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Estate Planning: There's More at Stake than Just Taxes

The primary goal in estate planning for many clients is minimizing taxes. Clients with this in mind may hesitate to begin planning their estates given the uncertainty that currently surrounds the future of the federal estate tax. Other clients may feel that they do not need to worry about estate planning because their estates might fall within the current federal estate tax exemption, or because they have already planned their estates in a tax-efficient manner.

Estate planning, however, is about more than minimizing taxes – it is about taking care of people, whether yourself or those who are dear to you. Notwithstanding the uncertain tax environment, estate planning can be an effective tool for securing the financial future of your family, as well as ensuring that your wishes regarding health care and end-of-life issues are respected. Even those clients who have already planned their estates around the federal estate tax may have family or business situations arise that call for an updated estate plan. This client advisory will highlight estate planning alternatives you may want to consider to protect your spouse or partner, your dependents and yourself, regardless of the fate of the estate tax.

Providing for Your Spouse or Partner Intended Beneficiaries.

Creating a will allows you to determine the distribution of your estate. If you die intestate (that is, without a will), state law will make this decision for you.

If you do not have a will, are married and have children who are also the children of your spouse, your spouse will receive the first \$100,000 of your intestate estate if you are a resident of Connecticut (\$50,000 if you are a resident of New York), plus one-half of the rest of the estate. Your children will receive the other half of the estate.

Intestate distributions can be problematic if your children are still minors or one of them has special needs. They can also seriously disrupt the financial expectations of the surviving spouse. Further complications could arise if you have children who are not also children of your spouse.

Legislatures design intestacy laws to conform to their conceptions of the best interests of the survivors, but these laws may not be the best plan of estate distribution for you and your family. If you have minor children, you may want to ensure that the whole of your estate passes to your spouse so that he or she can continue to provide for your family without the involvement of a guardian. Furthermore, as most intestacy laws do not make provisions for non-married partners, wills are essential planning tools for such couples.

Multiple Marriages and Blended Families.

If you or your spouse has been married more than once, you may want to tailor your estate plan to reflect your family's particular needs. You may be able to do this in a way that will equitably provide

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for your loved ones, while diffusing potential disputes that might arise between family members. For example, you can elect to name your spouse the lifetime beneficiary of a marital trust. This will allow the spouse to benefit from the trust's income during his or her life, while passing the principal to designated children after the spouse's death.

Life Insurance.

The death of a primary income earner can place a tremendous financial strain on a family, especially if the family has small children or is facing the costs of higher education. Life insurance can help families meet these long-term challenges. Insurance proceeds can also help families deal with immediate, short-term demands, by putting cash in the hands of survivors who may need to pay for estate administration and funeral expenses. Life insurance can also provide liquidity for estate taxes. This may be particularly useful if the estate has difficult-to-value assets (e.g., a family business) or assets that do not generate income (e.g., residential real estate).

ILITs.

One tax-efficient way of transferring the benefits of a life insurance policy to children is an irrevocable life insurance trust ("ILIT"). An ILIT owns an insurance policy and, upon the death of the insured, the proceeds of the policy are payable to the trustee for the benefit of designated persons – for example, for children to pay for their educational expenses or other activities. The grantor of the ILIT deposits annual amounts of cash into the trust, which the trustee (who must be someone other than the grantor) then uses to pay

the insurance premiums. If the grantor makes these gifts in such a way that they fall within the annual gift tax exclusion, the life insurance proceeds will pass to the intended beneficiaries outside of the insured's taxable estate.

There are also non-tax-related reasons for creating an ILIT. You may want the proceeds from your policy to go into trust because the beneficiaries are minor children, and a trust will allow you to arrange for management of these assets until the children are prepared for that responsibility. A trust can also help you protect the insurance proceeds from third parties, such as creditors who might otherwise have a claim on them.

Avoiding Probate.

There are a number of reasons why you may want to avoid the probate of your estate. Some states charge probate fees based on the value of the assets passing under a will (rather than based on the value of all of your assets, some of which might be in trust). In these states, minimizing your probate estate can therefore reduce expenses that would otherwise deplete the assets passing to your family. Probate can also tie up your assets for a period of time after your death. While this delay can be very brief if your estate is uncomplicated, it can be lengthened if, for example, a family member challenges the distribution of your estate.

Finally, probate is a public process that could reveal details of your financial affairs that you would prefer to keep private. You can avoid this public scrutiny by placing your assets in a revocable trust. Such a trust can also be advantageous if you own

real estate in multiple states or an interest in a closely-held business.

Planning for Your Children and Dependents

Appointing a Guardian.

If you have minor children, estate planning can be critical for ensuring that your intentions regarding their upbringing are respected. In a will, you can express your preference as to who will serve as the guardian of your children. While the power of designating a guardian ultimately lies with a court, judges generally respect the wishes of a parent in this area. A judge can only guess your wishes, however, if they are not recorded in a will. This can be particularly problematic if your preferences are at all different from what the court thinks the “average” person might choose.

Children with Special Needs.

If you have children or dependents with special needs, estate planning can be a crucial means of preserving their standard of living and professional care. If a person with mental or physical challenges receives a large enough inheritance, he or she could be prevented from collecting governmental assistance for which he or she would otherwise qualify. This outcome can be avoided through the use of a properly structured special needs trust, which can prohibit the use of trust funds for items covered by government assistance, like food, clothing, and shelter. The trust funds can then be used to pay for important “extras,” such as accessible vehicles, upgraded housing, personal assistants and recreational activities. A special needs trust can therefore help ensure that

a dependent with special needs will be able to continue to enjoy his or her accustomed standard of living.

Asset Protection.

Estate planning allows you to support family and loved ones while ensuring that the funds or assets you provide are used responsibly. Whether or not there is an estate tax, proper planning may be necessary to protect beneficiaries from themselves. If, for example, you would like to leave funds to a child who may have a gambling or substance abuse problem, you can place these funds in a trust with directions on how they will be spent. One way to do this is to appoint a bank, trusted friend or advisor as the trustee with instructions only to disburse funds for particular purposes, such as education or the down payment on a first home. This kind of discretionary trust can also be used to prevent third parties, such as ex-spouses and creditors, from having access to funds that you have set aside.

This method of asset protection can also be useful in providing for children who are not mature enough to manage funds for themselves. You can require that the child justify to the trustee the need for any proposed expenditures, thereby simultaneously protecting the funds from the impulses of youth while instilling in the child a sense of financial responsibility.

Family Business Succession.

Estate planning is an essential part of planning for the future of a family business, especially if an interest in such a business is one of your primary assets. If your children have different ideas about the future of the family business and their

participation in it, planning for succession can diffuse a potential source of conflict. Planning your estate can be an opportunity for you to discuss the business with your children in order to ensure an orderly transfer of ownership.

Buy-sell agreements can also help smooth transition within a family business. Such an agreement can specify who will be able to purchase a deceased shareholder’s interest in a business and what price will be paid for that interest. A buy-sell agreement can therefore avoid valuation disputes and prevent unwanted interference in the business by a family member whose talents may not be within the scope of the business.

Life insurance proceeds can also be used to equalize inheritance between those children who would like to participate in the business and those who choose to opt out, without requiring the children who stay in the business to sell off needed capital assets. Even if all of your children choose to keep an interest in the business, the proceeds of a life insurance policy can be used to preserve cash flow in a time of transition.

Taking Care of Others by Taking Care of Yourself

Another way to look after your loved ones is to make appropriate arrangements for your own future care. With a durable power of attorney, you can select one or more persons to administer your finances in case you become legally incompetent. A revocable trust can also be used for the management of your assets by a trustee in the event of your incapacity. You can also

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give your family guidance regarding your medical treatment by recording your wishes in a health care directive. A health care directive allows you to designate one or more individuals to make decisions regarding your medical treatment in the event that you are unable to do so. Finally, long-term care insurance can not only assist with paying for care, but can often include care coordinator services and easier access to specialized provider networks.

Conclusion

Whatever happens to the estate tax, the need to provide for loved ones will continue. Estate planning remains a vital means of supporting spouses, partners and dependents in a variety of situations. Your estate plan, however, will only achieve your goals if you keep it up to date. Even if you already have a plan in place, you may want to review it to make sure it reflects your present wishes and family situation. With the proper planning, you can give yourself and your loved ones the priceless gift of peace of mind.

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Year-End Financial Planning

As 2007 draws to a close, you may want to consider the following financial planning options:

Annual Gift Exclusions. The annual gift tax exclusion is a sum which is exempted from gift tax under the Internal Revenue Code. In 2007, individuals may give up to \$12,000 to a recipient without incurring gift tax, while the exclusion for married couples who consent to gift-splitting is \$24,000 per recipient. This exclusion applies only to gifts of a present interest. Please note that a gift made by check to a non-charitable recipient is taken into account for the tax year in which the check is deposited or cashed by the recipient. Therefore, if you would like to use this method to make gifts qualifying for the gift tax exclusion, you will need to give the recipient enough time to deposit or cash the check before the end of the year.

Charitable Contributions from IRAs. Under the Pension Protection Act of 2006, individuals who have attained age 70 ½ may exclude up to \$100,000 from their gross income for direct distributions from their IRAs to qualified charitable organizations. To be eligible for this exclusion, an individual must have reached age 70 ½ by the date of the gift. This charitable gift incentive expires at the end of 2007, so you will need to act soon if you would like to take advantage of this provision.

Qualified Conservation Contributions. The Pension Protection Act of 2006 allows individual taxpayers an increased tax deduction for qualified conservation contributions (real property donated to a charitable organization exclusively for conservation purposes). It also increases such tax deductions to 100% for contributions by certain farmers or ranchers. The provision permits individuals to carry forward unused deduction amounts for 15 years. Like the exclusion for IRA contributions noted above, this incentive expires after December 31, 2007, so you will need to act quickly if you would like to make a qualifying contribution.

Section 529 Qualified Tuition Programs. The Pension Protection Act of 2006 also made permanent the tax benefits of Section 529 Qualified Tuition Programs. These programs allow individuals to save for college expenses on a tax-free basis, provided the funds are ultimately used for qualified tuition expenses. Section 529 Plans were approved by Congress in 2001, but uncertainty about the future tax treatment of these accounts made some people hesitant to contribute to them. Now that the ongoing tax advantages of Section 529 Plans are secure, you may want to take advantage of them.

Your state may also offer tax incentives for contributions to such accounts. Connecticut, for example, allows deductions from adjusted gross income for contributions made to Connecticut Higher Education Trust (“CHET”) accounts after January 1, 2006. Individuals whose filing status is single or married filing separately may deduct up to \$5,000 for state income tax purposes for such a contribution, while the deduction allowed on a joint return is \$10,000. For more information about Section 529 Plans, please see our Spring 2006 Client Advisory on paying for education expenses.

Optimizing Use of Capital Losses. Given the volatility of the stock market over the past year, you may own stocks, mutual funds or other investment assets with unrealized capital losses. If you choose to recognize such losses by selling these assets, the losses can be used to offset capital gains or up to \$3,000 of ordinary income. If you have a capital loss carry-forward from a prior taxable year, it may be to your advantage to realize capital gains this year. Please note, however, that the IRS denies capital loss deductions for stocks, mutual funds or other securities purchased and resold within 31 days.

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