THE BUILDING BLOCKS OF AN ESTATE PLAN
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I. INTRODUCTION

The most common estate plan (intestacy aside) is to simply leave all assets to the surviving spouse by survivorship, or beneficiary provisions and will. Upon the death of the surviving spouse (or an unmarried individual), the decedent's estate is then distributed outright to the children or in trust for their benefit, generally with staggered distributions at various ages. Most often, one-third distributions occur at the ages of 25, 30 and 35. Whether property passes by will, living trust or beneficiary designation, direct distribution of the estate in this manner is an effective plan only if the total estate for the unmarried individual or couple is comfortably under the estate tax threshold for one person – currently $11,580,000 (but set to go down to around $6,000,000 in 2025). Otherwise, some level of tax planning is in order. When tax planning is used, depending on the size of the estate and the family circumstances, additional techniques can provide significant tax savings and other non-tax benefits.

In general, an individual may give up to $15,000 each year to any number of people without triggering a gift tax. This annual allowance does not carry over into future years. Annual gifts must be gifts of a present interest, not a future interest. Additionally, each individual has an $11,580,000 lifetime allowance. This may be used for the part of a gift to a person that exceeds $15,000 in any year, and to the extent not used during life, the remainder of this lifetime allowance (the "exemption equivalent") may be given at death tax-free. Any excess amounts, however, are subject to a 40% estate tax.

A. Gross Estate. Generally, the "Gross Estate" includes the fair market value of all assets, including:

1. Life Insurance proceeds payable upon death;

2. Other non-probate assets, such as JTWROS and POD assets;

3. Personal effects;

4. Value of all assets before deductions for mortgages and other debts;

5. Gross value of notes, annuities, IRAs and qualified plans, without deduction for built-in income tax.

B. Federal Estate Tax Return. A Federal Estate Tax Return must be filed (even if no taxes will be due):

1. When the gross estate (not the net estate) of the Decedent exceeds $11,580,000;

2. Even if gifts to the spouse (resulting in a marital deduction) or gifts to charity (resulting in a charitable deduction) or debts will ultimately bring the *net* estate under the $11,580,000 threshold; and

3. Within nine months of the date of death.

C. <u>When does the estate tax system become an issue</u>?

1. A single person must deal with estate tax when his or her estate approaches $11,580,000. Married couples must also address estate tax issues when their combined gross estates approach $11,580,000, not $23,160,000, because simple wills leaving everything to the survivor will result in the entire estate being left in the name of one person.

2. Consideration must also be given to expected increases, including appreciation, vesting of stock options, and expected inheritance from parents.

3. High levels of life insurance must also be considered.

D. <u>Generation Skipping Transfer (GST) Tax</u>. In addition to the estate tax, the IRS imposes a GST tax on gifts that “skip” a generation. Any gifts you leave directly to a grandchild are subject to both estate tax *and* GST tax (unless your “skipped” child is no longer living). For example, you may leave assets to a trust to benefit your children for life, and then your grandchildren. The assets would be subject to estate tax at your death, but the trust may be drafted so that the assets are not included in the child’s estate and therefore are subject to estate tax at the child’s death. The assets would, however, be subject to the GST tax at the child’s death, because they “skipped” the child’s estate and went from you to a trust that now benefits your grandchildren. Just as there is an estate tax exemption, there is also a GST tax exemption of $11,580,000. By applying your GST exemption to the trust for your descendants, you can make gifts that will pass tax-free for multiple generations.

II. WILLS AND PROBATE V. REVOCABLE LIVING TRUST

The first step in estate planning is to decide whether to use a traditional will, with probate after each death, or instead to utilize a living trust. Each year the number of estate planning clients insisting on non-probate alternatives grows. Many clients assume that having gone to an attorney for estate planning they have taken steps necessary to avoid probate. Traditionally Texas attorneys have down-played the benefits of non-probate alternatives in light of our streamlined “independent” administration. As revocable trusts have gained popularity, however, they have become more mainstream, and thus easier to implement in full before death. The advantages can no longer be ignored.

A. <u>Specialized Situations</u>. In certain cases, using a revocable living trust should be the standard. Examples of triggering facts include:

1. A Will contest is likely. The practitioner should consider the possibility of a will contest whenever:

a. Children are being treated unequally, or left out;

b. Persons other than the children are included;

c. A second spouse is the primary beneficiary;

d. A single person leaves the estate to non-traditional recipients.

2. Out of state real property is involved. An ancillary probate will be necessary in the other state, which may end up being a dependent administration state.

3. The client is likely to move out of Texas. If the client's employer tends to move him from state to state, if the client indicates a desire to move back to a native state where the rest of the family lives, or if the client indicates a desire to retire in another state, the odds loom large that the client will never receive the benefit of a Texas independent administration.

B. Universal Situations. Although the Texas version of independent administration can be handled very efficiently, there are a number of reasons that clients prefer to avoid probate altogether.

1. Court Appearance. Even one simple prove-up hearing can be difficult for an elderly or incapacitated person, it can be intimidating and stressful, and it can be a difficult emotional experience.

2. Inventory. The general public resents the inventory. In a non-taxable estate, most clients see it as a waste of time and energy. They all see it as a violation of their right to privacy. Some believe it "sets up" the survivor or the children by making them more susceptible to opportunistic salesmen or suitors.

3. More Difficult. Independent administration is not without its inconveniences. For each account the executor may have to produce current Letters Testamentary, a death certificate, various affidavits. Moreover, a surviving spouse often has difficulty focusing on business for the estate for some time after the death. When revocable living trusts are "funded" while both spouses are living, the assets are already in place, and in many cases no transfers are necessary after the first death.

4. Probate Maximization. Traditionally clients avoid probate the best they can by using beneficiary designations, JTWROS accounts, POD provisions and other survivorship techniques. Many are left with only the home and personal effects passing through probate. Unfortunately, for couples with more than $11,580,000 in total gross estate, minimizing probate has the affect of maximizing estate taxes. Moreover, the assets typically left in probate are not best suited for the bypass trust. Accordingly, it is

often necessary to restyle accounts and change beneficiary designations on each asset in order to force the assets into probate, and thus make them available for the bypass trust. This generally involves just as much effort up front as it would take to place the assets in a living trust. Then the process must be repeated at each death to transfer the asset from the estate to the bypass trust or other recipient.

III. BYPASS TRUST

Typically the next step in estate planning for a married couple is to provide (by will or living trust) that upon the death of the first spouse, the estate is divided into two parts: the survivor's estate and a Bypass Trust.[1]

- The surviving spouse is obviously the sole beneficiary of his or her own estate and is either the sole beneficiary of the Bypass Trust or is the primary beneficiary with optional secondary benefits for descendants.

- With proper drafting, the surviving spouse can act as sole trustee without causing the Bypass Trust to be included in the survivor's taxable estate at the second death, thus assuring that both tax exemptions are fully utilized, while allowing the survivor full control over the entire estate.

- Additionally, all growth in the Bypass Trust passes estate tax free at the second death.

A. Income Distributions. The Bypass Trust is often drafted with mandatory income distributions for the surviving spouse. This *all income* requirement has the potential of freezing the value of the Bypass Trust. An *optional* income provision allowing (but not requiring) income to be distributed to the spouse (as primary beneficiary) or descendants (as secondary beneficiaries) is a far better planning technique.

1. To the extent the surviving spouse does not need the trust income, having the discretion to leave the income in the trust allows it to accumulate and grow estate tax free for the benefit of the children and more remote descendants.

2. Income needed by the spouse can still be disbursed, or income can be disbursed to children in lower income tax brackets.

3. With proper financial planning for the Bypass Trust, growth oriented investments can be used, rather than income producing investments, so that income taxes are deferred and then ultimately paid at capital gain rates upon liquidation.

This flexible manner of managing income distributions allows the family to control the income and estate tax consequences of the increases. Under a mandatory income distribution requirement, the income is always taxed to the spouse and the income distributed but not

[1] The Bypass Trust is also commonly referred to as the B-Trust, Exemption Trust, Credit Shelter Trust, or Family Trust.

consumed grows in the estate of the surviving spouse and is subject to estate tax at his or her death.

B. Distributions. Introducing flexibility to the distribution scheme always provides the client with planning alternatives. Such flexibility can take several forms.

1. The spouse/trustee can be given the option of allowing principal distributions to the grantor's descendants during his or her lifetime.

2. He or she may be given a special or limited power of appointment, which provides the surviving spouse the power to appoint the trust assets to one or more of the grantor's descendants or an even broader class of beneficiaries during the surviving spouse's lifetime.

3. The surviving spouse may still serve as trustee when these flexible provisions are included, without being treated as a deemed owner of the Bypass Trust, by providing that distributions to the survivor of income and principal will be made only as needed for health, education, maintenance and support, which is very liberally construed.

4. A surviving spouse's testamentary limited power of appointment over the remainder of the Bypass Trust can also be a useful planning technique if (i) the grantors feel that family circumstances may change, (ii) they simply want to let the survivor determine later how the trust should be ultimately divided, or (iii) they want to keep the children in "check" during the survivor's lifetime. Building in deferred flexibility can also give the spouse the option of later transforming the Bypass Trust into a GST Trust (discussed later).

C. Disclaimer Provisions. The primary estate planning document, and certain beneficiary designations, should also contain a provision directing disclaimed property to the Bypass Trust. This gives the surviving spouse the opportunity to decline certain property, yet assure that it will end up in the Bypass Trust.

D. Retirement Assets. The primary estate planning document should also give specific direction for long term management of any retirement account proceeds left to the Bypass Trust. While deferred tax assets are never the ideal choice for a Bypass Trust,[2] Some estates are primarily composed of such assets, thus eliminating other options. Under IRA regulations, retirement account proceeds left to estates and most trusts must be disbursed by December 31st of the year following death unless special trust terms are included. Carefully complying with the IRS sanctioned trust terms can assure continued tax deferral over an extended period of time.

E. Contractual Agreements. The primary estate planning document should specifically provide for (i) a non-pro rata division of the community estate, (ii) the right to credit

[2] Generally appreciating assets, rather than depreciating assets, should be directed to the Bypass Trust. Leaving a $11,580,000 IRA to a Bypass Trust, and then losing one-third of it in income taxes would be a waste of the credit shelter exemption if $11,580,000 of appreciating after-tax assets could have funded the trust.

assets passing directly to a surviving spouse as an offset against a like value of assets passing to the Bypass Trust, and (iii) community property exchanges. In essence this gives the survivor the ability to "pick" and "choose" which assets will fund the Bypass Trust.

IV. MARITAL TRUST AND GST PLANNING

The next level of planning typically comes into play for a couple when their combined assets exceed an amount equal to twice the tax exemption, or because of separate property issues one spouse's estate exceeds the exemption amount. Estate tax can still be avoided by charitable giving or deferred until the second death by virtue of a marital deduction, which is allowed upon a gift directly to a spouse, a Qualified Terminable Interest Property (QTIP) trust or a Power of Appointment (POA) Trust. The outright marital deduction gift to the survivor is the most common type of marital deduction gift, but the use of a Marital Trust can add additional benefits.

A. <u>QTIP Trust</u>. The most commonly used Marital Trust is the QTIP Trust. The QTIP Trust *must* pay all income to the surviving spouse, who *must* be given the right to force all assets into income producing ("productive") investments. This latter power need not be enforced, but must be available. No person, other than the surviving spouse, can receive any assets from the Trust during the lifetime of the spouse. The primary advantage of the QTIP Trust over the POA Trust is the availability of the "reverse QTIP election."[3] To incorporate the reverse QTIP election, the marital deduction assets are divided into (at least) two parts. One part is a QTIP Trust, which uses the remainder of the GST Exemption available to the deceased spouse. The rest of the marital deduction assets can be (i) given to the survivor outright, (ii) given to a POA Trust, or (iii) given to a second Non-Exempt QTIP Trust. This bifurcation creates a planning advantage. The surviving spouse can expend principal from the Non-GST Exempt assets (whether held outright or in trust), while allowing the corpus in the GST Exempt Trusts to grow and appreciate in value for the next generations. All of the assets are still available to the surviving spouse as needed to continue an accustomed lifestyle, but distributions can be made in the most tax advantageous way possible.

B. <u>POA Trust</u>. While POA Trusts are rarely used, they can provide added flexibility and benefit. With a POA Trust, the spouse is still a mandatory income recipient with the right (but not the duty) to force the Trustee to make all trust assets productive. However, with the POA Trust, the spouse can appoint (require the Trustee to distribute) trust assets in whole or part to other family members. Assets appointed in this manner are treated as gifts by the surviving spouse and are subject to the $15,000 per person, per year annual gift limitations. This can be especially advantageous if the spouse desires to make annual gifts but cannot conveniently do so from his or her own assets. As an example, the surviving spouse's "half" of the estate might be composed primarily of the home, personal effects and IRA rollovers, none of which are a good source for annual gifts from an income tax standpoint.

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[3] IRC Sec. 2652(a)(3) allows a "reverse QTIP election" on all or part of a QTIP Trust. This means that the property will be eligible to receive GST Exemption available from the first spouse's estate, despite being excluded for estate tax purposes. "GST Exemption" is allowed to fund a trust that will continue for more than one generation. Although it could all be spent by the children, to the extent that it is not it passes estate tax free to the next generation.

C. Outright Marital Gift. The excess estate could also be given to the spouse directly and qualify as a marital deduction gift. An outright gift is simpler and may make the survivor feel more secure initially, however, there are disadvantages to an outright gift.

1. If all of the excess estate is given outright to the survivor, the deceased spouse loses the opportunity to fully utilize his GST exemption, while the survivor may end up with an excess estate exceeding his or her own GST allowance.

2. Assets owned outright are not protected from creditors nor from Medicaid spend-down requirements.

3. Assets owned outright can be disposed of in any manner, so there is no guarantee that the assets will ultimately be distributed to the children of the first spouse.

4. Assets owned outright are not protected from future spouses.

D. Blended Family Planning. Occasionally, with a blended family or with a spouse with significant inheritance, the estates may be quite lopsided. The wealthy spouse may want the tight restraint of an income only QTIP Trust which will defer tax until the second death, but guarantee return of the assets to his or her own children. The QTIP may well even avoid tax, to the extent that the survivor does not fully utilize his or her own tax exemption on the survivor's own assets. Additionally, this arrangement may capture all or part of the GST Exemption of the spouse without the wealth at the time of the second death.

V. CHILDREN'S GST EXEMPT AND NON-EXEMPT TRUSTS

In like manner, excess assets can be divided into GST Exempt and Non-GST Exempt Trusts for the children. Even when GST planning is done, typically excess assets (after taxes) are distributed outright to children after the second death (assuming the children have reached a threshold age) unless a spendthrift child is a concern. Non-GST assets can also be maintained in trust, however, with the following benefits.

A. Asset Protection**.** Upon the death of the parents, all of the testamentary trusts are irrevocable trusts from third parties, and thus excellent "asset protection trusts" if spendthrift provisions exist within the trust instruments which insulates trust funds from a beneficiary's creditors.

B. Divorce Protection. These non-GST Exempt continuation trusts are also insulated from commingling and attribution of community property laws to discretionary income, thus providing significant divorce protection for the assets.

C. Flexibility.

1. Control. Upon reaching a specified age, the child can act as his or her own trustee, as long as an ascertainable distribution standard is included.

2. Preservation of GST Trust. Distributions should be made primarily from this trust in order to preserve the GST-Exempt trust which will be non-taxable at the death of the child.

D. Using the Child's GST Exemption. Additionally, with proper planning the tax exemption and GST exemption of a child without his or her own wealth can be applied to this trust at the death of that child, so that the trust can continue tax-free for multiple generations.

E. Distributions. The non-GST Exempt Trust may be a sprinkling trust for the benefit of the child's (or grantor's) descendants or may give the child limited powers to appoint to that same class of beneficiaries during his or her lifetime. By implementing this planning technique during the children's lives, they are able to financially assist their own children and watch them enjoy the benefits of tax-free gifts distributed from the GST Exempt Trust. Moreover, income tax may be shifted to persons in lower income tax brackets.

F. Preservation of Capital. Assets in a trust are typically spent more slowly than assets owned outright by children.

G. Ultimate Distribution. The ultimate distribution of the non-GST Exempt trust may still be controlled by the wishes of the parents, so that the child cannot leave the excess to someone outside the expectations or approval of the parents. If the grantor wants to shift some or all of the control over the ultimate disposition of the assets to the child, then special testamentary powers of appointment can be drafted to define the potential recipients either conservatively or liberally.

VI. LIFETIME GST-EXEMPT "GIFT" TRUST

There are a number of circumstances in which the GST Exempt Trust can produce even more benefit if funded, in whole or part, during the parents' lifetime. Typically such trusts are established using "Crummey" withdrawal powers so that the gifts are covered by the annual gift allowances available to the parents for each beneficiary.[4]

A. Funding Excess GST Exemption. Assuming assets suitable for gifting are available to the parents while living, the GST allowance could be funded with annual gifts during life. This can create dramatic tax savings because all of the future growth and income on the lifetime gifts to the GST trust would accumulate gift and estate tax free.[5]

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[4] Technically the $15,000 annual gift allowances are only available for gifts of a "present interest," meaning they are actually given to a person in that year. Ordinarily gifts to a trust would not satisfy this requirement, and thus they would be subject to gift tax, or alternatively they would use part of the unified credit gifting allowance (currently $11,580,000). To avoid this result, a short-term opportunity to withdraw the gifted assets can be offered to the beneficiary, who can decline the offer for himself and his minor children. If not withdrawn within 30 days, the gifted assets stay in trust. Because the beneficiary had a fair chance to take the assets, the annual exclusion applies to the gift.

[5] When properly constructed, GST Exemption is allocated based on what goes into the trust, with unlimited internal growth potential. Thus, if $355,000 per spouse is gifted during life, it could multiply numerous times and still be GST Exempt.

B. <u>Structuring the Gift Trust as a Defective Grantor Trust</u>. If the GST Trust is constructed as a defective grantor trust, the tax savings would be even more dramatic.

1. The parents would still pay any income tax accruing on income received in the trust– just as they would have done had the gifts not been made at all.

2. This avoids highest bracket trust rates and potentially higher marginal brackets for children in peak earnings years.

3. Accumulation in the GST Trust is more rapid, similar to the growth in a tax-deferred IRA, but there is no back-side tax for the trust or the children.

4. Payment of the income tax by the parents further reduces their taxable estates.

5. The duty to pay the income tax for the Trust actually allows the parent to give more than $15,000/per beneficiary each year, because the tax payment does not count against the annual gifting allowance.

This retained income tax obligation can be "turned off" at any time, should it later become a burden for the parents, after which time the Trust can pay its own way. Alternatively, the Trust can invest in growth assets to defer income tax and then ultimately allow realized gains to be paid at capital gain rates, which are lower than regular income tax rates.

C. <u>Gifting Leveraged Assets</u>. The lifetime gifts can be further leveraged by gifting discounted assets, such as minority interests in a closely held business or family partnership. This creates the additional advantage of locating an asset to give when the parents are relatively illiquid.

D. <u>The Gift Trust Can Double as a Life Insurance Trust</u>. Assuming the surviving spouse will not need the life insurance, or that the policies are second-to-die, shifting life insurance investments to the Gift Trust provides the dual advantage of leveraging the GST allowance while removing a large taxable item from the estate at a comparably nominal gifting value.

E. <u>Protection of Gifted Assets</u>. The use of the Gift Trust extends the asset protection and divorce protection of testamentary gifts to the gifts made during life.

F. <u>Equalizing the Estate</u>. The Gift Trust can be established as a one-basket trust during the life of the grantors, then convert to equal split-off trusts for each child (primarily) and his or her descendants (secondarily) after the death of the surviving spouse, and thus after the intervivos gifts are concluded. This assures equity between the children in cases where some children have larger families than others. Otherwise, lifetime gifting to all available beneficiaries would disproportionately advantage the family of the child with the most children, while disadvantaging the family of the child with the smallest family.

G. "Using" the Exemptions Available to Secondary Beneficiaries. Most clients really want the children to have the assets. Adding minor benefit to more remote descendants (and in some cases spouses of descendants) can dramatically increase the amount that can be gifted to the Trust each year. The benefits given to the secondary beneficiaries may be nominal or contingent so that the children really end up with the benefit the "gifts" made for the secondary beneficiaries. [6]

H. Control. Using the Gift Trust, the parents would be able to put control of all gifted trusts in the hands of a single responsible trustee, thus avoiding concern that the assets would be squandered by certain beneficiaries during the lifetime of the parents. The trustee can be one of the children, another relative, or a third party. The parents could provide for ongoing management of the trust shares (or some of them) after the second death, or simply allow each child to take control of his or her trust share at that time.

I. Dovetailing. The Gift Trust could be merged with the Bypass Trust and other GST exempt shares established after death to simplify administration.

J. Full-Funding. The Gift Trust can in some cases be fully funded with the GST allowance during life.[7] In this event the tax free allowance available at death would pass to the children outright or in a non-GST Exempt trust.

VII. LIFE INSURANCE TRUST FOR SPOUSE

Life insurance proceeds ultimately will be taxable as part of the estate at the second death if the insured owns the policy or the spouse is the beneficiary. The tax on life insurance can be avoided in any of the following ways. Transfers of policies within three years of death are disregarded.

1. Ownership in Spouse. This does not solve the problem if the spouse is also the beneficiary. She ends up with cash, and it is a part of her estate.

2. Ownership in Children. This can work, provided the surviving spouse does not need the funds; skipping tax on parent's estate only is acceptable; there are no concerns about divorces or creditors of the children; the children are all adults; and the children are mature enough to take the funds outright.

3. Ownership by Gift Trust. An intervivos trust for the children, typically GST Exempt, can own the policies. A surviving spouse will not be a beneficiary, but otherwise the problems of children owning the policies outright are avoided.

4. Life Insurance Trust. This is typically the best alternative if a surviving spouse may need access to the funds. A life insurance trust protects the assets from tax at both deaths, working much like a

[6] Benefits given to spouses may terminate upon a divorce, or be limited to situations where they are left widowed. Even then the spouse may be a secondary beneficiary to the grandchildren who would step into the primary benefit of their deceased parent's share.

[7] Variables affecting the likelihood of full prefunding include (1) the age of the parents when gifting begins, (2) the number of natural beneficiaries, (3) whether spousal annual gifts are utilized, and (4) the extent of assets available for funding.

bypass trust; it can be continued after both deaths if needed; and the trust will be fully protected from creditors. This trust would be funded with separate property gifts by the insured.[8] In some cases two separate life insurance trusts are necessary. They may not be mirror images of one another, and special trustees may be needed if the spouses serve as trustees for one another.

VIII. AVOID WASTING EXEMPTIONS

The tax-free allowance and the GST allowance are valuable long-term benefits if used well. Care must be taken to avoid wasting allocation of these resources.

A. Spousal Trusts. Do not allocate GST Exemption, or credit shelter exemption, to a life insurance trust if:

1. The surviving spouse is likely to expend a significant portion of the assets during his or her lifetime, or

2. The life insurance trust will be used to pay estate taxes.

B. Gifts to Descendants. Do not allocate exemption to gifts that you expect a descendant to expend during his or her lifetime.

1. Educational funds or side trusts can be separately established with the expectation that the beneficiary will significantly expend the assets; and

2. Non-GST Exempt subtrusts can be set aside (even within a Gift Trust) for children who are likely to spend their trust share during their lifetimes, or who are unlikely to have a taxable estate, after taking into account their trust share. In such an event, GST allocation can be reserved for the trust shares of the wealthier children or those less likely to expend their trust share for other reasons.

C. Coordinating Beneficiary Designations. The best of estate plans can be totally defeated by a lack of coordination with beneficiary designations. A couple may create a bypass trust through wills, and then leave virtually all of the assets directly to the survivor by non-probate transfers of life insurance, IRAs, and joint tenancy with survivorship accounts. Ill-considered efforts to move assets through the estate can likewise result in disaster.

IX. FAMILY LIMITED PARTNERSHIPS

Investment assets can be transferred to a Family Limited Partnership ("FLP"). The parents then "slice off" and gift partnership shares to their descendants (or a trust for them) each year. The advantages of such action are numerous.

[8] The beneficiary can make no contributions to the trust, or the trust balance will be taxable in his or her estate at death. That means that no community property can be put into a life insurance trust for a spouse. Community property can be converted into separate property and then used to fund the trust or give amounts sufficient to pay life insurance premiums.

1. The General Partners can control 100% of the partnership, even if they own only a small part of it.

2. Retained control does not cause all of the partnership to be deemed part of the gross estate.

3. Annual gifts of FLP interests may be made (painless giving).

4. Gifts cannot be squandered or abused by the donee, because he or she does not have possession or control of underlying assets.

5. Distributions of income to Limited Partners can be deferred or avoided by the General Partner.

6. income tax can be shifted to lower brackets on the portions of the FLP owned by descendants.

7. Fractional FLP interests are valued at "discount" at estate tax time ranging from 15-55%; thus, one million in assets may be immediately squeezed down to $650,000 (with immediate elimination of estate tax on the discount).

8. The percentage of any life insurance included in the estate (if you do not use a life insurance trust) can be diluted by having the FLP own the policies (both because of the discount and because of the gifting).

9. The FLP minimizes probate in much the same way a living trust does. Although it does not eliminate probate, it simplifies it and simplifies the division between the Bypass Trust and the remainder of the estate.

10. Use of the FLP can eliminate the need to have probate on out-of-state assets if the property is in the FLP.

11. Use of the FLP avoids retitling of individual assets at each gift or death.

12. Giving fractional interests in the FLP assures that individual assets do not have fragmented ownership.

13. Buy-Sell restrictions limit transfers out of the family.

14. Use of the FLP simplifies gifting by allowing the gift to be accomplished by simply signing a piece of paper each year rather than literally moving the assets into the possession of the children.

15. Liability of General Partner to other partners is based on a lower standard than Trustee, thus exposure to children is minimized.

16. General Partners have the ongoing ability to amend or revoke the FLP.

17. A FLP offers significant creditor protection and divorce protection for all partners.

18. A Trust or Corporation can be a general or limited partner, and the FLP can own a corporation.

19. Children or their existing Trusts can exchange assets for FLP interests to consolidate past gifts.

20. Multiple entities and Trusts can retain interests in the FLP, allowing pooling of assets for leveraging investments.

21. Liability is avoided for the limited partners as to any business engaged in by the partnership.

22. Disparate distribution is available. Thus, the General Partners could distribute its share of the income while retaining the income attributable to the share of the Children. In addition, if the General Partners need more than

their share of the income for any reason, they can salary it out for services and thus reduce the profit pool to be allocated among the partners.

23. Existing trusts and custodial accounts can invest in the FLP, diminishing the impact of turning over assets at age of majority, in that the asset turned over is a limited partnership interest, bearing no burden of management nor benefit of control.

24. As to any appreciating assets contributed to the partnership, step up in basis is not lost as to the part not yet given away to the children.

X. SHIFT OWNERSHIP OF ASSETS

Parents can gift assets to children over time. Certain assets that are expected to appreciate rapidly in the future may be most appropriate for gifting, before that appreciation occurs. Start-up ventures and construction projects can be established within an entity owned primarily by the children (or their trust) from inception, with nominal capital outlay by them. If the parents need to retain control, consider using voting agreements or general partnership shares in a limited partnership. There are numerous ways to effect gifts, depending on the circumstances.

1. Outright Gifts.

a. Advantages. The primary advantage of outright gifts is simplicity, since nothing special is required to make the gifts, other than transfer documentation. The gift is a present interest gift to the child, thus it qualifies for the annual exclusion from gift taxes.

b. Disadvantages.

(1) Management Problems During Child's Minority. The major disadvantage of outright gifts to a minor would be the inability to effectively manage the assets during the child's minority. In order to sell an asset originally given to a minor, it would be necessary to establish a guardianship for the child (which is cumbersome and expensive) or obtain a court order (which is only available to a limited extent).

(2) Control. The child would actually own the assets, thus a child can fully dispose of the assets upon the first to occur of (i) attaining age 18, (ii) marriage, or (iii) upon having the disabilities of minority removed.

2. TUTMA or TUGMA.

a. Requirements. The requirements for making gifts to a minor pursuant to the Texas Uniform Transfers to Minors Act ("TUTMA"), include the following:

(1) Specifically providing that the gift is made to a custodian for the beneficiary pursuant to the Texas Uniform Transfers to Minors Act.

(2) The beneficiary of the gift must be under age 21 at the time of the gift, and the custodial arrangement terminates when the child reaches age 21. This is a change from the previous Texas Uniform Gifts to Minors Act ("TUGMA"), which only went through age 18.

(3) The gift must be solely for the benefit of one person, there may be only one custodian, the donor must put the gift within the possession and control of the custodian, and the custodian must be the donor, another adult, or a trust company.

b. Advantages.

(1) Simplicity. A custodianship has virtually all of the simplicity of a direct gift, although it will create certain fiduciary obligations and responsibilities for the custodian.

(2) Annual Gifts. A gift to a TUGMA account qualifies for the annual exclusion.

(3) Wide Variety of Gifts. TUTMA allows a wide variety of assets to be given to the donee through use of a custodianship, including money, securities, life insurance policies, partnership interests, annuity contracts, real estate, and tangible personal property.

(4) Lasts Through Age 21 Instead of 18.

c. Disadvantages.

(1) Termination Age. The beneficiary will be entitled to all funds at age 21.

(2) Estate Tax Issues. When a parent sets up a custodianship for a child and names himself as custodian, the assets will be included in the estate of the parent if he dies before the child reaches majority.

3. 2503(c) Trust. Generally only a gift of a "present interest" qualifies for the $15,000 annual exclusion, which generally excludes a gift to a trust for "future" benefit. There are exceptions, however. An IRC Section 2503(c) trust makes the annual exclusion available for certain types of gifts made to a trust, provided the trust principal and income may be expended by, or for the benefit of, the beneficiary before he attains the age of 21 years; and provided the trust principal and income will pass to the donee when he attains the age of 21. If he dies before attaining that age, it will be payable to his estate or as he may appoint under a general power of appointment. If estate tax savings are a desired result of the gifts, it is inadvisable to use the donor as the trustee of a 2503(c) Trust, because the trust typically will be included in the estate of a donor who is acting as Trustee if he dies before the trust ends.

b. Advantages.

(1) Income Tax Entity. A 2503(c) trust is a separate entity for income tax purposes. It has its own tax brackets. As such, income earned for a beneficiary under the age of 14 years is not subject to the kiddie tax. Instead, that income would be taxed to the trust, except to the extent distributions are made from the trust. This is primarily an advantage only for smaller trusts.

(2) Ease of Administration. Although trust income tax returns need to be filed, a 2503(c) trust is less cumbersome than some other trusts.

(3) Flexibility. The trustee of a 2053(c) trust has wide discretion to invest the trust assets and make distributions.

c. Disadvantages.

(1) Termination Time. This trust must legally end at age 21.

(2) Separate Trusts. Because a 2503(c) trust may have only one beneficiary, each child must have a separate trust.

4. Crummey Trust. Crummey trusts are named after the case which first held that the annual exclusion was available for gifts to trusts which contained certain withdrawal rights. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968). Crummey trusts can be created for multiple beneficiaries, or for a single beneficiary. A lifetime "GST Exempt Gift Trust" is often created as a Crummey Trust.

a. Withdrawal Right. The beneficiary must be given a technical right to demand or withdraw the gift that was made, which makes the gift to the trust a "present interest" rather than a future interest. This right can end after 30 days and a parent can voluntarily decide (for a minor) to leave the gift in the trust.

b. Termination Date. Unlike a 2503(c) Trust, there is no mandatory time for terminating a Crummey trust.

c. Trustee. For the same reasons set forth with regard to a 2503(c) Trust, it is inadvisable to allow anyone who will be making gifts to that trust to serve as the trustee.

d. Administration of the Trust.

(1) Annual Notices. Care should be taken to ensure that the withdrawal rights will be recognized for annual exclusion purposes. So, each year in which a gift is made notice of the withdrawal right will be given to the beneficiary.

(2) Income Taxation. A Crummey trust can be designed so the beneficiary is the deemed owner, the settlor is the deemed owner, or the trust is the deemed owner of the assets for income tax purposes.

5. Trust That Do Not Qualify for Annual Exclusion Gifts. Other trusts can also be used for gifts to descendants, but if any do not come within one of the requirements for qualifying for the annual exclusion, the gifts to that trust will be taxable gifts or use part of the $11,580,000 lifetime allowance. Using the lifetime exemption during life, rather than at death can have advantages. This trust is often used to receive gifts that can be used for multiple generations.