

Chapter 25

PLANNING YOUR ESTATE — AVOIDING PROBATE AND FAMILY FIGHTS

The purpose of this chapter is to explain the process to: (i) reduce the size of your and your spouse's taxable estate at death in a manner to avoid or minimize any federal estate taxes then in effect; (ii) direct the disposition of your and your spouse's assets at death; (iii) provide support to dependent family members upon your and/or your spouse's death. This process should serve to minimize family feuds after you and your spouse are deceased.

Economic Growth and Tax Relief Reconciliation Act of 2001¹

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Tax Act of 2001"), the federal estate tax is scheduled to be reduced, through larger "exclusion amounts"² and eventually repealed in 2010. However, unless Congress acts, all of the 2001 tax changes will expire on December 31, 2010. The reinstatement certainly creates uncertainty and planning complexity in that Congress will be forced to again deal with the topic of estate planning. Fortunately or unfortunately, the outcome of estate tax reform in 2011 will be dependent upon the political environment at such time.

The repeal of the estate tax will be in accordance with the following schedule:

¹ CCH Tax Briefing, Special Report May 29, 2001.

² Implemented in the form of a unified credit against the tax.

<u>YEAR</u>	<u>APPLICABLE EXCLUSION AMOUNT</u>	<u>TOP ESTATE TAX RATE</u>
2002	\$1 million	50%
2003	\$1 million	49%
2004	\$1.5 million	48%
2005	\$1.5 million	47%
2006	\$2 million	46%
2006	\$2 million	45%
2007	\$2 million	45%
2008	\$2 million	45%
2009	\$3.5 million	45%
2010	N/A	N/A

Under present law, generally, property acquired from a decedent receives a "stepped-up" basis equal to its fair market value on the date of a decedent's death, or alternate valuation date. Where property has appreciated in value, this step-up in basis results in a lower capital gains tax upon the ultimate disposition of the property.

When federal estate taxes are repealed in 2010, assets acquired from a decedent no longer receive a step-up in basis. Under the Tax Act of 2001 (for decedents dying after December 31, 2009) assets receive a "carryover basis" equal to the lesser of their fair market value on the date of death, or their adjusted basis in the hands of the decedent. This carryover basis translates into higher capital gains taxes upon sale of the property.

There are two exceptions to the operation of the carryover basis rules. The Tax Act of 2001 provides for the allocation of basis to specific non-cash assets, up to fair market value, in the total amount of up to 1.3 million dollars. In addition, 3 million dollars of basis can be allocated to property passing to a surviving spouse, or in certain trusts for a spouse's benefit.

Certain property in an estate is not eligible for a basis increase. The most notable exception is property acquired by a decedent from a non-spouse less than three years before death. The purpose of this exception is to avoid the transfer of low basis property to a decedent, just before death, in order to receive the stepped-up basis on the property.

As to gifts, beginning in year 2010, those gifts in excess of 1 million dollars, aggregated over one's lifetime, will be subject to a gift tax equal to the top individual income tax rate at that time.

Estate Inventory

The first step of an estate plan involves completion of an estate inventory. An estate inventory is a list of all assets owned by you, and your spouse, if married, with the fair market values included. An accurate estate inventory is important because the estate plan will be based upon the information contained in this inventory. An example of an estate inventory is included in Figure 25-1.

From the estate inventory, you will be able to estimate your "taxable estate." Federal estate taxes are generally levied upon your taxable estate. Your taxable estate includes all assets that you own, including, but not limited to, your home, all other real estate, life insurance, the fair market value of your practice and other business interests, retirement plan assets, all bank accounts, stock, bonds and other investments. One-half of all assets owned jointly with your spouse will also be included in your taxable estate.

Applicable Exclusion Amount

If your taxable estate is below the applicable "exclusion amount", the entire value of your taxable estate is exempt from federal estate tax. The exclusion amount applies, however, only to assets that pass to persons other than your spouse, e.g., your children.

In addition to the exclusion amount, a deduction is available for all assets passing to your surviving spouse upon your death. This deduction is known as the "unlimited marital deduction" because it allows you to pass an unlimited amount to your surviving spouse free from federal estate tax. For example, you could win \$2,000,000.00 in the lottery and pass away the next day. If your \$2,000,000.00 in winnings passed to your surviving spouse, no federal estate tax would be due as a result of the unlimited marital deduction. Please note that if your surviving spouse is not a United States citizen, no unlimited marital deduction would be available for assets passing to your spouse, unless such assets passed to a special type of trust. If either you or your spouse are not an United States citizen, your estate plan needs to be particularly tailored for such circumstances.

In addition to the unlimited marital deduction, deductions may be available for debts of the deceased and the expenses incurred in administering the deceased person's estate, e.g., attorneys' fees and funeral expenses.

Because of the unlimited marital deduction, any size of taxable estate can be passed to a spouse, free of federal estate tax. Upon the death of the spouse, however, the marital deduction will no longer be available unless your spouse has remarried. Assuming your spouse has not remarried, he or she would have to use his or her exemption amount to shield his or her estate from federal estate tax. In addition to the exclusion amount, your surviving spouse's estate may also be entitled to a "state death tax credit", based upon death taxes paid to your state, as well as deductions for debts and administration expenses. However, the state death tax credit allowed against the estate tax will be reduced by 25% in 2002, 50% in 2003, 75% in 2004 and repealed completely thereafter. In 2005, the state death tax credit is repealed and replaced with a deduction for state death taxes paid. Because your surviving spouse's exclusion amount can only shield a statutory defined amount from federal estate tax under the current estate tax system, federal estate tax will generally be due to the extent that your surviving spouse's taxable estate exceeds the exclusion amount, unless there are sufficient debts and administrative expense deductions to reduce the tax to zero.

Effective Use of the Applicable Exclusion Amount and Marital Deduction

If you are married, the unlimited marital deduction appears to eliminate all federal estate tax worries for you because the deduction allows you to leave an unlimited amount to your spouse free from federal estate tax. Unfortunately, however, the unlimited marital deduction only defers federal estate tax until your surviving spouse's death. The following examples illustrate how and why the unlimited marital deduction only defers federal estate tax until your surviving spouse's death and also illustrate how the use of a special type of trust can minimize or eliminate federal estate taxes. It should be assumed that both spouses are United States citizens.

Factual Situation. Dr. Johnson has a taxable estate of \$1,600,000.00 and is married with children. Dr. Johnson's spouse's only asset is one-half of the family checking account having a minimal balance.

Ex. 1. Dr. Johnson dies leaving a Last Will and Testament which leaves all of his assets to his surviving spouse. The \$1,600,000.00 passing to his surviving spouse, including one-half of the family checking account, qualifies for the unlimited marital deduction and no federal estate tax is due on such amount. Because no federal estate tax is due upon Dr. Johnson's death, the federal estate tax result seems ideal. Unfortunately, federal estate taxes have only been deferred and not avoided.

Upon Dr. Johnson's death, Dr. Johnson's spouse receives approximately \$1,600,000.00 in assets from Dr. Johnson. The spouse's taxable estate is now worth approximately \$1,600,000.00. When Dr. Johnson's spouse passes away, no marital deduction is available because Dr. Johnson's spouse has not remarried and wishes, in any event, to leave all of the estate to the children. Here, Dr. Johnson's spouse's estate owes approximately \$255,000.00 in federal estate tax.

In this situation, all assets were "bunched" together in the taxable estate of the surviving spouse, since such assets passed directly to the surviving spouse upon Dr. Johnson's death. Because the surviving spouse had not remarried at the time of his or her death and all assets passed directly to children at that time, no unlimited marital deduction was available to the estate of Dr. Johnson's surviving spouse. Therefore, Dr. Johnson's surviving spouse had only the exclusion amount, equal to \$1,000,000.00 in year 2002 of the taxable estate, and another smaller credit, known as the state death tax credit, to shield the taxable estate from federal estate tax. Although Dr. Johnson and the surviving spouse each had separate exclusion amounts, equal to \$1,000,000.00 in year 2002, only the surviving spouse's exemption amount was utilized. Dr. Johnson's exclusion amount was wasted upon Dr. Johnson's death because all of the doctor's assets were left directly to the surviving spouse. As previously noted, an individual cannot use his or her exclusion amount for assets passing to the surviving spouse.

Ex. 2. Dr. Johnson dies, but instead of leaving the entire taxable estate to the his or her surviving spouse, \$1,000,000.00 is left to the children and the balance, \$600,000.00 in assets, is left to the spouse. Dr. Johnson's estate pays no federal estate taxes because the \$1,000,000.00 passing to his children equals Dr. Johnson's

exclusion amount. The balance of the Dr. Johnson's taxable estate, \$600,000.00, which passes to Dr. Johnson's surviving spouse, qualifies for the marital deduction so that no federal estate tax is due. In this case, Dr. Johnson's estate owes no federal estate tax upon Dr. Johnson's death.

When Dr. Johnson's surviving spouse passes away, the surviving spouse's taxable estate includes the \$600,000.00 received from Dr. Johnson, plus the modest family checking account. Dr. Johnson's surviving spouse has an exclusion amount, equal to \$1,000,000.00 in year 2002, to shield his or her taxable estate of approximately \$600,000.00 from federal estate tax. Upon the spouse's death, the spouse's estate pays no federal estate taxes, instead of the approximate \$255,000.00 in federal estate taxes in Example 1. No federal estate tax is due because Dr. Johnson utilized a portion of the exclusion amount upon death, by leaving \$1,000,000.00 in assets to the children. By leaving \$1,000,000.00 in assets to the children, Dr. Johnson limited the amount of assets passing to the surviving spouse to \$600,000.00. Consequently, the surviving spouse has more than enough exclusion amount to shield the assets from federal estate taxes upon death.

While the Johnsons have achieved an ideal federal estate tax result, Dr. Johnson's surviving spouse has lost the use of the \$1,000,000.00 that passed to the Johnson children upon Dr. Johnson's death. Both Dr. Johnson and the surviving spouse would have preferred that the surviving spouse have the use of the \$1,000,000.00 during lifetime, so that the surviving spouse could live in the manner in which he or she had become accustomed.

Ex. 3. Dr. Johnson passes away leaving the entire \$1,600,000.00 taxable estate, other than household items, to a trust known as a "marital deduction/credit shelter trust."

A trust is a written document in which a person instructs another person, or bank how to manage assets placed therein, including how and when income and principal may be paid. The person or bank charged with following the instructions contained in the trust or document is called the "trustee." A trust also generally provides who will receive the person's assets upon death.

A marital deduction/credit shelter trust is a trust that a husband or wife, or both, may create during their lifetimes or upon their deaths. In most cases, husbands and wives create such trusts during their lifetimes in documents separate from their Last Wills.

In the Johnsons' case, use of a marital deduction/credit shelter trust would eliminate all federal estate tax and allow Dr. Johnson's surviving spouse to benefit from the \$1,000,000.00 that would otherwise pass to the children upon Dr. Johnson's death.

Upon Dr. Johnson's death, the trust document creates a trust fund consisting of two parts, called "Trust A" and "Trust B." Some attorneys refer to Trust A as the

marital trust and to Trust B as the credit shelter trust, hence, the name, marital deduction/credit shelter trust.

The trust document generally requires the trustee to place up to the exclusion amount, equal to \$1,000,000.00 in year 2002, of Dr. Johnson's assets into Trust B and to place the balance of his or her assets into Trust A. In our example, approximately \$1,000,000.00 would be placed in Trust B and approximately \$600,000.00 would be placed in Trust A upon Dr. Johnson's death.

Dr. Johnson's surviving spouse would be the primary beneficiary of the \$600,000.00 placed in Trust A. Dr. Johnson's surviving spouse could be allowed to demand all the principal and income from Trust A at any time. Alternatively, Dr. Johnson's surviving spouse could be given the right to all income from Trust A, as well as the principal from Trust A, if the trustee determined that a principal payment was necessary so that the surviving spouse could continue to live in his or her accustomed manner. Under current tax law, the \$600,000.00 in assets passing to Trust A would be deemed to pass to Dr. Johnson's surviving spouse and, therefore, qualify for the marital deduction. Therefore, no federal estate tax would be due on the \$600,000.00 in assets passing to Trust A.

Dr. Johnson's surviving spouse could also be the primary beneficiary of the \$1,000,000.00 in assets passing to Trust B. The trust document could allow the trustee to pay all income to the surviving spouse and to pay Trust B principal and income to the surviving spouse for health, maintenance and support.

In a properly drafted trust, all assets placed in Trust B would qualify for the exclusion amount even though the surviving spouse is Trust B's sole beneficiary during her lifetime. Upon the surviving spouse's death, the \$1,000,000.00 placed in Trust B at the time of Dr. Johnson's death, and any appreciation of those assets, would not be subject to federal estate tax. If the trust is properly drafted, the assets placed in Trust B would not be treated as being owned by the surviving spouse for estate tax purposes. Only the \$600,000.00 placed in Trust A upon Dr. Johnson's death would be subject to federal estate tax upon the surviving spouse's death. Upon the surviving spouse's death, the surviving spouse's exclusion amount is sufficient to eliminate all federal estate tax on the \$600,000.00 that the surviving spouse is deemed to own.

Ex. 4. The examples, above, are based upon the assumption that Dr. Johnson passes away first. Let us now assume that Dr. Johnson's spouse passes away first, owning only one-half of the family's modest checking account. As with the examples above, let us further assume that Dr. Johnson, but not the spouse, has created a marital deduction/credit shelter trust and that Dr. Johnson has a \$1,600,000.00 taxable estate. Assume Dr. Johnson's spouse's Will leaves everything to Dr. Johnson. Upon the spouse's death, no federal estate tax is due because the checking account passes to Dr. Johnson and qualifies for the marital deduction. Upon Dr. Johnson's death, however, approximately \$255,000.00 in

federal estate tax is due, even though Dr. Johnson has established a marital deduction/credit shelter trust.

Dr. Johnson's spouse's exemption amount, equal to \$1,000,000.00 in year 2002, was wasted because the spouse died first, owned minimal assets, the family checking account, and did not have his/her own marital deduction/credit shelter trust. After the death of Dr. Johnson's spouse, Dr. Johnson's taxable estate was still worth \$1,600,000.00.

Ex. 5. Prior to Dr. Johnson's death, Dr. Johnson makes a gift of 1/2 of the assets, \$800,000.00, to his or her surviving spouse. There is no gift tax on the gift because it qualifies for the unlimited marital deduction under the gift tax law. Dr. Johnson's surviving spouse also creates a marital deduction/credit shelter trust. Dr. Johnson's spouse passes away first, leaving \$800,000.00 to a marital deduction/credit shelter trust. All of such assets pass federal estate tax-free into Trust B, the credit shelter portion, of the spouse's trust, shielded by the exclusion amount. During Dr. Johnson's lifetime, Dr. Johnson receives the income from the credit shelter trust. Dr. Johnson then dies. Dr. Johnson's taxable estate is now \$800,000.00, rather than \$1,600,000.00. The \$800,000.00 held in the spouse's credit shelter trust is excluded from Dr. Johnson's taxable estate. Dr. Johnson's own exemption amount is, therefore, sufficient to shield the \$800,000.00 from the federal estate tax. By each instituting marital deduction/credit shelter trusts and rearranging their property ownership, the Johnsons have avoided federal estate tax on the \$1,600,000.00 in assets that pass to their children.

Through the proper use of marital deduction/credit shelter trusts and appropriate arrangement of property ownership, married couples can pass up to 2 million dollars in year 2002 federal estate tax-free to their children or other beneficiaries. Marital deduction/credit shelter trusts can help insure that husband and wife each utilize their exemption amounts. For married couples with aggregate taxable estates exceeding 2 million dollars, in year 2002, additional estate planning is currently necessary to eliminate or minimize federal estate tax. In the above examples, the Johnsons' aggregate estates totaled approximately \$1,600,000.00.

Let us now assume that Dr. Johnson and Dr. Johnson's spouse each have taxable estates of \$1,600,000.00, \$3,200,000.00 in total, and that the Johnsons have each established marital deduction/credit shelter trusts and have divided their assets so that each of them own assets having equal value. Only 2 million dollars of their total aggregate taxable estates of 3.2 million dollars would be shielded from taxes by the marital deduction/credit shelter trusts, \$1,000,000.00 for the first to die and \$1,000,000.00 for the second to die. The excess of their taxable estates over 2 million dollars would still be subject to federal estate tax on the death of the surviving spouse.

Additional planning considerations face unmarried individuals who only have one exemption amount available. Normally, such additional estate planning includes a program of planned gifts. Proper use of gifts can reduce the value of the taxable estate and thereby reduce or eliminate federal estate taxes under current law.

Gifts

Under federal law, you are entitled to a \$10,000.00 per year "annual exclusion" for each gift recipient. You may use your annual exclusions only for gifts that you make during your lifetime, and, in certain circumstances, gifts made by your spouse during his or her lifetime. The annual exclusion allows you to give up to \$10,000.00 per year to each gift recipient; son, daughter, grandchild, friend, etc., free of gift tax and without depletion of your exclusion amount. Married persons may, as a married couple, give up to \$20,000.00 per gift to each recipient per year.

For example, assuming Dr. and Mrs. Johnson had two children in the example above, they could give, together, to each of the children \$20,000.00 per year free from gift tax and without depletion of their exclusion amounts. To the extent the Johnsons, together, exceeded the \$20,000.00 limit to one of their children, the Johnsons would commence to deplete their respective exclusion amounts. For example, if Dr. Johnson and spouse gave \$30,000.00 to their son in year 2002, and had not depleted their exclusion amounts, no gift tax would be due as illustrated below:

\$30,000.00	Gift to son
- \$10,000.00	Dr. Johnson's annual exclusion shields \$10,000.00 in value
- \$10,000.00	Spouse's annual exclusion shields \$10,000.00 in value
- \$ 5,000.00	Dr. Johnson's exclusion amount reduced by \$5,000.00
- <u>\$ 5,000.00</u>	Spouse's exclusion amount reduced by \$5,000.00
\$ -0-	tax on gifts

After making the gift described above, each of the Johnsons would still have the ability to pass up to \$995,000.00 in year 2002 estate tax free to their heirs (\$1,000,000.00 - \$5,000.00 = \$995,000.00). The Johnsons' use of gifting is especially advantageous if the assets which the Johnsons have given away appreciate in value. For example, if the \$30,000.00 in assets given to the Johnsons' son is worth \$90,000.00 upon the death of Dr. Johnson and his or her spouse, the Johnsons would have succeeded in giving away \$90,000.00 to a son, although the value of the gift for gift tax purposes was \$30,000.00.

Gifts Qualifying For the Annual Exclusion

To qualify for the \$10,000.00 annual exclusion for each gift recipient, your gifts must be of a present interest in the asset you are giving away. An outright gift to a child or grandchild or other gift recipient is a present interest and, therefore, qualifies for the annual exclusion. Other types of gifts such as the following qualify as present interest even though they are not outright gifts:

1. Gifts to custodianships under the Uniform Gifts to Minors Act or the Unified Transfers to Minors Act; and
2. Gifts to Irrevocable "Crummey" trusts; and
3. Gifts to "2503(b) trusts" or "2503(c) trusts."

Gifts to Custodianship Accounts

Gifts to custodianships are gifts of a present interest that qualify for the annual exclusion. A custodianship is a special account that can be established at a bank, brokerage house, or other financial institution for a person who has not attained age 21. The account is held by a custodian for the gift recipient until the recipient attains age 21. The custodian may be any person or, in some cases, a financial institution. When the recipient attains age 21, he or she receives a full right of possession to the entire account. Prior to the recipient's attaining age 21, the custodian may make payments for the benefit of the gift recipient, including payments for health and education.

Although custodianships are useful, assets transferred to a custodianship account become the outright property of the gift recipient when the gift recipient attains age 21. Age 21 may be too young for a person to receive a large windfall. If you live in a state that has not recently updated its custodianship laws, the gift recipient may even be entitled to outright ownership of the account upon attaining age 18. Before creating a custodianship account, check with an attorney in your state to determine at what age outright ownership occurs. Additionally, great care must be taken in choosing a custodian. Ironically, the parent of the gift recipient is not necessarily the ideal choice for custodian because the parent might be able to utilize the assets in the custodianship account to satisfy his or her support obligations to the gift recipient. If the parent can utilize the funds to satisfy support obligations, the custodianship assets may be included in the taxable estate of the parent, should the parent pass away prior to the termination of the custodianship account.

Irrevocable Crummey Trusts

One way to delay outright ownership of gifts beyond age 21, and to make such gifts present interests qualifying for the annual exclusion, is the use of an irrevocable Crummey trust. The trust is a written document in which you instruct another person, or bank, how to manage the assets placed therein, including how and when income and principal may be paid. Trusts also generally provide who will receive the assets placed therein upon your death. Again the person or bank charged with following your instructions in the trust is called the trustee.

A Crummey trust is an irrevocable trust that you establish during your lifetime. An irrevocable trust is a trust that you cannot modify or revoke during your lifetime. You may not demand assets back from a Crummey trust after they are placed in the trust. The name Crummey trust has its origin in a famous case known as Crummey v. The Commissioner of the Internal Revenue, which Mr. Crummey won.

One requirement of a Crummey trust is that the trust's beneficiaries be given notice when contributions are made to the trust. Beneficiaries are then generally given from 30 to 60 days to withdraw their share of the contribution. It is the beneficiary's withdrawal power that qualifies the contribution to a Crummey trust as a present interest qualifying for the annual exclusion. In the case of beneficiaries who are minors, notices can be given to the minors' legal guardians. Assets placed in a Crummey trust may be utilized for the benefit of the trust's named beneficiaries, even while the creator of the trust is alive. For example, assets that you place in a Crummey trust

could be utilized for your children's education, college tuition and related expenses while you are alive.

You may also use a Crummey trust to pass life insurance proceeds to your intended beneficiaries free of federal estate tax. To accomplish this tax-free transfer of life insurance, the crummey trust initially purchases and owns the life insurance policy. Each year, the creator of the trust deposits to the trust an amount equal to the annual insurance premium. The trustee then pays the annual premiums. The annual insurance premiums are generally less than the number of annual exclusions available, generally equal to the number of trust beneficiaries.

You may also transfer a pre-existing life insurance policy into a Crummey trust. If you transferred a pre-existing policy to a Crummey trust, you would have to survive three years after the transfer in order for the life insurance policy to be excluded from your taxable estate. Crummey trusts may also be drafted so that your spouse can benefit therefrom after your death and not have to include the assets in the Crummey trust in his or her taxable estate.

Section 2503(b) and 2503(c) Trusts

Two other types of gifts that qualify for the annual exclusion are gifts to so-called "2503(b) trusts" and "2503(c) trusts." These two types of trusts take their name from the sections of the Internal Revenue Code which permit gifts to them to be treated as present interests, qualifying for the \$10,000.00 per recipient annual exclusion.

A section 2503(b) trust is a trust that requires payment of income to its beneficiary. A possible advantage to the section 2503(b) trust is that there is no requirement that any trust principal ever be paid to the trust beneficiary. Thus, a 2503(b) trust could be ideal for immature, inexperienced, or financially irresponsible beneficiaries. The disadvantage to a section 2503(b) trust is that only the value of the gift of income qualifies for the annual exclusion. The value of the gift of income is determined by using tables issued by the IRS and would depend upon: (i) how long the trust beneficiary would be receiving the income; and (ii) a certain interest rate specified by the federal government. Because the annual exclusion is only available for the value of the gift of the income, gifts to a section 2503(b) trust would deplete some of your exemption amount.

A section 2503(c) trust is a trust that requires that all trust property and income be paid to the beneficiary when he or she attains age 21. If the beneficiary dies before reaching 21, the trust must be paid to such beneficiary's estate or to persons specified by such beneficiary. Prior to the beneficiary's attainment of age 21 or his or her death, trust property and income therefrom may only be expended for the benefit of the beneficiary. One advantage to this type of trust over the 2503(b) trust, is that income does not have to be paid to the beneficiary. Rather, the trustee is given discretion to determine whether trust property and income should be paid to the beneficiary. One disadvantage is that trust property and income of the 2503(c) trust must be paid to the beneficiary upon the beneficiary's attainment of age 21.

Unlimited Exclusions for Gifts for Tuition and Medical Care

In addition to the \$10,000.00 per recipient annual gift tax exclusion, you are entitled to an unlimited gift tax exclusion for certain payments for tuition and medical care.

The tuition exclusion only applies to gifts for tuition and does not include gifts for books, supplies, room and board.

The unlimited exclusion for medical care generally applies only to the diagnosis, cure, mitigation, treatment and prevention of disease and expenditures designed to affect the structure or function of the body. The exclusion is not available to the extent that the gift recipient is reimbursed for medical expenditures by insurance.

Gifts for tuition and medical care must be made directly to the service provider in order to qualify for the unlimited exclusion. The unlimited exclusion is not available if the gift is made directly to the student or patient. For example, college tuition payments should be paid directly to the educational institution. If you give the student the tuition funds and the student pays the tuition, the unlimited exclusion is not available. The gift may, however, qualify for the \$10,000.00 annual exclusion. If neither the unlimited exclusion nor the \$10,000.00 annual exclusion are available, you would deplete some of your exclusion amount.

Gifts to Spouses — The Gift Tax Marital Deduction

Just as the federal estate tax allows an unlimited deduction for gifts to a surviving spouse, there is an unlimited gift tax marital deduction for lifetime gifts to your spouse. Although the deduction is generally unlimited, there is an exception for gifts to spouses who are not United States citizens. Gifts to noncitizen spouses do not qualify for the marital deduction. Rather, such gifts may qualify for a statutory spousal annual exclusion. Gifts to a noncitizen spouse are limited because the federal government is concerned that a noncitizen spouse would receive a gift and then leave the United States. Regardless of this rationale's doubtful validity, great care must be taken in developing an estate plan for a married couple when one of the spouses is not a United States citizen.

Gift and Estate Tax Charitable Deduction

Lifetime and deathtime gifts to charities are generally gift and estate tax-free because they generally qualify for the gift tax and estate tax charitable deductions. Unlike the charitable income tax deduction, there are no percentage restrictions on the amount of the gift and estate tax deductions to be taken. The deduction is available only for amounts that actually pass to a charity. Therefore, if your Will or other estate planning documents, your trust, for example, requires that administration expenses and taxes be paid from assets that you leave to a charity, your estate tax charitable deduction may be reduced by such taxes and expenses. To the extent that taxes are payable from assets passing to charity, the calculation of the estate tax may become difficult, requiring an interrelated calculation.

In addition to outright gifts to charity, certain types of trusts may be utilized to satisfy your charitable inclinations. One type of trust provides that you and/or your spouse and/or other

family members receive the right to an annuity from trust assets, and that upon the death(s) of such person(s), a charity receives the balance of the trust. Other types of trusts create private foundations that may directly carry out charitable purposes or benefit other charities. To receive a gift tax or estate tax charitable deduction for gifts to all of such trusts, the trusts must adhere to strict rules. Persons with those with charitable motives should carefully consider the advantages and disadvantages of charitable trusts with proper advice.

Liquidity Planning

In some instances, even the use of marital deductions/credit shelter trusts, Crummey trusts, charitable trusts, gifts and other estate planning techniques will not eliminate federal estate taxes. In such cases, one of your goals should be to develop a source of liquid assets from which to pay estate taxes. Development of a source of liquid assets is particularly important if a substantial portion of your taxable estate consists of real estate or other illiquid assets. Life insurance may be the appropriate vehicle with which to create the source of funds. In the alternative, you may consider a planned program of investing in marketable stocks, bonds, securities and other investments.

Living Trusts to Avoid Probate

Probate is the process by which a court supervises the transfer of assets of a deceased person to a deceased person's heirs or beneficiaries. Probate generally involves the probate court's appointment of a person or bank to ensure that assets will pass as provided by the deceased person's Will or by state law, in cases in which there is no Will. When probate is necessary, a court will generally appoint a representative responsible for locating and identifying the deceased person's assets, paying the deceased person's bills and estate taxes and distributing the balance of estate assets to the various heirs. In cases in which the deceased person left a Will, the court-appointed representative may be called an executor or executrix. In cases in which the deceased did not leave a Will, the representative may be called an administrator or administratrix. In some states, the term "personal representative" is utilized to describe the court-appointed representative.

As a general rule, the only assets supervised by the court are those assets that do not pass through other arrangements, which include:

1. Life insurance having a named beneficiary;
2. Assets owned jointly with rights of survivorship;
3. Bank accounts and other accounts payable on death to certain persons;
4. IRA's and other retirement benefits passing by beneficiary designation; and
5. Assets owned in a living trust.

The key disadvantages to probate are the attorney fees incurred in handling matters with the court and the fact that all information filed with the court is generally public record. Despite common belief, court costs are generally minimal and probate does not generally increase the amount of estate taxes to be paid.

The common link between the methods of avoiding probate, described above, is that they are a matter of independent contract between you and another party. For example, insurance companies are bound, by contract to pay to your designated beneficiaries the life insurance proceeds. Similarly, banks are generally required to pay joint and survivorship bank accounts to surviving owner, as a matter of contract.

One of the most popular ways to avoid probate is through the use of a living trust. Living trusts are effective to avoid probate in many states. As previously indicated, a trust is a written document in which you instruct another person, or bank, how to manage assets placed therein, including how and when income and principal may be paid. In effect, a trust is an entity created by a written document for the purpose of holding, managing, and distributing assets. In addition to providing how most assets will be managed during your lifetime, the trust will also provide who will receive your assets upon your death.

You place assets into your trust by changing the owner of the assets to the trustee. The trustee is the person or bank charged with following the instructions contained in the document trust. In many states, the creator of the trust may also be the trustee. For example, Dr. Smith could place a bank account into a trust by changing the owner from "Dr. Smith" to "Dr. Smith, Trustee of the John Smith Trust, dated November 11, ____." With regard to stocks and bonds, Dr. John Smith could transfer such investments to the trust by having a brokerage account titled in the name of "John Smith, Trustee of the John Smith Trust, dated November 11, ____" or, if Dr. Smith held certificates, by having the certificates retitled in the name of "John Smith, Trustee of the John Doe Trust, dated November 11, ____." The foregoing examples assume that the date of the trust was November 11, ____ and that Dr. Smith would be serving as his own trustee.

A living trust avoids probate because the trust is an entity which continues in existence after your death. Upon your death, the person then named to serve as trustee follows your instructions with respect to distribution of your assets. The living trusts can be structured so that it is marital deduction/credit shelter trust after death.

Many married couples own all their assets jointly with right of survivorship because such ownership will result in avoidance of probate. While such survivorship ownership is an effective planning tool to avoid probate, such ownership can lead to poor estate tax results. For example, survivorship ownership may result in all of your assets passing directly to your surviving spouse, thereby wasting your spouse's exclusion amount. Conversely, assets held in a living trust, that becomes a marital deduction/credit shelter trust upon death of the first spouse, will utilize the exclusion amount to the extent of the assets in, or passing to, the trust and such assets will be available for your spouse's benefit, as set forth in the trust document.

Certain assets should not be transferred to a living trust. For example, IRA's should generally continue to be held by the financial institution as custodian. As you make withdrawals from your IRA's, such withdrawals can be added to a living trust. Similarly, profit-sharing plans and other qualified retirement accounts should generally continue to be held by the plan's trustee. The problem with placing an IRA or other qualified retirement asset into a living trust is that you will be treated as receiving the assets for income tax purposes. Always consult with your tax advisor prior to making withdrawals or modifications with respect to your IRA's and qualified retirement plan assets.

Your Will

Your Last Will and Testament is the document that directs the disposition of your assets upon your death. If you do not have a Last Will and Testament, the law of your state will control who will receive your assets. If you are married and pass away without a Will, your surviving spouse will generally be entitled to a portion of your assets, but not necessarily all of your assets. Therefore, your Last Will and Testament is an essential document in your estate plan.

In addition to specifying who will receive your assets, your Last Will and Testament is also the document in which you can name an executor and guardians for your minor children. If you do not specify an executor or a guardian, the law of your state and the state court will generally determine who will serve in those capacities.

A frequently asked question is whether a Last Will and Testament is necessary if you have signed a living trust and have placed all of your assets therein or if all of your assets are otherwise owned in a manner designed to avoid probate. e.g., jointly with right of survivorship. Even if you have taken one or more of these steps in order to avoid probate, a Last Will and Testament is necessary for two reasons. First, to the extent that you have not transferred all of your assets into your living trust prior to your death, your Last Will and Testament would be needed in order to specify that such assets be placed in your trust. Secondly, a Last Will and Testament would still be necessary to appoint guardians for your minor children. Therefore, a Last Will and Testament is an essential part of any estate plan, whether or not the estate plan has been designed to avoid probate and whether or not you have instituted a living trust.