Insurance Co.*, 424 S.W.2d 612 (Tex. 1968), rehearing denied; *O'Neil v. Mack Trucks, Inc.,* 542 S.W.2d 112, 114 (Tex. 1976).

[17]Tex. Prop. Code §42.0021.

[18]Tex. Prop. Code §42.0021.

[19]ERISA §206(d). *Patterson v. Shumate*, 112 S. Ct. 2242 (S. Ct. 1992); CCH PPG ¶23,853W. *Youngblood v. FDIC*, Slip Op., No. 93-1403 (5th Cir. 1994).

(4) be fully exempt from all demands in any bankruptcy proceeding of the insured or beneficiary.

Sec. 2 The exemptions provided by Section 1 of this article apply without regard to whether:

(1) the power to change the beneficiary is reserved to the **insured**; or

(2) the insured or the insured's estate is a contingent beneficiary.

Sec. 3 The exemptions provided by Section 1 of this article do not apply to:

(1) premium payments made in fraud of creditors subject to the applicable statute of limitations for the recovery of the premium payments; or

(2) a debt of the insured or beneficiary secured by a pledge of the policy or its proceeds.

Sec. 4 This article does not prevent the proper assignment of any money or benefits to be paid or rendered under an insurance policy or annuity contract to which this article applies, or any rights under the policy or contract, by the insured, owner, or annuitant in accordance with the terms of the policy or contract.

Sec. 5 Wherever any policy of insurance, annuity contract, or plan or program of annuities and benefits mentioned in Section 1 of this article shall contain a provision against assignment or commutation by any beneficiary thereunder of the money or benefits to be paid or rendered thereunder, or any rights therein, any assignment or commutation or any attempted assignment or commutation by such beneficiary of such money or benefits or rights in violation of such provision shall be wholly void. [Emphasis added.]

Sec. 6 For purposes of regulation under this code, an annuity contract issued by a life, health, or accident insurance company, including a mutual company or fraternal company, or under any plan or program of annuities or benefits in use by an employer or individual, shall be considered a policy or contract of insurance.[20] [Emphasis added.]

Limitations on Application of Statute. It seems clear that the legislature intended by the amendment for the exemption to extend to the cash value of life insurance without a dollar limitation, in response to a case that had held that the prior version of the statute was limited by the overall exemption dollar limitation for personal property found in Property Code §42.001(a)(1). However, this question is still not free from doubt.

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[20]Tex. Ins. Code § Article 21.22.

Article 21.22 was amended in 1991. When Section 1 was added in 1987 there was doubt as to whether it would be literally construed. At least one bankruptcy case held that Section 1 of Article 21.22 was limited by Property Code §42.001 which limits the exemption for personal property to $60,000 in the case of a family and $30,000 in the case of a single individual.[21] The 1991 amendment added the phrase " Notwithstanding any provision of this **code** other than this article" to the first sentence of section 1. My interpretation of this article is that it should not be read literally without limitation; however, in the context where the statute is found, the "code" is the Insurance Code and not the Property Code. The 1999 legislature has amended the statutes yet again, and this time there ought to be little doubt but that the statute means what it says; *viz.*, life insurance is entitled to an unlimited exemption from creditors, absent fraud.

The Texas Attorney General considered this issue in Opinion No. DM-125, and concluded that "the total exemption provided for the cash value of a life insurance policy in article 21.22, section 1 of the Insurance Code to prevail over the limited exemption provided in sections 42.001 and 42.002 of the Property Code. Life insurance proceeds and cash values thus are wholly exempt from seizure under process."

Note further that this exemption arguably does not apply to the owner as such, unless the owner is also the insured or a beneficiary. The exemption applies to "policy proceeds and cash values, to be paid or rendered to the *insured* or any *beneficiary*." *Cf. In re Gould (Gould v. Phillips,* 457 F.2d 393 (5th Cir. 1972); *Bartholow v. Garner,* 43 Bankr. 463 (N.D. Tex. 1984). The 1999 amendments may have changed this, but I haven't researched the question yet.

Private annuities were made exempt under the statute in 1993. The exemption for annuities was recognized by the 5th Circuit in a 1994 decision *Walden v. McGinnes* (5th Cir. 1994) Case No. 93-8207.

Query: What is an annuity? Traditionally an annuity was thought of as the opposite of a life insurance contract. Under the terms of a true, traditional life contingency only annuity, the annuitant received annuity payments at regular fixed intervals and in fixed amounts. On the death of the annuitant the annuity payments ceased. If the annuitant outlives his life expectancy, the annuitant wins; if the annuitant does not outlive his life expectancy, the annuity company wins: the opposite of life insurance. A common variation on the traditional theme is to put a term certain feature in the contract, thereby limiting the risk of premature death to the annuitant. There is a price for this—the periodic payments will be reduced somewhat to reflect this additional obligation of the annuity company. An annuity contract for the life of the participant or for ten years, whichever is longer, is a common annuity feature.

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[21] *In re Brothers,* Bkrtcy. N.D. Tex., 1988, 94 B.R. 82.

Modern annuity contracts, like life insurance contracts, are beginning to look more and more like investment contracts, little different from an investment in a mutual fund, in the case of certain variable contracts. The IRS has struggled with this issue for years, and periodically Congress responds with legislation such as that we have seen in recent years under TEFRA and TRA ‘86 where restrictions have been placed on single premium deferred contracts, modified endowment contracts and the like.

The question posed here is when is a contract that is defined as an “ annuity” or “life insurance” under the contract what it purports to be under Art. 21.22. Perhaps the question could favorably be resolved by asking whether the contract is subject to regulation under the Insurance Code, which it probably is, in which case it ought to benefit from the exemption described by the Code.

- **Spendthrift Trusts Cannot Be Reached by Creditors of Third Party Beneficiary.** Assets in a trust established by a grantor for a beneficiary other than the grantor, as a rule, cannot be reached by the creditors of the beneficiary, if the trust contains language indicating that it is intended to be a “spendthrift trust.”

§112.035. Spendthrift Trusts

(a) A settlor may provide in the terms of the trust that the interest of a beneficiary in the income or in the principal or in both may not be voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee.

(b) A declaration in a trust instrument that the interest of a beneficiary shall be held subject to a “spendthrift trust” is sufficient to restrain voluntary or involuntary alienation of the interest by a beneficiary to the maximum extent permitted by this subtitle.

(c) A trust containing terms authorized under Subsection (a) or (b) of this section may be referred to as a spendthrift trust.

(d) **If the settlor is also a beneficiary of the trust, a provision restraining the voluntary or involuntary transfer of his beneficial interest does not prevent his creditors from satisfying claims from his interest in the trust estate.**[22] [Emphasis added.]

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[22]Texas Trust Code §112.035(a).

Lifetime spendthrift trusts for children and spouses (especially children and spouses who are professionals) should be considered by virtually all testators disposing of substantial assets. Not only can a lifetime trust be utilized to achieve certain generation skipping tax objectives and to give protection in the event of divorce, but as a spendthrift trust it can afford considerable security by protecting the trust assets from the claims of the beneficiary's creditors (including, perhaps, their spouses).

If the only reason why a testator or a beneficiary would not want such a trust is because of the trustee's fees and fear that the beneficiary will not have sufficient control over the assets, consider appointing the beneficiary as trustee, or give the beneficiary the power to appoint and remove the trustee. Use an ascertainable standard relating to health, education, support and maintenance, and give the trustee discretion as to whether or not to consider other sources of support. This **ought** to be a valid spendthrift trust. The fact that the beneficiary is also the trustee with the power to make distributions to himself **ought not** to make any difference. Neither the Texas Trust Code nor the cases contain any language which should limit the application of the spendthrift trust doctrine in cases where the beneficiary was acting in a fiduciary capacity.

- **Spendthrift Trusts In Which the Grantor is a Beneficiary.** There is some uncertainty regarding the extent to which a creditor can reach the assets in a self-settled trust in which there are beneficiaries other than the settlor.[23] If the trust is discretionary, or subject to a standard, are the creditors limited to whatever the settlor might, in the exercise of trustee discretion, be entitled, or, instead, to whatever distributions the settlor could legally demand and receive? Is that which the settlor can demand or might receive the same as the settlor's “interest”? The settlor's interest may be greater than that which the settlor has the unqualified right to demand, but the creditors are entitled to this interest even if the settlor would not be[24]; however, what about the interests of the other beneficiaries? Can the creditor invade that interest too, simply because the settlor was a permissible beneficiary? The case law is wanting in clear examples.[25] If the settlor reserves a general power of appointment, whether inter-vivos or testamentary, the settlor’s creditors will probably be able to reach the assets over which the power of appointment may be exercised.[26]

Under the Trust Code, the creditors can reach the settlor’s interest in a self-settled trust, but it will ordinarily require a court to determine just what that interest is, and that fact alone may dissuade a creditor from pursuing the matter.

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[23]*Cf, Becknal v. Atwood,* 518 S.W.2d 593 (Tex. Civ. App.-Amarillo 1975, no writ); *Fewell v. Republic National Bank of Dallas,* 513 S.W.2d 506 (Tex. Civ. App.-Eastland 1974, writ ref'd n.r.e.).

[24]*Glass v. Carpenter,* 330 S.W.2d 530 (Tex. Civ. App.-San Antonio 1959, writ ref'd n.r.e.).

[25]See Note-*Trusts-Spendthrift Provisions-Validity of Restraint on Alienation Where Settlor is Beneficiary,* 14 SW. L.J. 552 (1960).

[26]*Bank of Dallas v. Republic Bank of Dallas,* 540 S.W.2d 499 (Tex. Civ. App.-Waco 1976, writ ref’d n.r.e.).

• **Fraudulent Transfers.** Any transfer made with the intent to delay, hinder or defraud any creditor, present or future, will be ineffective if made for less than equivalent value. Furthermore, the presence of a transfer under such circumstances can result in the denial of a discharge, in the event of bankruptcy. The Texas Fraudulent Transfers Act provides:

§24.005. Transfers Fraudulent as to Present and Future Creditors

(a) **A transfer** made or obligation incurred by a debtor **is fraudulent** as to a creditor, **whether the creditor's claim arose within a reasonable time before or after the transfer was made** or the obligation was incurred, ***if*** **the debtor made the transfer** or incurred the obligation:

(1) with actual intent to hinder**, delay, or defraud any creditor of the debtor;** or

(2) **without receiving a reasonably equivalent value** in exchange for the transfer or obligation, **and the debtor**:

(A) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

(B) intended to incur, or **believed that the debtor would incur, debts beyond the debtor's ability to pay** as they became due.

(b) In determining actual intent under Subsection (a)(1) of this section, consideration may be given, among other factors, to whether:

(1) the transfer or obligation was to an insider;

(2) the debtor retained possession or control of the property transferred after the transfer;

(3) the transfer or obligation was concealed;

(4) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;

(5) the transfer was of substantially all the debtor's assets;

(6) the debtor absconded;

(7) the debtor removed or concealed assets;

(8) the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

(9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

(10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and

(11) the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.[27]

§24.006. Transfers Fraudulent as to Present Creditors

(a) **A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.**

(b) A transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.[28]

Literally read, this statute is very broad indeed. A transfer, no matter when made, is defined to be fraudulent if it was done with intent to hinder or delay a future creditor whose claim, if it will arise at all, will arise many years after the transfer is made. Moreover, a gratuitous transfer is fraudulent, no matter when made, if at the time of the transfer the debtor believed that he would (might?) incur debts (in the indeterminate future?) beyond his ability to pay as they become due, notwithstanding a lack of intent to hinder creditors.

On the other hand, where the factors listed in §24.005(b) are not present, the donor is solvent, and the likelihood of future insolvency as a result of specifically foreseeable creditor claims is remote (though possible), I do not believe that the statute prohibits reasonable gifts. We are all aware that economic ruination can unexpectantly strike anyone at anytime. We are all generally concerned about the vicissitudes of fate, the general unpredictability of life, and anyone with any sense knows that the slings and arrows of outrageous fortune can impact anyone. Thus, it is my opinion that if a person seeks to insure that his family and those financially dependent upon him will not be left destitute and helpless in the event of an **unforeseeable** financial or legal disaster, it is not improper to make gifts for that purpose at a time when the client is solvent and has no reason to expect to be rendered insolvent in the foreseeable future.

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[27]Texas Business and Commerce Code, §§ 24.001-24.013.

[28]Chapter 24, Texas Business and Commerce Code, §24.005.

POST MORTEM PLANNING USING IRC[29] §§2032A, 6166 and 303

There should be no estate tax to pay in the estate of the first spouse to die. However, eventually the tax piper must get paid. If the interest in a closely held business or farm or ranch exceeds a certain percentage of the estate, and if other conditions are met, it may be possible to either lower the estate taxes or to defer payment of the tax or both. The following discussion will only apply to the estate of the surviving spouse. Further, if you are able to keep your joint estate under $1.35 million (using 2000 tax rates) you will not need to be concerned with §§2032A, 6166 and 303. It may be possible to keep your estate below $1.35 million in 2000by making annual exclusion gifts.

- **§2032A.** §2032A allows the estate to value property in accordance with its actual use value, rather than its fair market value. This can result in significant savings in the case of farm and ranch land that has a low yearly income relative to its fair market value. In order to qualify, the farm or ranch property must constitute a large percentage of the overall value of the estate, and there must be “qualified use” of the land and “material participation” by the decedent.

Summarizing §2032A is not an easy matter, since the application of the statute in the real world is very complex. The four main conditions, in simplified form are as follows:

i. **50%** or more of the adjusted value of the gross estate must consist of the adjusted value of real **or personal** property which **on the date of the decedent's death** was being used for a “**qualified use”** by the decedent or a member of the decedent's family, and was acquired from or passed from the decedent to a qualified heir of the decedent.

ii. **25%** or more of the adjusted value of the gross estate must consist of the adjusted value of **real property** which meets the requirements set forth in paragraph i above, and in paragraph iii below.

iii. During the **eight year period** ending on the date of the decedent's death, there must have been periods aggregating **five years** or more during which the real property was owned by the decedent or a member of the decedent's family and used for “**qualified use”** by the decedent or a member of the decedent's family **and** there was “**material participation”** by the decedent or a member of the decedent's family in the operation of a farm or other business, and the property is designated in a special agreement with the IRS. If the decedent was receiving old-age benefits under Title II of the Social Security Act or was disabled, the eight year period shall end on the date such disability or retirement began.[30]

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[29] All references herein to the "IRC" are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

[30] IRC §2032A(b)(4).

iv. Such real property is designated in an agreement specified in IRC §2032A(d)(2).

- **§6166.** If the value of an interest in a closely held business exceeds **35%** of the adjusted gross estate, the executor may elect to pay all or a portion of the estate taxes in installments. Interest only can be paid for the first five years, with the tax being paid in up to ten annual installments thereafter. Interest is charged at only 4%. However, the 4% interest portion is only with respect to the tax on $1,000,000, reduced by the unified credit. The tax on $1,000,000, prior to the application of the unified credit is $345,800. In 1987, the unified credit is $192,800. Therefore, the 4% rate is limited to the first $153,000 of estate tax liability.

There are a number of other special conditions and tests which must be met before IRC §6166 will be available. Passive assets cannot be considered in the application of the 35% test.[31] In the case of a sole proprietorship, only the assets of the business which are actually used in the enterprise will be counted for purposes of satisfying the 35% test. In order to qualify for §6166 treatment, the proprietorship, partnership or corporation must be an active trade or business.[32]

An interest in a corporation will qualify if either the corporation has 15 or fewer shareholders, or if the decedent held 20% or more in value of the voting stock.[33] If a husband and wife hold an interest as community property, as tenants in common, as joint tenants, or as tenants by the entirety, they are treated as one person for purposes of the numbers of owners tests.[34] Other provisions of §6166 provide for aggregation with certain members of a decedent's family under certain circumstances and for certain purposes. Business may be aggregated for purposes of meeting the 35% test if 20% or more of the total value of each is included in the decedent's gross estate.[35]

- **§303.** Under IRC §303, redemptions of corporate stock are generally treated as if they were dividends. If the conditions of IRC §303 are met, the redemption of stock out of an estate will instead be treated as the sale of a capital asset.

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[31] IRC §6166(b)(9).

[32] See Rev. Ruls. 75-365, 75-366 and 75-367.

[33] IRC §6166(b)(1)(C).

[34] IRC §6166(b)(2)(B).

[35] IRC §6166(c).

The stock must be included in the decedent's gross estate for federal estate tax purposes, and the value of all of the corporation's stock which is included in the decedent's gross estate must exceed 35% of the adjusted gross estate. Furthermore, the redemption proceeds cannot exceed the estate, inheritance and succession taxes payable by reason of the death of the decedent, plus the amount of funeral expenses and cost of administration deductible for federal estate tax purposes. The generation skipping tax is treated as a death tax if it occurs at the same time as or as a result of the decedent's death.[36]

The shareholder redeeming the stock must actually be liable for the tax.[37] Therefore, if the will provided that all of the taxes and expenses were to be paid by the residuary estate, and the stock is not a part of the residuary estate, §303 will not be available!

To an extent, it may be possible during life to take a few simple steps in order to meet the 35% test. For instance, operating assets owned by the decedent individually and leased to the corporation could be transferred to it, thereby increasing the value of the stock as a percentage of the gross estate. Charitable contributions, if made during lifetime will reduce the size of the adjusted gross estate, but if the same contributions are made at death, these gifts will be includible.

§303 is only important if a business has retained earnings and profits.

- **Cost of Analyzing.** It would take at least $3000 worth of legal time and expense to adequately analyze and implement planning that would assure that §§2032A, 6166 and 303 will be available. The §2032A issue is complicated enough that if that issue were pursued to the fullest, even more expense could be involved. If you anticipate keeping your estate below the estate tax threshold or close to it, §§2032A, 6166 and 303 will not be that critical. I recommend that we consider these issues after a basic estate plan has been put in place.

* * * *

If it looks as if you are going to have a taxable estate after all nontaxable gifts are made, then you may want us to do a thorough analysis of §§2032A and 6166 as a means for reducing the burden of estate taxes.

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[36]IRC §303(d).

[37]IRC §303(b)(3).

Recommendations

I would initially recommend that you sign the basic estate planning documents soon, if you do not have a basic estate plan in effect already. I also recommend that you consider a means for keeping the life insurance proceeds out of your estate, if you have life insurance with significant death benefits. An irrevocable trust might be in order here. (See intermediate estate planning considerations above.) Anything beyond that would of course depend on your personal financial situation and preferences. After I have had a chance to visit with you and to review your assets and needs, we can decide on what, if any, further planning would be advisable.

Yours very truly,

Noel C. Ice

NCI/ice

Enclosures: Approximate Fee Schedule

cc: [CCFIELD]

Stoney, hide the following addresses mannually, except for the ones we need!!!!!!!!!!

[CCCFIELD]