PROFESSIONAL DEVELOPMENT

ESTATE PLANNING

5TH EDITION

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Dearborn
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Published by Dearborn•R&R Newkirk,
a division of Dearborn Financial Publishing, Inc.®

Printed in the United States of America.

Second printing, March 1998

Library of Congress Cataloging-in-Publication Data

Estate planning. -- 5th ed.
p. cm.
ISBN 0-7931-2406-9 (pbk.)
1. Estate planning--United States. I. Dearborn–R & R Newkirk.
KF750.E824 1996
346.7305'2--dc20
[347.30652] 96-41337
CIP

Estate Planning, Fifth Edition
(PP#: 5414-0905; ISBN: 0-7931-2406-9)
FICF Graduate One, Fifth Edition
(PP#: 5420-0205; ISBN: 0-7931-2410-7)

EDITOR'S UPDATE

The *Taxpayer Relief Act of 1997* affected a number of Internal Revenue Code provisions related to estate planning. To the extent these provisions affect the content of this book, they are explained below.

> *Note: If you are taking this course through our Supervised Study program for continuing education or other credit, you will* ***not*** *be tested on this new information.*

Unified Estate and Gift Tax Credit

The unified estate and gift tax credit amount of $192,800 (equal to an effective exemption amount of $600,000) will increase annually beginning with estates of decedents dying after and gifts made after 1997. The credit will increase so that the applicable exemption or exclusion amount will be $1 million in 2006. Until the change is fully phased in, the applicable exclusion amount will be as follows:

1998	$625,000
1999	$650,000
2000–2001	$675,000
2002–2003	$700,000
2004	$850,000
2005	$950,000
2006	$1,000,000

Effective Date: This provision is effective for estates of decedents dying after and gifts made after December 31, 1997.

Qualified Family-Owned Business Exclusion

Qualified family-owned business interests may be excluded from the decedent's gross estate to the extent that the amount excluded for these interests when added to the amount effectively excluded by the unified credit (see above) does not exceed $1.3 million.

The requirements that must be met to qualify for this exclusion are complex, and a detailed discussion of those requirements is beyond the scope of this text. Generally speaking, however, in order to qualify, the total of all transfers of qualified family-business interests to qualified heirs plus certain lifetime gifts to family members must exceed 50 percent of the decedent's adjusted gross estate (which is defined specially for purposes of this calculation).

To qualify as a family-owned business, the decedent or members of the decedent's family must have owned and materially participated in the family business for at least five of the eight years preceding the decedent's death and the business must meet certain other ownership requirements. There are also provisions for recapturing the estate tax benefit of the exclusion if certain events occur within ten years of the decedent's death (for example, the qualified heir fails to meet the material participation requirements).

Effective Date: This provision is effective for estates of decedents dying after December 31, 1997.

Cost-of-Living Adjustments for Certain Annual Exclusions

Beginning in 1999, the $10,000 annual exclusion for gifts, the $750,000 ceiling on special use valuation, the $1 million generation-skipping transfer tax exemption and the $1 million ceiling on the value of a closely held business for the special low interest rate treatment for executors electing to pay estate tax in installments will all be indexed for inflation.

The cost-of-living-adjustment will equal the percentage, if any, that the Consumer Price Index for the preceding calendar year exceeds the Consumer Price Index for calendar year 1997. The indexing of the annual gift exclusion is rounded to the next lowest multiple of $1,000; the indexing of the other amounts is rounded to the next lowest multiple of $10,000.

Effective Date: This provision is effective for estates of decedents dying after and gifts made after December 31, 1997.

QTIP Treatment of Survivorship Interest in Qualified Plans

In community property states, a nonparticipant spouse may be treated as having a vested community property interest in his or her spouse's qualified plan, individual retirement account (IRA) or simplified employee pension (SEP). A nonparticipant spouse's survivorship interest in a participant spouse's qualified plan, IRA or SEP may qualify for QTIP treatment in cases where the nonparticipant spouse predeceases the participant spouse.

Effective Date: This provision is effective for estates of decedents dying after August 5, 1997.

Gift Tax

Gift Tax Filing for Charitable Gifts: A donor making a gift to charity in excess of the annual exclusion is not required to file a gift tax return if the entire value of the gift qualifies for a gift tax charitable deduction. However, gifts of partial interests must still be reported.

Revaluation of Gifts: In computing adjusted taxable gifts for estate tax purposes, the IRS may not revalue lifetime gifts if: (1) the gift was adequately disclosed and (2) the gift tax statute of limitations has expired.

Effective Date: The provisions on gift tax filing and on revaluation of gifts is effective with respect to gifts made after August 5, 1997. The provision requiring adequate disclosure of gifts before the statute of limitations begins to run is effective for gifts made in calendar years ending after August 5, 1997.

Charitable Remainder Trusts

The Tax Act imposes two new requirements on charitable remainder trusts.

Fifty Percent Payout Limitation: The first new requirement is that the payout rate to an income beneficiary of a charitable remainder trust cannot exceed 50 percent of the trust's fair market value. In the case of a charitable remainder annuity trust, this means that the annual payout cannot exceed 50 percent of the initial fair market value of the trust's assets; in the case of a charitable remainder unitrust, this means that the annual payout cannot exceed 50 percent of the fair market value of the trust's assets determined annually. It is anticipated that trusts failing this 50 percent requirement will be treated as complex trusts (rather than charitable remainder trusts) and all of the trust's income will be taxed to the trust's beneficiaries.

Ten Percent Minimum Value Requirement: The second new requirement imposed by the Tax Act is that the value of the charitable remainder must be at least 10 percent of the net fair market value of property initially transferred to the trust. In the case of a charitable remainder annuity trust, the value of the remainder interest must be at least 10 percent of the initial fair market value of the trust's assets; in the case of a charitable remainder unitrust, the 10 percent minimum requirement applies to each contribution of property to the trust.

A trust that would qualify for charitable remainder trust treatment except for its failure to meet the minimum value test may be declared void from its inception or it may be reformed to meet the 10 percent requirement. If the trust is declared void as of its inception, no income tax deduction will be allowed for any transfer to the trust and any transfer entered into by trust will be treated as entered into by the transferor. The trust can be brought up to the 10 percent requirement by reducing the payout percentage or by shortening the trust's term (or both).

Effective Date: The 50 percent maximum payout provision applies to transfers in trust after June 18, 1997. The 10 percent limitation on the minimum value of the remainder interest generally applies to transfers in trust after July 28, 1997 (though certain exceptions exist).

Gifts from a Revocable Trust Made Within Three Years of Death

The value of any property transferred to a donee from a decedent's revocable trust within three years of the decedent's death as well as the value of property in such a trust where the decedent relinquished the power to revoke during the three years before his or her death will not be includible in the decedent's gross estate.

Transfers from a revocable trust are treated as though they were made directly by the decedent for purposes of Code Sections 2035 and 2038; thus, a gift from a revocable trust that falls within the annual exclusion is not included in the decedent's gross estate.

Effective Date: This provision is effective for estates of decedents dying after and gifts made after August 5, 1997.

Income Taxation of Revocable Trusts

An election may be made to treat a qualified revocable trust as part of a decedent's estate for federal income tax purposes. The election is irrevocable and is effective for two years from the date of the decedent's death if no federal estate tax return is to be filed, or six months after the final determination of estate tax liability if a federal estate tax return is required. The election must be made by both the trustee of the revocable trust and the executor of the decedent's estate, if any, by the due date for filing the estate's income tax return for its first tax year.

Effective Date: This provision is effective for estates of decedents dying after and gifts made after August 5, 1997.

Qualified Domestic Trusts (QDOTs)

In order to permit the estate of a decedent with a nonresident spouse to qualify for the marital deduction in situations where trusts are prohibited, the Treasury Department has been granted authority to treat as trusts those legal arrangements that have substantially the same effect as trusts.

In addition, the Treasury Department has been granted authority to waive the requirement that a qualified domestic trust have a U.S. trustee in situations where a country prohibits a trust from having a U.S. trustee.

Effective Date: These provisions are effective for estates of decedents dying after August 5, 1997.

Acknowledgment

The publisher wishes to thank Louis Harrison, partner with Lord, Bissell & Brook, who served as critical reviewer for this fifth edition of *Estate Planning*.

Stephen J. Cochilla, JD, Editor

Introduction

The purpose of this course is to help the financial services professional build upon his or her educational background, training and experience. The basic knowledge of estate planning offered in this course will increase opportunities to render a valuable service to clients and, at the same time, present a means of increasing personal stature through individual achievement.

It will equip the financial services professional with the technical knowledge necessary to operate on a more professional level. It can provide the self-confidence he or she needs to seek out prospects whom he or she previously would never have approached.

You will find that the knowledge acquired from this course will greatly expand your market. However, you should never overlook the potential for advancement that lies within your normal market.

About the Course

This *Estate Planning* course has been written with three practical objectives in mind: to furnish you with as much technical knowledge as is necessary to give you a basic foundation in estate planning; to present it in an orderly, progressive fashion; and to do this in the minimum amount of time consistent with a thorough understanding of the material.

You will be introduced to the practicalities of finding prospects in need of an estate planning service. You will be given some useful ideas in approaching these prospects and in motivating them to recognize their need for a comprehensive job of estate planning. You will study the transfer of an estate owner's assets at death, discovering that the full value of those assets never reach the hands of the estate owner's heirs because of the cost and expenses that inevitably accompany the transfer process and result in estate shrinkage. You will examine the major contributing factor to this shrinkage—death taxes, state and federal—and look at the impact of the federal gift tax.

Next, you will study the various distribution methods for the assets of the estate, and some of the instrumentalities, such as wills and trusts, used in arranging an estate owner's affairs. You will discover that many of the instrumentalities can be used not only to accomplish the estate owner's objectives for disposition of his or her estate, but also to reduce or minimize the shrinkage effect studied earlier. Then, the key role of insurance in alleviating the shrinkage problem and accomplishing the estate owner's desired objectives is examined.

Next, the overall topic is estate efficiency once the estate settlement costs have been reduced as much as possible. Finally, we cover the important topic of estate liquidity—the availability of ready cash to pay needed expenses as they arise and thus avoid a distress sale of valuable estate assets—and the role insurance plays in providing that liquidity.

In Appendix A, the course concludes with a separate comprehensive case study, utilizing all the material you have learned previously. You will see how the financial services professional, along with the client's other professional advisors, analyzes an estate owner's affairs and formulates a comprehensive estate plan.

The study of this course should be approached with this conclusion in mind. Study each chapter and subject with an eye to its place in the overall picture of estate planning. Don't skip pages; don't skip about in the course. Read the material carefully, thoughtfully and in the order in which it is presented.

As you progress from one chapter to the next, you will find that the text leads you in a logical sequence from one subject to the next, and thus, to the conclusion of the course. If you follow this organized procedure, you will enjoy your studies and will benefit from a better overall understanding of what estate protection is all about.

Please bear in mind that we have simplified a complex subject and that much more is involved in estate planning than we have been able to cover fully in this course. However, we have tried to give you an "aerial photograph" of the subject, with some in-depth looks at various facets of it.

Terminology

In the past, this book was read almost exclusively by life insurance agents. Furthermore, when people sought advice on estate planning and related issues, they would often look to their life insurance agent. However, the marketplace for financial services and financial advice has changed; people now seek financial advice from many different sources. And this book is now read by many different financial professionals.

To reflect this reality, we have used the term "financial services professional" throughout the book to describe you, the reader, in your role as advisor. However, when discussing the sale of a life insurance policy, we do use the term "life agent" or "life underwriter."

The terms "financial services professional" and "financial advisor" are not meant to suggest that you should act or advise a person on all financial matters. Whatever your position—be it life insurance agent, stockbroker, banker, etc.—it is important that you act only in your area of expertise. When questions arise that fall outside that area, an advisor must seek out the proper expert.

The Financial Services Professional—A Salesperson

As you begin this course, you should understand that it is a sales training course. Never lose sight of the fact that first, last and always you are a salesperson, and your continued growth and expanded knowledge are sales tools: tools you acquire to enable you to see more people, to present your ideas more forcefully and to close more sales.

We have recognized the necessity of practical sales considerations in the course. The discussion of prospecting, approaching the prospect and motivating him or her to act all are intended to help you in your sales efforts.

A Final Word

There is no mystery in estate planning that cannot be understood by diligent study. Acquiring the skills leading to success in this field requires nothing more than hard work and some imagination. If you bring to your study of this course the same determination and enthusiasm you apply to your normal sales pursuits, you will gain immeasurably from your efforts.

Welcome to *Estate Planning!*

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An Overview of Estate Planning

Developing an estate plan involves more than an understanding of tax laws. The heart of an estate plan is the proper coordination of a client's financial resources with his or her needs and objectives. This chapter provides an overview of the nature of estate planning and the estate planning process.

Estate planning refers to the broad area of activity concerned with the analysis of an estate owner's financial affairs and the arrangement of those affairs in a manner that best accomplishes the estate owner's objectives. One definition of estate planning is "determining and expressing the method or methods of arranging or rearranging a person's property to accomplish the goals of the client." Estate planning experts take that definition one step further and define estate planning as "organizing the resources of the estate to adequately provide for the present and future needs of the surviving family."

Whatever reference point is used, one clear statement that defines the purpose of estate planning is *to arrange a person's personal and business assets so that, at death, the maximum beneficial use can be made of his or her material wealth.* It is upon this definition that this text has been developed.

THE NATURE OF ESTATE PLANNING

The origin of estate planning as an active force in asset conservation can be traced back to the 15th century and the English feudal system. Under that system, the primary property owner or lord of the manor, in exchange for a lifetime of faithful service and allegiance, allowed individuals to hold legal title to portions of his property. When the titleholder died and passed the title to heirs, the common law of that period provided that a monetary payment had to be made to the lord of the manor for the privilege of passing that title.

"Estate planners" during this period assisted titleholders in avoiding the payment of a heavy tribute by passing the title to a carefully selected person, in whom the