

What Every Lawyer Should Know About Estate Planning – Part II

Utah State Bar, Summer Convention

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I. Open

- a. Welcome and Introduction
- b. Follow up on Andrew L. Howell presentation last year – Part I
- c. Part II - Recent changes and advanced ideas discussing ways to help clients in estate planning and asset protection by recognizing opportunities and being familiar with a few techniques
 - i. Tax (estate tax primarily and some income tax planning)
 - ii. Asset Protection
 - iii. Charitable Giving
- d. Overview
 - i. Malpractice issues
 - ii. Recent estate law changes
 - 1. 2010 election
 - 2. 2011 new exemption amount for estate and gift tax
 - 3. Portability
 - 4. A/B, credit shelter, bypass (marital/family) trusts
 - iii. Estate planning ideas
 - 1. Estate tax strategies
 - 2. Asset protection strategies
 - 3. Charitable giving strategies

II. Malpractice

- a. Statistics show that 4 out of 5 lawyers will be sued for malpractice during their career and that no group of lawyers is immune – new lawyers, experienced lawyers, solo practitioners, those in big firms, rural or urban based, malpractice claims are non discriminatory.
- b. Historically estate planning attorneys have been more immune from malpractice claims than those practicing in other areas. Much of this immunity came from the concept of privity. If the attorney represented only the client and the client is now dead, there is no client to bring a claim against the attorney. The concept of privity has eroded over the years and more and more courts are allowing beneficiaries (who were never a client of the lawyer) to bring malpractice claims against the lawyer.
- c. In both the number of claims and cost of such claims, estate planning and probate has become the third largest category of malpractice claims against attorneys and appears to continue on the upward trend for years to come. In a report published by the American Bar Association in 2003, Estate, Trust and Probate accounted for 9% of all malpractice claims.
- d. The “baby boomer” cohort, those born between 1946 and 1964, is dramatically increasing the 60+ population. The U. S. Census Bureau predicts that the senior population in the U. S. will increase to 70.2 million by the year 2030, and that Utah’s senior population (65 and older) will grow to 482,542 by the year 2030. Utah’s 65+ population will increase by **165 percent** between 2000 and 2030. In addition, the 85+ population in Utah will increase by **123 percent** between 2000 and 2030.
 - i. Upon the death of the baby boomers it is expected that over \$40 billion of worth will pass to the next generation. Such a transfer of wealth is sure to trigger strong emotions among family members, many of whom have a very fragile relationship already and whose scars from years past have never healed and thus they are willing to fight against each other or anyone involved in the planning no matter the cost.
 - ii. With these changing demographics and massive amounts of intergenerational wealth transfer, there is more and more work being done and that will need to be done in this area, thus more opportunities for exposure to malpractice claims.
- e. The claims for malpractice in estate planning and probate come in a variety of ways:
 - i. 40% involved preparation of documents;
 - ii. 16% are characterized as advice claims;
 - iii. 9% result from a failure to know the substantive law or issues relating to the specific practice of estate planning (dabbling in estate planning or probate) – these lawyers are significantly more claims prone, especially if doing the planning or probate for friends and family members.
 - iv. Claims include:

1. Failure to spot and handle the estate tax, income tax, GST tax issues.
 - a. Clients purchase large insurance policies that end up being included in the clients taxable estate (ILIT)
 - b. Failure to make use of tax elections
 - c. Failure to make tax-free gifts during life
 - d. Assisting in gifting without recognizing the generation skipping transfer tax (GST)
2. Improper titling of assets
 - a. Improper beneficiary designations on life insurance and retirement accounts
 - b. Clients sale, purchase, move assets and bank accounts and fail to properly title them in the trust or establish POD's.
 - c. Many clients like the idea of using joint tenancy with rights of survivorship as a simple alternative to estate planning and they put their children on the deed to their home to avoid probate etc. upon their death. What they fail to recognize is that they have also given the home to the children during their life and if a child is sued or bankrupt, mom and dad may lose their home and the children will also lose the step-up in basis in the assets
3. Not naming successor executors, agents and trustees
4. Failure to understand and advise probate clients of the elective share, exempt property, homestead and family allowance statutes and how they work in their favor
 - a. Probate may be good (especially for business owners) and the family should be advised to file a probate and give notice to all unknown creditors, not doing so may result in creditors making claims on the estate months or years after the death of the client
5. Failure to understand and apply the intestacy statutes appropriately
6. Failure to understand the right and beneficial impact of renunciation or disclaimers
7. Failure to properly administer the estate
 - a. specifically when charitable organizations are involved
8. Failure to understand the statutes of limitations
9. Failure to follow instructions or intent of testator
 - a. Not following or having notes with how documents are to be drafted
 - b. Client or beneficiaries recalling something said or done (or not said or not done) and lawyer remembering it differently
10. Inadequate discovery/investigation
11. Not determining or documenting capacity or undue influence
 - a. As the life expectancy increases so does the possibility for fraud, undue influence and lack of capacity

- b. Why is this client/caretaker/beneficiary or child seeking your help to make changes to a Will or Trust rather than the original drafting attorney? Are the requested changes really the intent of the Testator?
- 12. Making preliminary distributions without regard to future liabilities
- 13. Error in execution
 - a. Many claims brought against planners involve very simple matters, such as having insufficient or improper witnesses or improper witness and attestation clauses
- 14. Delay in drafting or implementing plan
- 15. Failure to update planning with new laws
- 16. Not keeping with regular formalities when working with friends and family

- f. Strategies to avoid malpractice claims in estate planning
 - i. Be specific in engagement letter and follow it
 - ii. Clearly identify who you represent and the scope of such representation, perhaps even disclaiming any responsibility for the tax effect of such planning on the beneficiaries. Certainly when married couples are clients, the engagement letter needs to clarify what conflicts may arise and what action will be taken when such conflicts do arise.
 - iii. Use specialists
 - 1. If the client desires to move assets out of his or her taxable estate by using tools such as gifting through a family limited partnership, irrevocable life insurance trusts or sales to intentionally defective grantor trusts or grantor retained annuity trusts, it is best to partner with attorneys that understand such complex planning and allow them to guide the client through these planning techniques
 - iv. Document strategies rejected by client
 - 1. Many times clients desire to leave only a portion of assets to a surviving spouse, not taking advantage of the unlimited marital deduction and thus leaving their estate subject to estate tax upon the death of the first spouse (rather than the death of the second spouse). Such strategies must be clearly documented as the clients intent so no future claim against the attorney can be made for not advising the client otherwise. Document the advice, that the client rejected it and why. If a client disinherits a child, document why and that the language in the Will was made at the specific instruction of the client.
 - v. Don't miss deadlines
 - vi. Use proper care in execution
 - 1. Ensure capacity
 - 2. Ensure no undue influence
 - vii. Communicate in writing
 - viii. Keep up on current estate and trust local and national law and especially keep current on IRS regulations and procedure and the Internal Revenue Code.

III. Recent changes – January 1 2010 a day most estate planners never thought would come; no estate tax; a chance for heirs of the very wealthy to receive billions of dollars estate tax free.

a. Estate Tax

- i. No estate tax was the rule for those who died in 2010 until December 17, 2010 when President Obama signed into law the Tax Relief, Unemployment Insurance Authorization and Job Creation Act of 2010. The law created a never before seen situation for the heirs of America's wealthiest families. The law allows the executor of an estate to make an affirmative election on the 706 estate tax return to elect to have the 2010 rules of no estate tax apply (with a modified carry-over basis of \$1.3m, plus \$3m for assets left for a surviving spouse) or to do nothing and allow the default "new" rule of 2011 apply which is an estate tax exemption of \$5m, a top rate of 35% and a full step up in basis on assets owned by the decedent. America's wealthiest families will most certainly elect to have the 2010 "no estate tax" rules apply allowing massive amounts of wealth to pass estate tax free and costing the US treasury approximately \$8.75 billion in estate tax revenue that it could have generated because of the death of just 5 of the billionaires that died in 2010 (not counting all the millionaires that died).
- ii. Estate Tax Exemption for 2011 and 2012: The new \$5m exemption is set to sunset January 1, 2013 when the exemption reverts back to \$1m per person with a top rate of 55%.
- iii. Gift Tax Exemption for 2011 and 2012: \$5m per person lifetime gift exemption (\$10m per couple), in addition to the \$13,000 annual gift tax amount a donor can give to as many persons as they wish gift tax free. (Gift tax is a tax on the donor, not the donee). (GST exemption only \$1m)
 1. Opportunity to transfer wealth to the next generation(s) free of gift and estate tax, which may be especially advantageous given the depressed value of assets currently, allowing appreciation to occur outside of the clients estate.
 - a. Recapture or "Clawback" issue – It is unclear what effect the reversion back to \$1m exemption will have on those who make a \$2m-\$5m gift during 2011 and 2012. Based on current law, a recapture will occur; but all future appreciation and income on the gifted assets will be excluded from the taxable estate. Bottom line: wealthy clients should be making gifts to trusts for future generations in the next couple of years, but advisors should explain to them this recapture idea.

b. Portability

- i. The new law also allows for what is called “portability” for the next two years. In the past each spouses estate tax exemption was individual and if not used upon their death it could not be used by the other spouse, hence the use of traditional AB trusts, Credit Shelter trusts, Marital/Family Trusts or Bypass Trusts (all the same thing).
- ii. Portability means that if the deceased spouse did not use his or her exemption amount the surviving spouse can use any unused portion. For example if H dies and has assets of \$4m in his name only, the \$1m of unused exemption can pass to W so that upon her death she can pass \$6m to the children free of estate tax, W’s \$5m exemption plus H’s unused exemption can be used for lifetime gifts or transfers at death.
- iii. Factors
 1. Must file a 706 estate tax return for deceased spouse to elect portability
 2. No portability for \$1m GST exemption
 3. Surviving spouse must be a US citizen
 4. There is no minimum term limit to marriage
 5. Portable amount does not adjust for inflation (as the \$5m exemption does)
 6. If surviving spouse remarries, X and X dies, surviving spouse can only use the exemption of X; the original spouses unused exemption amount is lost.
- iv. Issues
 1. Premarital Agreements – prevent or allow the use of exemption
 2. “No need for trusts” – WRONG
 - a. Only good until December 31, 2012
 - b. Why AB, Credit Shelter, Bypass or Marital/Family Trust are still needed (see below)

- c. Why the A/B, Credit Shelter, Bypass or Family/Marital Trusts are still viable and should be used:
- i. Portability has a very short life
 - ii. Portability does not apply to GST Tax, where a Credit Shelter trust could be free of generation skipping transfer tax (GST) and could be used to fund trusts for children and grandchildren
 - iii. Appreciation/increase in the assets are NOT outside the surviving spouses estate
 1. Example: H dies leaving \$5m to W who has \$3m in assets in her name. Both H's and W's assets double in value before W dies. At W's death she can leave \$10m estate tax free with portability, but she now has a total estate worth \$16m and she pays an estate tax on \$6m (tax of \$2.1m). If a bypass trust had been used, the original \$5m and \$5m in growth would have been out of her taxable estate so upon W's death she would have an estate subject to tax of only \$6m less her \$5m exemption for only \$1m subject to estate tax (\$350k). A potential savings of \$1.75m.
 - iv. No loss of exemption on remarriage
 - v. Creditor protection on assets left in credit shelter trust (protected from spouses creditors)
 - vi. Credit Shelter trust can be managed by others rather than or including surviving spouse (bank, children, etc.)
 - vii. Credit Shelter trust can ensure that the assets pass to the deceased children and grandchildren and not surviving spouses new husband or wife and their children. VERY IMPORTANT FOR 2ND MARRIAGES

IV. Estate Planning Ideas Every Lawyer Should Know

a. Estate Tax Planning Strategies

- i. Irrevocable Life Insurance Trust – remove death benefit from taxable estate
- ii. Estate Freeze with an Installment Sale to a Grantor Trust (Defective Grantor Trust) – see attached diagram
 1. What it is: DGT is a special type of grantor trust designed intentionally with an income tax defect. While the client is deemed the owner of the DGT for income tax purposes, the assets of the DGT are out of the client's estate for estate tax purposes. Sales to the DGT are ignored for income tax purposes because they are, in effect, sales to one's self.
 2. Why we use it: Ability to sell an asset to the DGT and avoid the recognition of gain and "freeze" the value of the asset for estate tax purposes so all appreciation occurs inside the DGT outside of the taxable estate.
 3. Example: John, holds \$4m in closely held stock which has great potential for appreciation/sale or IPO. He desires trust assets be used perpetually for all his descendants and avoid the possibility or risk of future creditors/judgments.
 4. Results: John set up an Alaska LLC & DGT (self-settled) and transferred stock worth \$4m to LLC. John transferred 100% of the LLC interest to the DGT (gift of \$800k using lifetime exclusion and sold \$2m of LLC interest on 20 year interest only note from LLC to DGT at a 30% discount for lack of marketability and lack of control for a total value of \$2.8m). The company sold three years later for \$90m. The shareholder (LLC) receives \$50m in cash after income tax. \$3m is transferred to the Member of the LCC (DGT) which pays \$2m plus interest to client on the note. \$47m is held in LLC and/or transferred to the Trust for discretionary distributions to the trust beneficiaries in perpetuity. If client dies today there is an estate tax savings of almost \$16m. (\$50m less \$5m exemption, taxed at 35% = \$15,750,000)
 5. When to consider: When there is the potential for a dramatic appreciation of asset value – "ESTATE FREEZE" and client wants added asset protection, dynasty trust (perpetual) for benefit of descendants and/or pre marital planning when a Pre-Marital Agreement may not work.

b. Asset Protection Strategies

- i. What asset protection is: Advanced planning to place assets out of reach of potential future unknown creditors, done with full disclosure, by strategic ownership of assets and/or by compartmentalizing risk.
- ii. What asset protection is not: Hiding assets or misrepresenting what a client owns with an intent to hinder, defraud, delay creditors or create insolvency
- iii. Separate Revocable Living Trusts (RLT).
 1. Assets in one spouse's RLT can be protected from potential claims against the other spouse (2005 UT App 87 (Utah App. 02/25/2005))
- iv. Irrevocable Trusts – client no longer owns the assets nor has control over them. (not shown on balance sheet)
- v. Self-Settled Trusts
 1. Historically, the settlor or grantor of a trust could not be a beneficiary, the Rule Against Perpetuities applied to prevent dynasty trusts and only offshore trusts (i.e. Cook Islands) were available for self settled trusts. The offshore trusts were misused for income tax avoidance. Alaska, Nevada and now 12-15 States have adopted similar self-settled trust statutes where the settlor or grantor can be a beneficiary, but the assets are protected from creditors and are outside of the taxable estate.
 2. Domestic – Nevada, Alaska, etc.
 3. Foreign – Cook Islands, etc.
- vi. Summary - **PLAN BEFORE THERE'S A PROBLEM.** Keep enough insurance. Have an umbrella liability policy; maintain proper titling of assets; maximize ownership of exempt assets; fund retirement assets to protect non-exempt cash.

The only asset protection planning worth doing is planning that can be fully disclosed.

c. Charitable Giving.

It is expected that by 2055 \$40 Billion will pass to the next generation (largest intergenerational transfer of wealth in history); many of whom struggle with leaving big money to their children and are leaving to charity instead.

i. Private Foundations. IRS – compliance/approval – much more difficult to get private foundations approved because of recent abuses

i. CRUT

1. Charitable Remainder Uni-trust is a trust that accepts a charitable donation up front which qualifies for an income tax deduction, returns annual payments to the donors based on a set percentage of the corpus of the trust until the death of the donor (or the death of a donor and spouse or some term of years). Following death or term, the remainder of the trust assets go to the designated charity.
2. Great idea for the deferral of tax on the sale of low basis assets for the charitable minded client.

ii. Donor Advised Funds

1. 2006 Pension Protection Act created a statutory definition of a DAF as any fund or account:
 - a. Which is separately identified by reference to the contribution of a donor or donors;
 - b. Which is owned and controlled by the sponsoring organization; and
 - c. With respect to which a donor or person appointed by the donor has or reasonably expects to have advisory rights with respect to investments or distribution
2. The “new” private foundation, great for those charitably minded clients that want to “control” the donation of future funds, but get a tax deduction now.
 - a. Avoid tax on funds going to charity (tithing)
 - b. Pre-funded charitable contributions

Summary of Ideas

1. 2011-2012 gifting
 - a. Outright gifts
 - b. Gifts to trust
 - c. Forgiveness of debt/loans
2. Discounts and estate freeze techniques such as sales to Grantor Trusts
3. Advanced asset protection planning such as self settled Nevada trusts
4. Charitable giving with a donor advised fund

ESTATE FREEZE WITH A SALE TO DGT OVERVIEW

