

The Wealth Planning Group
At
Martin, Stilwell & Jones, LLP



“How to Avoid a Financial Train Wreck”

Introduction

It is important that a family define its objectives for wealth transfer and preservation planning. If a proposed plan does not meet the family objectives, or accomplishes some, but not all of the objectives, it may not be worth doing. Also, a proposed plan that does not make common sense may not be worth doing. A list of fifteen common objectives for estate, financial and tax planning follows. A family limited partnership is often used in intermediate or advanced planning assignments. Of these fifteen common estate planning objectives, the family limited partnership meets or supports eleven of them. We often use a living trust, supported by a pour over will and a durable power of attorney in our planning for wealthy business owners. The living trust meets or supports eight of these objectives. Use this information as a checklist. Judicious use of these tools for the stated objectives will help you and your family avoid a financial train wreck!

1) DISPOSITION OF ESTATE UPON DEATH.

Plan and document the ownership and control of family property upon the death of a family member.

• PREVAILING TOOLS TO MEET THIS OBJECTIVE:

- **The Family Living Trust** - This tool provides for a centralized plan of use and disposition. Unlike a will, the living trust also preserves and protects the property of the maker during his or her disability. The living trust is supported by a will and by a durable power of attorney which enables assets not transferred to the living trust prior to death or disability, to be transferred to the trust.
- **Traditional Last Will and Testament** - This tool provides for independent administration of the estate and can contain significant tax savings provisions.
- **Lifetime Gifts** - Gifts to individuals or trusts set up for their benefit during the life of the donor.

2) AVOID DISPUTES AND CONTESTS. Will contests, community property reimbursement claims, and other contests or disputes can substantially plunder an estate and result in an unintended disposition of property and significant legal costs.

*** PREVAILING TOOLS TO MEET THIS OBJECTIVE:**

- **No-contest Clauses** - No-contest provisions in the estate planning wills and trusts provide a significant deterrent to claims by “disgruntled parties”.
- **Love Letters and Letters of Wishes and Instructions** - “Love letters” explaining to children and other family members why certain estate planning dispositions have been made, reflecting the Client’s intent, will often reduce misunderstandings and dissolve sibling conflicts which otherwise would generate contest litigation.
- **Family Limited Partnerships** - If what is to be gained in a will contest is a limited partnership interest which the contestant cannot control or sell, much of the incentive of a contest proceeding is removed.

*We gratefully acknowledge the original work of Larry Weldon Gibbs, Attorney at Law, San Antonio, Texas, from which this material was adapted.

3) REDUCE THE FEDERAL ESTATE TAX BURDEN. Federal estate taxation, even with the phased increase of the unified credit, which began on January 1, 2002, can still substantially reduce the size of an estate. Starting in 2002, (i) the federal estate bracket for any estate in excess of \$1,000,000 in value began at 35%; (ii) the federal estate bracket for any estate in excess of \$2,000,000 in value begins at 45%; (iii) the federal estate bracket for any estate in excess of \$3,000,000 in value is 50% and (iv) the credit exemption amount (i.e., the amount an individual can pass free of estate taxes) gradually increases through 2009 and the effective estate tax rate decreases. In 2010 the estate tax goes away altogether. In 2011, it returns to where it was at the beginning of 2001; i.e. the credit exemption at \$1,000,000 is 50% according to the following schedule:

Year	Top Effective Bracket	Exemption Amount (In Millions of Dollars)
2002	50%	1
2003	49%	1
2004	48%	1.5
2005	47%	1.5
2006	46%	2
2007	45%	2
2008	45%	2
2009	45%	3.5
2010	REPEALED	N/A
2011	50%	1

NOTE: GST TAX WILL BE PEGGED AT THE HIGHEST ESTATE TAX RATE DURING THE REPEAL PERIOD

Post-mortem dispositions which “skip” a generation can be subject to a flat tax of up to 50%.

***PREVAILING TOOLS TO MEET THIS OBJECTIVE:**

- **Bypass or Credit Shelter Trusts** - Use a living trust or wills for a husband and wife that include a credit shelter disposition, in trust, for the surviving spouse. Properly drafted, the credit shelter trust or sub-trust protects and preserves the credit exemption amount available to a deceased spouse. This means that clients can pass to the second generation as much as \$4,000,000 or more free of federal estate tax in 2006, increasing through 2009 at the above indicated rate. Use a marital deduction gift or formula to avoid (and postpone) a federal estate tax upon the death of the first spouse. Make the formula elective if possible. It may be tax-smart to pay some tax upon the death of the first spouse. Don’t get tied into an inflexible arrangement which does not lend itself to post-mortem planning.

- **Irrevocable Life Insurance Trusts** - Properly formed and funded life insurance trusts, in which neither married client has incidents of ownership, may pass life insurance proceeds to the second generation free of federal taxation.

- **Transfer Restrictions in Family Business Entities** - Non-tax motivated restrictions upon transfer and ownership in a Family Limited Partnership, Limited Liability Company or a family Corporation can substantially reduce the value of ownership interests, especially minority interests.

- **Generation Skipping Gifts to avoid the Generation Skipping Transfer Tax (GST Tax)** - Each person may ultimately pass to third generation beneficiaries as much as \$1,000,000 free of federal estate tax (up to 50% generation skipping tax) upon the death of second generation beneficiaries.

- **Annual Exclusion Gifts of Interests in Family Business Entities** - Annual gifts of shares of ownership in a Family Limited Partnership or other family business entity (discounted to fair market value) using the present \$12,000 annual gift tax exclusion and indexed for inflation, can substantially reduce the size of an estate without depleting cash resources. Together, a husband and wife have a combined annual giving power of \$24,000 multiplied by the number of children and grandchildren who are to be the recipient of gifts, times the percentage value of discounts off the net asset value such minority interest gifts are able to obtain.

- **Charitable Remainder Trusts** - Properly formed charitable remainder trusts funded with appreciated property can produce substantial estate tax savings (and a present income tax deduction) which can pass a greater share of the estate (not less) to second and third generation beneficiaries, particularly if the charitable remainder beneficiary is a tax exempt organization created and controlled by the clients and their family members.

- **Grits and Grats** - A properly formed Grantor Retained Income Trust (“GRIT”) or Grantor Retained Annuity Trust (“GRAT”) can result in substantial tax savings for a personal residence or other family assets.

- **Installment Note and Private Annuity Sales of Family Business Interests and other Assets** - Properly structured sales of family property, including an interest in a Family Limited Partnership or other family business entity, can avoid (“freeze”) the prospective appreciation of the value of the asset in the clients’ estates.

“Excellent planning may be expensive. Lack of planning is unaffordable.”

4) AVOID GUARDIANSHIP AND THE COST OF GUARDIANSHIP, AND DISABILITY PLANNING. Apart from a review of existing disability insurance programs, the estate of a person who becomes incapacitated as the result of an injury or decline in health may be subject to the most costly and time-consuming legal proceeding of all: the guardianship.

*** PREVAILING TOOLS TO REACH THIS OBJECTIVE:**

- **The Living Trust** - A Living Trust, unlike a Will, provides for the management and conservation of the estate during an episode of disability.
- **Statutory Durable Power of Attorney** - A statutory durable power of attorney vests in a trusted personal representative the right to manage and transfer property for and on behalf of the maker and to transact business for the maker. The power can authorize the transfer of property to the maker's living trust.
- **Transfer Non-exempt Assets to Family Limited Partnership** - If substantially all of a person's non-exempt assets are in a Family Limited Partnership, there is little, if anything, left to manage and administer in an estate subject to probate or a guardianship proceeding.

5) RIGHT TO DIE PLANNING AND HEALTH CARE DECISIONS. Almost everyone is concerned with continuation of life on a life support system which prolongs the moment of death, and possibly increasing suffering and financial hardship for the family. The Terry Schiavo case brought these issues sharply into focus.

*** PREVAILING TOOLS TO MEET THIS OBJECTIVE:**

- **Advance Directives** - A "living will" or, in Texas, a Directive to Physicians.
- **Appointment of Healthcare Proxy or Agent** - The appointment of a trusted personal representative who is empowered to issue a directive to physicians to remove life support systems if the client cannot do so.
- **Medical Power of Attorney** - In Texas, a medical power of attorney can provide for the appointment of a personal representative to make health care decisions for the patient. If the patient cannot or has not made a Directive to Physicians, the personal representative can issue one.

6) RESOURCE PLANNING AND ALLOCATION. In the usual case, the breadwinning spouse considers his or her first obligation to be to the other spouse and then to the children. Available resources need to be allocated and protected to insure that a dependent spouse and children will have the financial support needed if a spouse, or both of them, are incapable of providing support. To the extent sufficient resources are not reasonably available, steps should be taken to consider and if possible, establish various insurance coverages and arrangements.

*** PREVAILING TOOLS TO REACH THIS OBJECTIVE:**

- **Disability and Life Insurance**-Disability and life insurance products should be considered as resource and income replacement alternatives.

7) LIQUIDITY PLANNING. Estate and inheritance taxes can substantially diminish or destroy an estate which must sell illiquid assets (if it can) to produce the money needed to pay tax dollars. Particularly vulnerable are family ranches, farms, and businesses. Substantial value may be tied up in land or a business which the family does not want to sell or cannot sell. A forced sale can produce financial hardship, and in some cases, a complete loss of the primary family asset to foreclosure of a federal estate tax lien because there is no market for the asset following the date of death.

***PREVAILING TOOLS TO MEET THIS OBJECTIVE:**

- **Life Insurance Planning** - Provide for liquidity through appropriate life insurance planning.
- **Special Use Valuation** - Undertake planning to preserve and protect the Section 2032A special use valuation and the installment pay-out tax.
- **Family Owned Business Exemption** - Use planning techniques to preserve and protect the Section 2032B qualified family owned business exemption.
- **Section 303 bailouts** - Plan for the tax advantaged Section 303 bailout of cash from the family closely held corporation in a partial redemption of stock.
- **Family Buy-Sell business arrangements** - Make proper use of the IRC Chapter 14 rules to freeze business values through properly structured buy-sell arrangements.
- **Value "Scrunching" Strategies** - Limit the value of the primary asset by using one or more of the estate tax planning procedures previously itemized, especially the Family Limited Partnership or Limited Liability Company.

8) PROTECTION AND CONSERVATION OF CRITICAL FAMILY RESOURCES. Much can, and should, be done to protect resources needed by the family for retirement, support and maintenance, and business continuation. Little good is accomplished if the family is stripped of its financial resources, especially if husband and wife are unable, due to age, to substantially replace what was lost.

*** PREVAILING TOOLS TO REACH THIS OBJECTIVE:**

- **Properly Structured Family Limited Partnerships and Limited Liability Companies** - The Family Limited Partnership and the Limited Liability Company provide limited liability to the Limited Partners and Members.
- **Proper Choice of Entity Planning for the Family Business** - Incorporation of the family business or a professional practice can substantially limit the liability and family resource exposure to claims incurred as a result of operating a family business or in conducting a professional practice. In most states, a professional is not protected from personal liability to clients or patients resulting from services he or she provides, but is given limited liability from claims originating from the services of another professional in the practice.
- **Homestead and other Statutory Exemptions** - Plan to fully utilize the state homestead exemption and other exemptions prescribed by state law.
- **Qualified Plans and Individual Retirement Accounts** - Provide protection of retirement resources in a Qualified Retirement Plan or Individual Retirement Account under state and federal law.
- **Statutory Limits on Seizure by Judgment Creditors** - In states which have adopted the Uniform Limited Partnership Act, particularly Section 703 of the Act, and similar provisions related to limited liability companies, the ownership interest of a limited partner or a member in a limited liability company is exempt from execution. These acts limit the remedy of a judgment creditor to a charging order against the income produced from an owner's limited partnership interest or limited liability company member interest.

- **Partition Community Property into Separate Property** - In community property states in which one spouse's acts or omissions may bind the entire community estate, use partitions of community property to protect the ownership interest and resources of an innocent spouse on non-exempt property. Set aside, in trust or otherwise, resources which will be needed to provide for the support and maintenance of a dependent spouse.

- **Gift or Resource Trusts for Children** - Set aside resources in an irrevocable spendthrift trust for children who may need these resources for education, support and maintenance.

- **Gifts to Qualified Education and Healthcare Savings Accounts** - The advent of section 529 plans, education IRA's and healthcare savings accounts provides excellent, tax-advantaged safe havens for critical family assets.

9) PROTECTION OF A CHILD'S INHERITANCE FROM LOSS IN A DIVORCE PROCEEDING OR LOSS TO THAT CHILD'S CREDITORS.

A father gives his two sons all of his interest in the family business in contemplation of his retirement. One son lost his one-half interest in a divorce proceeding. The other son lost his interest to his judgment creditors. This Texas based business, bearing the father's name, is now owned and operated by strangers.

*** PREVAILING TOOLS TO MEET THIS OBJECTIVE:**

- **Heritage Trusts** - Protect and preserve the heritage of a child or grandchild in a so-called Heritage Trust, with spendthrift trust protection authorized by the Texas Trust Code.

- **Family Limited Partnerships and Limited Liability Companies** - Interests in a Family Limited Partnership and Limited Liability Company, properly restricted as to ownership and transfer, are also protected.

“Asset protection, legally done and properly implemented, is a right-not a scheme! There is nothing illegal about protecting critical family resources from unknown future creditors.”

10) AVOID OR SUBSTANTIALLY LIMIT COSTS INCIDENT TO PROBATE.

*** PREVAILING TOOLS TO MEET THIS OBJECTIVE:**

- **The Living Trust** - A fully funded living trust holds record legal title to family assets. Probate is not required to pass record title to the beneficiaries since legal title is vested in the Trust. The creation and funding of a living trust can be expensive. The principal attribute of this procedure, is that we have the help of both the client and spouse to locate and transfer title to assets prior to the death of either of them. In the usual estate, after the client's death, there is frequently significant confusion and cost. The client isn't available to help inventory and value the estate. Client and spouse, in effect, pre-settle their estate at a cost which is generally much less than if settlement were left to the surviving spouse to handle after death.
- **The Family Limited Partnership**-The Family Limited Partnership helps make the living trust work. If the clients own 50 assets and these are transferred to a Family Limited Partnership, they no longer own 50 assets. They own instead a limited partnership interest, one asset, which, when transferred to the living trust, provides for a continuation of management and ownership without interruption. The clients own nothing which is subject to probate.
- **Joint and Survivorship Accounts**-Careful use of joint and survivorship bank accounts help avoid probate.
- **Beneficiary Designations**-Careful use of beneficiary designations in life insurance policies, death benefit plans, and buy-sell agreements is also helpful.

11) CONTROL AND MANAGEMENT. The disadvantage of estate planning gifts and transfers is the fractionalization and division of family owned assets. What was acquired by the family founders is now owned by a number of individuals. A sale of a family asset may be difficult if six, not one, owners' consents must be obtained. Fractionalization may retard the income producing ability of a single asset under centralized control.

***PREVAILING TOOLS TO MEET THIS OBJECTIVE:**

- **Family Limited Partnership or Limited Liability Company** - The Family Limited Partnership and the Limited Liability Company are ideal for gifts to family members. The gifts are of limited partnership or member interests. The donor usually continues, as a general partner or general manager, to manage the entirety of the family assets at the family partnership or limited liability company level.
- **Trustee Selection**-The selection of the trustee or trustees of family trusts is an important consideration. Whether one or multiple trusts are used, a common trustee can simplify the management and administration of jointly owned property.

12) FLEXIBILITY. While irrevocable trusts are truly irrevocable, the central obstacle to the administration of a long term trust is the choice of the trustee. Individuals die or become unable to continue service for any number of reasons. But, if a trustee has the authority to appoint his or her successor, and to authorize the successor to appoint his or her successor, continuation of family management into future generations is assured.

*** PREVAILING TOOLS TO MEET THIS OBJECTIVE:**

- **Succession Appointment Authority in Trustees** - This option is available under Texas law as to trusts. It is not available with respect to appointment of a successor personal representative in a will, at least in Texas.
- **Succession Appointment provisions in a Family Limited Partnership** - In properly structured limited partnerships, the service of the general partner and the selection of a successor general partner are to be determined by the limited partners, pursuant to the limited partnership agreement. As one general partner becomes unable to serve, another is elected to take his or her place.

13) INTEGRATION. It is not unusual in heading an estate engagement to find that the last will and testament provides one pattern or plan of disposition, and to find this pattern or plan completely circumvented by contrary post-mortem transfers of property under beneficiary designations, buy-sell agreements, and joint and survivorship bank accounts. In an integrated plan, there is one master plan. The master plan is prescribed in the living trust and, if indicated, a life insurance trust. All property, except qualified plan death benefits in certain cases, is to be distributed by the family living trust. Upon the death of the surviving spouse or only parent, the property of the living trust passes to heritage trusts for children. If a limited partnership is used, the limited partnership interests are held by the living trust for the use and benefit of the spouse, or surviving spouse, and will eventually be passed to children. If a life insurance trust is used, the life insurance trust eventually flows into heritage trusts for children.

*** PREVAILING TOOLS TO MEET THIS OBJECTIVE:**

- **Living Trust** - A fully funded living trust with master disposition scheme meets this objective.
- **Life Insurance Trust** - An irrevocable life insurance trust, if indicated, with a disposition scheme tracking that of the living trust will likewise meet this objective.
- **Beneficiary Designations on Retirement Accounts and Qualified Plans** - These should be carefully coordinated with the disposition scheme in the living trust.

