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DRYNAN & ROACH: ESTATE AND INSURANCE PLANNING TOPICS

I. The Unlimited Marital Deduction

II. Credit Shelter Trusts

III. Discounting techniques

IV. Life Insurance

V. Buy-Sell Agreements

VI. Tax Reform Act of 1997 and Estate Tax Planning

REMEMBER: When it comes to estate conservation and passing along the family farm there are three main questions:

1. **Who *does* own the farm?**
2. **Who *will* own the farm?**
3. **Who *should* own the farm?**

If the answers to questions 2 and 3 are different, call or write Tom Drynan and Barry Roach of Drynan & Roach at: 818 W. Riverside, Suite 400 Spokane, WA 99201 Phone: 509-626-4030 Toll-Free: l-888-527-8234 FAX: l-509-6244041

Drynan & Roach
An Estate Planning Group

ESTATE PLANNING TOPICS

1. The Unlimited Marital Deduction

2. Credit Shelter Trusts

3. Discounting Techniques

4. Life Insurance

5. Financial Planning

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THE MARITAL DEDUCTION

Any assets passing to a surviving spouse pass free of federal estate tax. Although the initial transfer is tax free, the marital deduction merely defers estate tax until the death of the surviving spouse. If all assets pass to a surviving spouse, the marital deduction will help to avoid federal estate tax at the first death. These assets are potentially subject to tax in the surviving spouse's estate. This, however has two drawbacks:

1. The assets are added to those of the spouse which places the estate in a higher bracket.
2. If the spouse remarries, assets may be redirected depending on the spouse's new will.

There are other ways to take advantage of the marital deduction. For example, a trust may be created which qualifies for the 'marital deduction because all income from it is distributed usually to the surviving spouse who may have as much or as little access to the principal. This strategy is especially useful when it is important to ensure the principal remains available for children.

CREDIT SHELTER TRUSTS

The "unified credit" is a credit a donor of a gift or an estate can use to reduce the amount of gift or estate tax due. Under current law, the credit is $202,050, an amount sufficient to exempt the first $625,000 of taxable lifetime gifts or transfers at death. The amount of assets the credit effectively exempts is the "applicable exclusion amount." Under the Taxpayer Relief Act of 1997, the applicable exclusion amount will increase over several years from 1998 to 2006 according to the following schedule.

DEATHS OR GIFTS IN	APP. EXCLUSION AMOUNT
1998	$625,000
1999	$650,000
2000	$675,000
2001	$675,000
2002	$700,000
2003	$700,000
2004	$850,000
2005	$850,000
2006 and after	$1 ,000,000

When an estate totals more than the applicable exclusion amount, there are alternatives to leaving almost everything to a spouse. In addition to the unlimited spousal bequest, one can leave up to the applicable exclusion amount to other beneficiaries tax-free. If an individual does not leave anything to anyone other than to a spouse, he or she forfeits that option. Then, when the spouse dies, assuming he or she has not remarried, the tax-free estate is limited to the spouse's applicable exclusion amount. Had the first spouse utilized his or her applicable exclusion amount, the amount passing tax-free would have been doubled.

To put it another way, when an estate exceeds the applicable exclusion amount, each spouse **may** wish to consider owning part of it individually. This, together with proper wills and other testamentary documents, assures up to twice the exemption equivalent amount can pass to heirs free of federal estate tax, regardless of which spouse dies first. The estate plan should consider the impact of either order of death and also the effect of inflation on specific assets within the estates.

Making this provision work, however, means each spouse must have sufficient separate assets so assets worth the applicable exclusion amount may pass to the credit shelter bypass trust. Insufficient separate property with which to fund a credit shelter bypass trust results in a portion or all of the unified credit being wasted at the first death. Assets may need to be partitioned as separate property to accomplish complete funding of the credit shelter bypass trust at the first death.

Tax savings are not inconsequential, since estates currently are taxed at a rate of up to 55 percent or on large estates as high as 60 percent. To protect the spouse during his or her lifetime, the exemption equivalent amount might be put into a credit shelter trust, with the spouse enjoying the income from it. After the spouse's death, the trust proceeds go to the named beneficiaries free of further estate taxes.

Utilizing ***the Unified Credit.*** Making this provision work effectively means each spouse must have sufficient separate assets in your respective estates so assets equal to the applicable exclusion amount may be passed along to the credit shelter trust.

Utilizing the Qualified Family Owned Business (QFOB) Exclusion. As the owner of an interest in a family owned business, one may be able to exclude part of the value of the business from your gross estate if you meet certain qualifications. The amount of the QFOB exclusion is the lesser of the value of the business interest or the excess of $1.3 million over the unified credit applicable exclusion amount for the year of death. For example, if a business owner were to die in 2006 or a subsequent year, the applicable exclusion amount would be $1,000,000. Thus, the potential amount of the family owned business exclusion would be $300,000 ($1,300,000 - $1,000,000). Each spouse can take advantage of the exclusion if eligible, meaning that the couple could pass $600,000 tax -free under the QFOB exclusion plus $2,000,000 under the unified credit. In 2006 and subsequent years, the maximum tax savings from 'the QFOB exclusion, if the estate is in the highest estate tax bracket (55 percent), would be $165,000 ($300,000 x.55).

There are numerous requirements to qualify for the QFOB exclusion. Generally, the adjusted value of the business interest must exceed 50 percent of the adjusted gross estate. Also, as a rule, the family as a whole must own more than 50 percent of the business. There are also other requirements related to continued active family involvement after the business owner's death.

DISCOUNTING TECHNIQUES

FAMILY LIMITED PARTNERSHIPS. A family limited partnership (FLP) can be an useful estate planning vehicle for shifting and preserving wealth within a family. Typically, a donor creates a FLP by transferring property title to the partnership. The donor would effectively retain control over the FLP by acting as the general partner. In this capacity, the donor assumes management control of the business as well as liability for the debts of the partnership.

The donor may subsequently name only his or her family members (defined as spouse, ancestors, lineal descendants or trusts established for the benefit of such persons) as limited or general partners - depending on the donor's assessment of their specific abilities and needs-to the FLP by gifting to each an interest in the partnership. This mechanism enables the donor to provide income to members active in the family business as well as those outside of it and to restrict control by certain members over the management of the assets. Technically, a donor could keep gifting to the donees an interest within the annual exclusion amount until the entire value of the property is shifted to the donees. The obvious benefits here are keeping the assets in the family, possibly for many generations, and shifting wealth to other family members. Moreover, the FLP is extremely handy in distributing assets which are hard to divide. Partnership units, for instance, may be assigned to an asset and spread out among various partner donees.

There is, however, a limit as to what kinds of assets may be placed in a FLP; family homes, IRAs, risky assets which are likely to attract liability (cars, planes, boats) and personal use assets (art or jewelry) are not included primarily because partnerships must be formed for business reasons other than as a mere repository of wealth. Contribution of encumbered assets with liabilities exceeding basis might also trigger immediate reportable taxable income. Lastly, stocks of S corporations may not be included in a FLP because only individuals, estates, or certain qualified subchapter-S trusts may become S corporation shareholders. One alternative would be creating a Qualified Subchapter-S Corporation Trust (QSST) as a receptacle for stocks in one or more S corporations. The QSST then allows the donor to split income among family members while eliminating the gift from inclusion in the donor's gross estate.

Another advantage to forming a FLP is the amount of control retained by the donor over the partnership. Limited partners often play a passive role, leaving the decision-making powers to the general partner without much room for interference or second-guessing. Also, limited partners cannot be liable for more than their respective investment or interest in the partnership, which would be the amount they were gifted plus any individual investment they may have made to the FLP.

In addition to the control issue, donors will benefit from the privacy, structural flexibility, tax advantages, creditor protection, and asset preservation aspects of a FLP. Specifically, a partnership agreement. may be tailored to suit the goals and amended to meet any changing needs of the donor. For example, the agreement may be drafted to include a confidentiality provision to ensure privacy or an arbitration clause in anticipation of future disputes between feuding family members. Indeed, the donor's wealth preservation objectives may be achieved through careful, creative drafting of the language of the partnership agreement.

The FLP also allows pass-through taxation because the partnership's income is taxed directly to the partners. The problem of double taxation, which can plague regular C corporations, would not occur here. Furthermore, there may be a reduction of overall estate tax consequences on these types of interest transfers during the donor's lifetime and at his or her death due to the substantial valuation discounts. It is vital the donor recognize the importance of valuation discounts in his or her estate planning.

At death, a donor's estate is taxed based on the fair market value of his or her estate. The difficulty in placing a value on a partnership as an asset of an estate arises from the very nature of the partnership. Key characteristics of a FLP, such as co-ownership, non-marketability, lack of control (minority interest or interest is not freely transferable), fractional interests in real estate, and buy-sell or other restrictive agreements, must all be considered in taking discounts from the value of the Partnership's underlying assets. To survive challenges by the IRS on the discount taken, the estate should be prepared to produce credible evidence of a non-tax business purpose, asset transfers recognizing the donees' rights as owners of the asset, and any other documentation supporting the discount. In sum, when the valuation discount is grounded in substance and reality, a donor may be able to both achieve a substantially lower estate value and avoid most of the transfer tax on post-death appreciation on the gifted assets.

This type of partnership also promotes asset preservation by limiting creditors' reach. Creditors usually cannot touch assets placed in a FLP unless a charging order is issued by a court of law. Even so, a charging order at best entitles the creditor to distributions made by the partnership to the debtor partner; assets and control of the partnership, however, are still beyond the creditor's grasp. Creditors naturally cannot force distributions of either income or principal.

Outside of the tax planning and asset protection purposes, a family partnership may be an excellent means through which parents could pass along their priceless business acumen, experience and advice to their children. Thus, in addition to enjoying the family wealth, the children donees would receive a significant lesson in how to manage this wealth and preserve it for the generation to come. Finally, management of diverse family assets can become more unified through the use of a FLP. A donor can contribute many different kinds of investments to the partnership, thereby consolidating and diversifying the assets at the same time.

As attractive as the FLP may appear thus far, there are some downsides, with the main one being strict compliance to the rules governing a FLP. Primarily, the partnership must demonstrate its capital is the material income producing factor and the donees have a real ownership interest in the capital and underlying assets of the partnership. Again, adherence is necessary to prevent any implication by the IRS the FLP is a mere tax avoidance scheme. One good way of minimizing the chances the IRS will view the FLP as a sham is to give the FLP a business or investment purpose. But, since the IRS scrutinizes most FLPs, the drawback here is the greater likelihood for an audit.

The donor should also factor into his or her decision to create a FLP the set up costs, administrative expenses, franchise tax, and need for business valuation from a qualified appraiser. And as mentioned above, another disadvantage is the donor's potential liability for the acts of any other general partners.

In conclusion, the family limited partnership can be a highly viable wealth shifting and preserving tool in estate planning. Not only does the FLP afford an opportunity to keep the wealth within the donor's family, but it also provides latitude in determining how much control is retained over these assets while creating a mechanism w&h can significantly discount the value of the property transferred.

Considering A Family Limited Partnership (FLP) For The Farm Real Estate. ***An*** FLP is a method of shifting assets from senior family members to younger members. Through the use of an FLP, wealth may be shifted to younger family members at a discount to face value; the discount recognizes that a minority interest in an asset may not be easily disposed of. As general partners, you could maintain control of the asset(s) by making gifts of limited partnership units to your children. The partnership agreement may provide for the children to become general partners at your deaths.

Outside of tax planning, an FLP may also provide a recipient with invaluable insight into managing and preserving wealth for the generation to come. Before establishing an FLP, however, you should factor into your decision the set up costs, administrative expenses, franchise tax, and possible need for valuation from a qualified appraiser.

LIFE INSURANCE

Purchasing Life Insurance In An Irrevocable Life Insurance Trust. Life ***insurance*** owned by the irrevocable trust is outside the taxable estate if proper procedures are followed and the insured has no incidents of ownership in the insurance. Therefore, an irrevocable trust creates liquidity without inflating the taxable estate with additional life insurance. You may wish to purchase survivorship whole life insurance within an irrevocable trust, for the payment of potential estate taxes and liabilities. The appropriate level of coverage will ultimately be affected by other planning techniques that are used.

Transferring The Existing Life Insurance To An Irrevocable Trust Or Designating Other Third Party Ownership. Life insurance owned by the trust may be outside the taxable estate if proper procedures are followed. The reduction of the grantor's estate tax liability is a significant advantage of the irrevocable trust. If you transfer the insurance into the trust and retain no incidents of ownership over the property and no powers over the corpus of the trust which could be construed as ownership, the assets placed into such a trust will escape inclusion in your gross estate. It is important to note, however, when life insurance policies owned by the grantor are given to an irrevocable trust and the grantor dies within three years of the date of transfer, the proceeds will be brought back into the estate.

IRREVOCABLE TRUSTS. Irrevocable trusts are a type of trust playing a role in the estate planning process. The reduction of the grantor's estate tax liability is the main advantage of the irrevocable trust. As long as the grantor establishes an irrevocable trust and retains no incidents of ownership over the property and no powers over the corpus of the trust which could be construed as ownership, the assets placed into such a trust will escape inclusion in the gross estate of the grantor.

There are exceptions to this rule. For example, when certain types of property (such as life insurance policies owned by the grantor) are transferred to the irrevocable trust and the grantor dies within three years of the date of transfer, the property will be brought back into the estate. Other transfers not excluded from the grantor's estate include transfers of property in which:

- Grantor reserves rights to alter, amend, or revoke;
- Grantor reserves lifetime right to use or enjoy property;
- Transfer takes effect upon the death of the grantor.

Assets properly placed in an irrevocable trust offer protection from creditors. This may have particular value for persons in occupations with a high risk of litigation. A irrevocable trust may be domestic or foreign; if the latter, it may have additional benefits. When this type of trust is established with particular assets, they are a completed gift and the property is ordinarily removed from the grantor's gross estate. Therefore, there may be gift tax liability on the value of the transferred to the corpus of such a trust. A disadvantage of this type of trust that such an arrangement lacks flexibility. Once it is established and funded, the irrevocable trust cannot be altered, amended, or terminated by the grantor, even in event of a medical emergency.

The irrevocable trust is particularly suited to holding life insurance which is purchased to create liquidity for payment of estate taxes. Generally, the trustee of the irrevocable trust is given the discretionary power to use cash which comes into the trust as beneficiary of the death benefit proceeds to purchase hard assets from the estate. The estate then has cash to pay the tax, and the assets may be distributed according to the terms of the trust.

Life insurance owned by the irrevocable trust is outside the taxable estate if proper procedures are followed and the insured has no incidents of ownership in the insurance. Therefore, an irrevocable trust creates liquidity without inflating the taxable estate with additional life insurance.

Under the present interest gift tax exclusion, every person may donate up to **$10,000** per donee per year. This amount may be donated to the irrevocable trust gift tax-free, assuming the gift would be structured properly to be classified as a present interest gift. The trust assets may be used to fund the premium on any additional insurance purchased.

Survivorship Life Insurance. The Economic Recovery Tax Act of ***198 1*** allowed postponement of estate taxes --through the Unlimited Marital Deduction -- until after the death of both husband and wife. While this provides couples with increased flexibility during lifetime, in many cases it places a substantial tax burden on the combined estate when the surviving spouse dies.

The Survivorship Life Solution. Unlike traditional life insurance, which provides protection on the life of a single insured, survivorship life covers two lives with proceeds payable at the second death. As such, it is perfectly suited to deal with the problem discussed above.

Advantages Over Individual Coverage.

A. Lower premiums - more cost effective than two policies.
B. Medical underwriting standards may be eased with respect to one of the insureds, due to second death payouts.
C. Lower "economic benefit" reportable for income taxes in Split Dollar Plans (often 10 times lower).

Ownership Arrangements. Third party ownership (adult children or an Irrevocable Life Insurance Trust) is often desirable for persons with potential estate tax problems. The policy may sometimes be transferred out of the estate after the first insured dies. If the survivor lives three years after the gift, the full face amount should be out of his or her estate. Questions of ownership should be discussed with an attorney.

The Four Ways to Pay Estate Taxes.

Present Value Cost per Dollar of Benefit
At Life Expectancy for a 65 Year Old Male Non-smoker