Insight on Estate Planning

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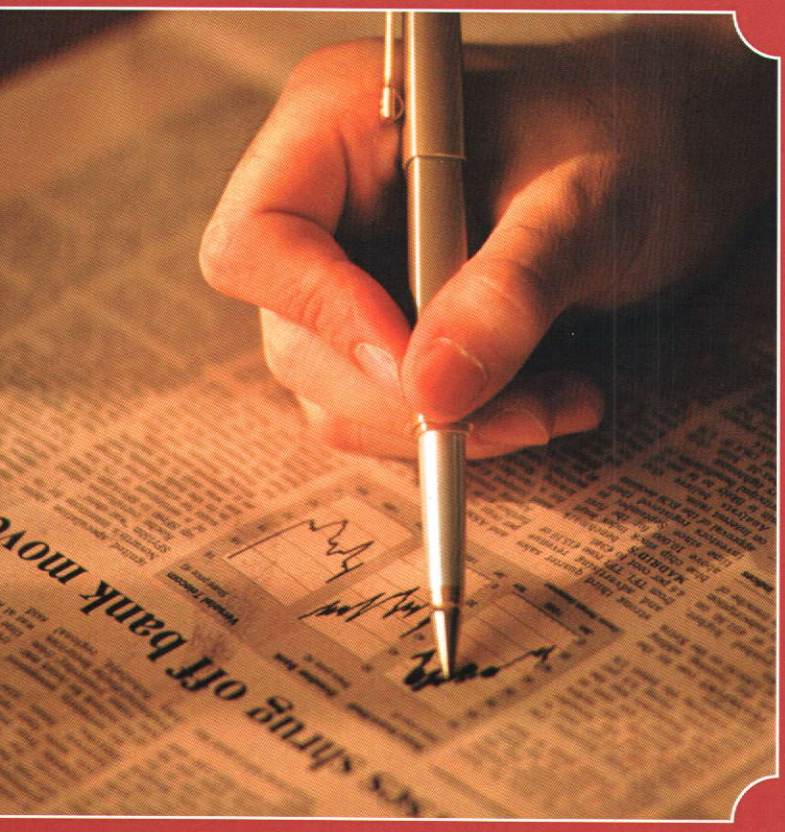

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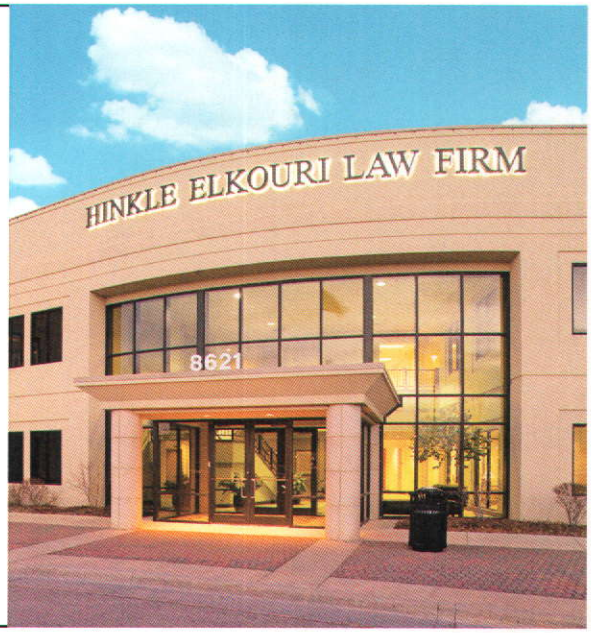


Investing in your estate plan

Whether your wealth matches that of Bill Gates or Warren Buffett, or your resources are more modest, the purpose of estate planning is the same: to ensure your assets are distributed according to your wishes and to preserve those assets so there's something left to distribute when you die.

Asset preservation involves several components, including asset protection techniques (such as creditor protection trusts), minimizing estate taxes and other expenses, and investment strategies designed to provide long-term growth. Let's focus on the investment component.

A balanced approach

Your investments should support the legal and tax planning aspects of your estate plan, so it's important for your lawyers, tax advisors and investment advisors to work together. Designing an investment strategy is challenging because you need to strike a balance between current income or liquidity needs and long-term growth.

As with other types of investment planning, the key to investing for your estate plan is *asset allocation* — that is, identifying the right mix of stocks, bonds, real estate, life insurance and other investments in light of your specific goals, time horizon and risk tolerance. At the same time, estate planning raises unique issues that may require a departure from traditional investment principles.

Many trusts, for example, provide income for you or other "current" beneficiaries and transfer what's left at the end of the trust term to one or more "remainder" beneficiaries. From an investment perspective, these types of trusts put the trustee in a difficult position because investment strategies that maximize current income are often at odds with strategies that maximize long-term growth.

To avoid conflicts between current and remainder beneficiaries, consider providing the trustee with detailed instructions on the investment strategies he or she should follow. Another option is to design the trust as a total return unitrust. This trust type pays out a set dollar amount or percentage of the trust's initial value to the current beneficiaries, allowing the trustee to focus on long-term growth without sacrificing current income needs.

A GRAT strategy

A grantor retained annuity trust (GRAT) can transfer wealth tax free, but you may need to adjust your investment strategy.

A fundamental principle of sound investing is to diversify your portfolio. By spreading your funds over different asset classes, funds, companies, industries, sectors and geographical regions, you reduce the risk that poor performance in one area will negatively affect your overall portfolio. But a GRAT turns this principle on its head: For

this type of trust to be successful, the less diversification the better.

A GRAT is an irrevocable trust that pays you an annuity for a term of years and then transfers any remaining assets to your children or other beneficiaries. When you contribute assets to a GRAT, you make a taxable gift equal to the present value of your beneficiaries' remainder interest, which is determined using a rate of return established by the IRS — the Section 7520 rate. If the assets in a GRAT outperform the Sec. 7520 rate, the excess earnings are transferred to your beneficiaries tax free.

There are two keys to a successful GRAT. First, you must survive the trust term; if you don't, the assets will be pulled back into your taxable estate. (This is known as mortality risk.) Second, the GRAT's investments must outperform the Sec. 7520 rate. Your best chance for achieving that is to segregate different asset classes into separate GRATs. Why? Because it insulates high-performing assets against losses generated by underperforming ones.

For example, let's say Michelle wants to invest $2 million in a five-year GRAT for the benefit of her daughter, Hazel, at a time when the Sec. 7520 rate is 4%. She selects an annuity payment of $449,255, which "zeroes out" the GRAT. In other words, assuming a 4% rate of return, the remainder interest would be zero, so there's no taxable gift.

Suppose that the trustee splits the $2 million between two mutual funds. One earns a 6% return over the GRAT's term, while the other earns only 2%. Because the overall return, 4%, merely matches the Sec. 7520 rate, the GRAT is unsuccessful — that is, it fails to transfer any assets tax free.

Suppose, instead, that Michelle had set up two separate $1 million GRATs investing in the same two mutual funds. The one investing in the 2% fund would fail, but the one investing in the 6% fund would outperform the Sec. 7520 rate, generating a tax-free gift to Hazel of more than $70,000.

This isn't to suggest that you should throw diversification out the window. To minimize your risk, it's important to balance investments in a GRAT with an appropriate mix of assets outside the GRAT (in separate GRATs or individual investments, for example).

In addition to segregating assets into separate trusts, you can also improve your results by using "rolling GRATs" to segregate assets over time. (See "Rolling with the punches" above.)

Many happy returns

These examples are just a few of the investment considerations that can affect your estate plan. By incorporating these considerations into your planning, you may improve the chances of achieving your goals. ▮

Rolling with the punches

Segregating assets into separate grantor retained annuity trusts (GRATs) can improve your chances of insulating strong performers against underperformers. The concept of rolling GRATs applies the same principle to insulate strong performance in one time period against poor performance in another.

Here's how it works: You create a series of short-term GRATs (two years, for example), in which each new GRAT is funded with annuity payments from the previous ones. Rolling GRATs are particularly effective in a volatile market because they're better able to take advantage of short-term upswings.

Over a period of time, many of the short-term GRATs will fail, but all it takes is a handful of GRATs that capture the market's upside to make the strategy a success. Suppose, for example, that you establish a traditional 10-year GRAT when the Section 7520 rate is 5%. If your returns during the 10-year period average only 4%, the GRAT will fail.

A rolling GRAT strategy might stand a better chance of success. Suppose that, while overall performance during the 10-year period is dismal, returns reach 11% during years five and six. Although most of the GRATs would fail, the one created at the beginning of year five would generate a significant tax-free gift.

There's nothing wrong with a defective trust

In recent years, the intentionally defective grantor trust (IDGT) has emerged as one of the most effective techniques available for minimizing taxes in large estates. By combining the estate tax benefits of an irrevocable trust with the income tax advantages of a grantor trust, IDGTs offer some intriguing estate planning opportunities.

Defective reasoning

Irrevocable trusts can allow you to freeze the value of assets for transfer tax purposes. When you contribute property to an irrevocable trust, you're subject to gift tax on its current fair market value, but all future appreciation in value passes to your beneficiaries tax free.

An IDGT (also referred to as an intentionally defective irrevocable trust, or IDIT) behaves like other irrevocable trusts for estate tax purposes, but by retaining certain powers over the trust (such as the right to reacquire trust assets by substituting other property of equal value), you can make it "defective" for income tax purposes. In other words, the assets are removed from your estate, but the IDGT is treated as a grantor trust for income tax purposes.

An IDGT can be an ideal vehicle for selling assets that have appreciated in value and are expected to continue appreciating.

Because you're treated as the owner of a grantor trust, you report the trust's net income on your individual tax return. Why is that a good thing? Because paying the trust's income taxes allows you to substantially increase the amount of wealth your beneficiaries receive without triggering additional gift or estate taxes.

Ordinarily, an irrevocable trust is responsible for its own taxes, which consume a portion of its assets. By structuring the trust as a grantor trust for income tax purposes, however, you achieve the equivalent of an additional tax-free gift to your beneficiaries: Your income tax payments reduce the size of your estate while increasing the trust's value by the amount of income taxes it would otherwise have paid.

The IRS has given its full blessing to this technique, ruling that a grantor's payment of taxes for a properly structured grantor trust doesn't constitute an indirect gift to the trust's beneficiaries.

Selling power

An IDGT can be an ideal vehicle for selling assets that have appreciated in value and are expected to continue appreciating. In a typical transaction, you make a taxable gift of seed money — say, 10% of the purchase price — to the trust. Next, you sell property to the trust in exchange for a promissory note.

A grantor trust is treated as the grantor's alter ego for income tax purposes. Essentially, a sale to an IDGT is a sale to yourself, so you won't recognize any capital gain or loss on the sale, nor will you owe any taxes on the note payments. You will, of course, pay taxes on the trust's net income.

The property sold to the IDGT — along with all future appreciation — is removed from your taxable estate. In addition, so long as the purchase price is equal to the property's fair market value and the note bears adequate interest at the applicable federal rate (AFR), there's no gift tax on the transaction. To the extent that the trust's earnings and appreciation top the AFR, the excess is transferred to your beneficiaries tax free.

IDGTs are particularly effective for sales of interests in closely held businesses, such as S corporations or limited liability companies. Even though an IDGT is treated as the grantor's alter ego for income tax purposes, it's treated as a separate entity for valuation purposes. Thus, minority interests sold to the trust are entitled to valuation discounts for lack of control and lack of marketability. These discounts reduce the amount of the note, maximizing the value transferred to your beneficiaries.

Better than a GRAT?

In many cases, a sale to an IDGT will be preferable to a GRAT. Why? GRATs are subject to mortality risk — if the grantor fails to survive the trust term, the trust assets are subject to estate taxes. With a sale to an IDGT, if the grantor dies before the note is paid, the unpaid balance will be included in his or her estate, but the underlying assets — together with any appreciation in value — will escape taxation. Whether the grantor's death before the note is paid will trigger income tax consequences is uncertain, though most estate planning professionals believe that it will not.

Another advantage of an IDGT is that the applicable federal rate used to determine the note payments is generally lower than the rate used to determine the size of a GRAT's annuity payment. Plus, an IDGT offers greater flexibility to vary the size of payments to the grantor.

On the other hand, a GRAT doesn't require you to put up seed money, and the law governing GRATs is better established. IDGTs aren't specifically sanctioned by the tax code, so they may be more susceptible to IRS scrutiny. Also, if the IRS finds that assets sold to an IDGT were undervalued, you may be subject to gift tax on the difference. With a GRAT, revaluation is less of a risk because you may be able to avoid or minimize gift taxes by adjusting the annuity payments.

In either case, conventional wisdom says that it's a good idea to file a gift tax return — whether the transaction is taxable or not — to start the clock on the statute of limitations for revaluation.

A flexible tool

The IDGT is a flexible tool with the potential to achieve significant gift and estate tax savings. With creativity and careful planning, it can be used to overcome a variety of estate planning challenges. ▮

Policy decisions

Is it time to cash out your life insurance?

Life insurance is a critical component of most estate plans because it can create a new source of wealth and liquidity to pay taxes and other expenses and to provide for your family. But there may be times when you need your assets to go toward something else. For example, maybe the continued premium obligations are putting a strain on your finances. Or your adult children are financially independent and don't need the insurance proceeds.

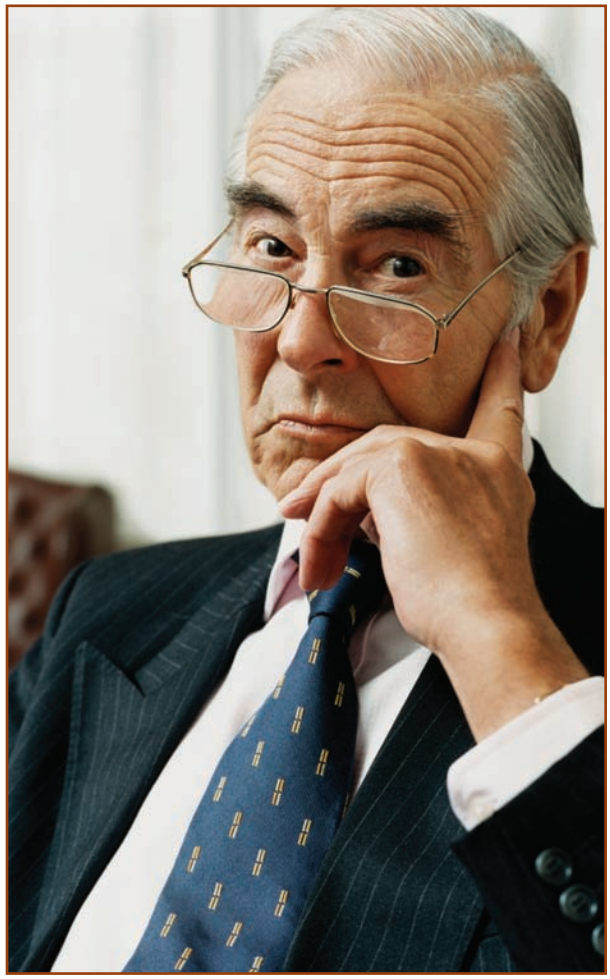
What are your options?

Let's consider Frank's situation. Frank is 70 years old and in good health, with a life expectancy of 13 years. His $2 million permanent life insurance policy, which he's owned for many years, has a cash surrender value of $500,000. Frank's tax basis in the policy, based on premiums paid, is $300,000.

Frank's family no longer needs the coverage, and Frank would love to use the money that's currently going toward paying the premiums for something else. He has several options:

Surrender the policy for its cash value. This is likely the worst option Frank can take because the amount by which the cash value exceeds his basis in the policy — $200,000 — is taxable at ordinary income tax rates as high as 35%.

Rates on charitable gift annuities typically are lower than those available on commercial annuities, but they're ideal if your objective is to balance current income needs with philanthropic objectives.



Tap the cash value. Frank may be able to access the cash value at a lower tax cost. Depending on the policy type and its terms, for example, he may be able to take tax-free partial surrenders or withdrawals (up to his basis). He may also have the option to take tax-free loans against the policy's cash value. Typically, current loan payments aren't required; the principal and all accrued interest are deducted from the death benefit when Frank dies.

Trade for an annuity. Another option is to exchange the policy for an immediate annuity. The exchange itself is tax free, but each annuity payment is a combination of tax-free return of basis and ordinary income. After Frank recovers

his entire basis, the annuity payments are fully taxable.

Give it to charity. If Frank is charitably inclined, he might consider donating the policy to charity. He'll receive an immediate charitable income tax deduction and avoid future premium payments. If he needs the income, however, he might exchange the policy for a charitable gift annuity, which pays him a fixed percentage of the gift's value annually for life. Rates on charitable gift annuities typically are lower than those available on commercial annuities, but they're ideal if Frank's objective is to balance current income needs with his philanthropic objectives.

Make a life settlement. The cash surrender value of Frank's policy is only a fraction of its face amount. He may do better by selling the policy to a life settlement company. These companies purchase policies for a lump sum that's less than the policy's face value, but typically is significantly greater than its cash value. The settlement company takes over the premium payments and either sells in the secondary market or collects the death benefit when Frank dies.

A word of caution on life settlements: Like any financial product, life settlements are susceptible to fraud and abuse, so it's important to do your homework and make sure that the life settlement company is reputable and financially stable.

A question of economics

If you have life insurance you no longer need, there's no one right solution. The answer depends on your current and future needs, the relative benefits of each option as well as their costs and fees, the potential tax implications of each option, and your comfort level with the various risks involved. ▮

Estate Planning Pitfall
You haven't recently valued your estate

An old business adage says "you can't manage what you can't measure," and this principle is equally applicable to estate planning. If you don't know what you have and what it's worth, how can you plan to distribute it in the most tax-efficient manner?

Over time, your net worth and circumstances change, as do federal and state estate tax laws and regulations. Thus, it's important to periodically take inventory of your assets to determine whether your estate plan requires adjustment. For example, perhaps your estate has grown larger than the federal estate tax exemption so more sophisticated planning techniques are necessary.

The success of many estate planning strategies depends on the accuracy of asset values reported in gift and estate tax returns. If you don't know the true value of your estate, hire a professional valuator or appraiser — particularly if you're transferring interests in a closely held business.

Retaining a qualified, independent appraiser offers many benefits. It minimizes the risk that the IRS or the courts will revalue your assets, potentially derailing your plans and generating unexpected tax liabilities. And good faith reliance on a qualified appraiser may relieve you from penalties in case the IRS determines that an asset's value was substantially understated.

A professional appraisal can also help you avoid an IRS attack on asset values you report in a federal gift tax return. The three-year statute of limitations for gift taxes begins when you file a return that "adequately discloses" the gift. Although an appraisal isn't required, it can help ensure you satisfy this requirement.

Estate planning counsel you can trust

When you are looking for ways to preserve and protect your wealth, or develop a succession plan for your business, you want cutting edge legal advice that achieves your objectives. In other words, you want the specialized services of the preeminent trusts and estates group at Hinkle Elkouri Law Firm L.L.C.

Since 1987, we have helped individuals and businesses throughout the Midwest with estate planning, business succession planning, tax planning and other wealth management issues. Because our various practice areas compliment each other, the firm's 40+ attorneys have built a reputation for discovering creative solutions to difficult situations, while providing exemplary service with the highest degree of confidentiality.

Our trusts and estates group is ready to serve you in these and other ways:

- Creating and funding revocable and irrevocable trusts
- Preparing wills, powers of attorney and health care directives
- Designing asset protection plans
- Determining the value of business entities
- Designing charitable giving plans
- Planning with life insurance
- Structuring business entities to optimize control and transfer of wealth
- Preparing buy-sell agreements and business succession plans
- Representing clients in probate, tax and trust administration matters
- Preparing pre-marital and post-marital agreements
- Assisting with elder law and medicaid issues

Dan C. Peare chairs Hinkle Elkouri's trusts and estates practice. He has extensive experience in high-net worth estate planning, asset protection planning and planning with family businesses. He also assists with business valuations and planning with life insurance. Dan speaks and writes frequently on estate planning and family business planning topics. He received his law degree from the University of Kansas School of Law, and holds a finance and MBA degrees from Wichita State University.

Hugh W. Gill has teamed with Dan Peare for over twelve years to form one of the best planning groups in Kansas. In addition to estate planning, Hugh manages sub-specialties in probate and trust administration, guardianships and conservatorships, disability planning, and post-mortem tax planning. Hugh holds finance, MBA and JD degrees from the University of Kansas.

Donna F. Bohn has over sixteen years of legal experience. She handles a variety of transactional matters for the firm's family business clients. Donna also concentrates in medicaid and elder law planning, business entity formation, structuring buy-sell agreements and split dollar insurance planning. Donna has an accounting degree from Kansas State University and law degree from Washburn University.

Kari D. Coultis is an attorney and a Certified Public Accountant. She focuses on estate planning design and construction. She supervises drafting assignments with legal assistants and attorneys to ensure errorless document preparation. She also assists with charitable planning, estate tax planning, tax litigation and business valuation matters. Kari holds a BS in Accounting and Business Administration, a Master of Accounting and Information Systems, and a JD degree from the University of Kansas.

We welcome the opportunity to discuss your needs and put our extensive knowledge and experience to work for you. Please call us at 316-267-2000 and let us know how we can be of service.

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