

Why Estate Planning Is Still Important

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The increase in the federal estate, gift and generation-skipping transfer tax exemptions, coupled with the uncertain future (and possible complete repeal) of the transfer tax system, have led many people to believe that estate planning is no longer necessary. Even if the federal transfer tax system is eliminated, state transfer taxes may remain (or even increase). Moreover, non-tax personal and business issues are important reasons to have a proper estate plan. Without a carefully considered estate plan, an individual's wealth may not be distributed according to his or her wishes, nor include appropriate trust arrangements. And for owners of closely-held businesses, coordinating business succession planning with personal estate planning will remain critical.

Intended Beneficiaries

If an individual dies intestate (*i.e.*, without a will), his or her estate is distributed according to the laws of intestate succession of the state where the decedent resided at the time of death. This may not be the distribution scheme that the decedent would have intended. For example, under the laws of intestate succession of Connecticut and New York, if a person dies intestate survived by a spouse and children, the surviving spouse is entitled to the first \$100,000 of assets in the case of Connecticut (or \$50,000 in the case of New York) of the decedent's estate, and the remaining assets are divided one-half to the surviving spouse and one-half to the children outright. This distribution

may be problematic. If the decedent is survived by a spouse and minor children, a preferable plan might be to leave the assets entirely to the spouse for the economic protection of the family. Furthermore, the laws of intestacy do not take into account circumstances such as where a beneficiary has substance abuse or creditor problems, is disabled, or has been adequately provided for prior to the decedent's death. The only way to avoid having the laws of intestate succession apply is for an individual to memorialize his or her wishes in a will, revocable trust or other written estate planning documents.

Appointing a Guardian

For an individual with minor children, a will often serves another extremely important purpose. A will provides a parent with the opportunity to designate who the parent prefers to have act as guardian of the children upon the parent's death. Although a judge ultimately decides who will be appointed as guardian of the children by determining what is in the best interests of the child, judges usually defer to the parent's wishes as designated in a will. If a parent dies intestate, or in the absence of a designated guardian under a valid will, a court may not know who the parent would prefer to raise his or her children.

Avoiding Probate By Creating a Revocable Trust

Trusts can accomplish many non-tax related estate planning goals. The

ability to avoid probate is one of the fundamental reasons why people create revocable trusts. If assets are held in a trust, the decedent is not usually required to publicly disclose those assets and their values following death, thus helping to ensure that the decedent's financial affairs will remain private. Moreover, assets placed in a revocable trust will not be subject to the delays and inconvenience caused by probate; instead, those assets are available immediately to support the family and pay the decedent's debts. This is especially important in two situations: (1) when a decedent owns real estate or tangible personal property located in a state other than the state in which the decedent resides, because the use of a living trust may avoid the cost of ancillary probate proceedings (*i.e.*, having the person's will admitted to probate in each state where his or her property is located), and (2) for individuals who own closely-held businesses, if the inability to have immediate access to assets may cause significant hardships.

Planning For The Possibility of Incapacity

An important part of estate planning is planning for incapacity. A general durable power of attorney allows you to designate one or more individuals to manage your assets in the event you become incompetent. Similarly, the use of a revocable trust permits an individual to arrange for the conduct of his or her affairs in the event of incapacity due to ill health or advanced age. If an individual creates a revocable trust prior to becoming incapacitated, a trustee of the trust assumes the management of the individual's financial affairs without interruption should the individual become disabled. If the individual recovers from the disability, he or she can once again take

over the management of the assets and affairs of the trust.

Asset Protection Planning for Beneficiaries

Regardless of the future of the transfer tax system, proper estate planning is advisable to protect beneficiaries with drug, alcohol or gambling problems, divorcing spouses and creditor issues. Through the use of trusts, an individual can give a trustee the power to control the management and distribution of assets to a beneficiary who is a minor, is inexperienced in handling financial matters, is a spendthrift or is susceptible to unscrupulous influences. In addition, assets held in trusts are protected from anyone exerting undue pressure on the beneficiary for investment capital or charitable contributions.

Providing for a beneficiary's assets to be held in trust can also help impose discipline upon a beneficiary who is incapable of, or inexperienced with, managing money on his or her own. For example, with a discretionary trust (*i.e.*, a trust whereby the trustee has the discretion to distribute funds to a beneficiary), if the beneficiary cannot justify why funds are needed for a particular purpose, the trustee is not required to make any such distribution. Thus, this discretionary power may be used to teach minors how to use inheritances prudently.

Trusts are also helpful to ensure that an individual's estate does not pass to unintended beneficiaries. Depending on the terms of the trust, beneficiaries typically have no right to demand that the assets of the trust be conveyed to them. As such, trust assets are generally protected from the claims of a beneficiary's creditors, including both commercial creditors and family creditors (*e.g.*, divorcing spouses).

Estate Planning for Multiple Marriages and Blended Families

For individuals who have been married more than once and have children from a prior marriage, it is imperative to have an estate plan that addresses the potentially competing financial interests of various family members. One of the benefits of estate planning in these situations is that it permits someone to provide income from a marital trust to a surviving spouse for his or her lifetime, while ensuring that after the death of the surviving spouse, the principal of the trust will be distributed to the decedent's children (as opposed to the surviving spouse's children from a prior or subsequent marriage).

Beneficiaries With Special Needs

Parents of children with disabilities have additional non-tax reasons for estate planning. Without a properly structured special needs trust (in New York, referred to as "supplemental needs trust"), a disabled beneficiary's direct inheritance through intestate succession or under a will may result in the person no longer qualifying for governmental assistance (*e.g.*, SSDI and Medicaid). With a properly structured special needs trust, assets allocated to the disabled person can be held in a trust without jeopardizing the beneficiary's eligibility for such benefits. Special needs trusts are often drafted to prohibit trust funds from being used to pay for food, clothing and shelter because such necessities are usually covered by government assistance. Rather, the trust assets can be used to supplement government benefits by paying for items designed to enhance the quality of life of the beneficiary, such as wheelchairs, handicap-accessible vans and personal attendants, as well as recreational and cultural experiences.

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Liquidity Planning and Life Insurance

A decedent's heirs often face the problem that they lack the funds to pay for estate taxes and other administration expenses, unless they are prepared to sell the decedent's assets (which may be problematic, especially if business assets are involved). Life insurance policies provide a means to pay anticipated taxes, to reduce debt upon the death of the insured and/or to create assets to be passed to beneficiaries. Moreover, life insurance is critical for income replacement if the primary wage earner of the family dies at a younger age.

In the case of business succession planning, even if estate taxes are not a concern, life insurance can be useful when there are management and liquidity needs and where funds are needed to preserve a closely-held business (e.g., to fund buy-sell agreements). Insurance proceeds can also be used to equalize an estate between children who want to continue the family business and those who would rather liquidate it and receive their share. The funds can buy out those children who want to liquidate the family business, without causing the remaining children to have to sell business assets that may be necessary for the operations of the entity.

Life Insurance Trusts

In addition to providing a very effective way to transfer wealth to persons in younger generations without the imposition of income, estate or gift taxes (assuming the trust is properly drafted), an irrevocable life insurance trust ("ILIT") also offer numerous non-tax advantages. An ILIT is an irrevocable trust which owns the insurance policy or policies on the life of the grantor (*i.e.*, the creator of the trust). The grantor of an ILIT usually makes annual gifts of cash to the trust,

which the trustee uses to pay the policy's premiums. If structured properly, the annual gifts made by the grantor qualify for the annual gift tax exclusion amount (currently, \$11,000 per donee) and, thus, it is often the case that no gift taxes arise. Although the grantor cannot retain any incident of ownership (such as serving as a trustee, retaining any power to amend or revoke the trust, changing beneficiaries or borrowing against the policy) without the proceeds being included in his or her estate, the grantor, as the creator of the ILIT, determines how the proceeds will be distributed. Thus, similar to the revocable trusts described above, the grantor specifies in the trust instrument how he or she would like the funds to be distributed following the grantor's death. However, unlike revocable trusts, the assets held by the insurance trust (that is, the policy proceeds) will ordinarily not be subject to estate taxes upon the grantor's death (unless the policies were transferred into the trust within three years of the grantor's death). In addition, favorable income tax treatment afforded to life insurance permits the values that accrue within the policy to accumulate free of income tax during the grantor's lifetime. Moreover, upon the grantor's death, the life insurance proceeds received by the trust (and ultimately, by the trust's beneficiaries) are not subject to income taxes. Consequently, the use of ILITs can provide individuals with a mechanism to transfer a significant amount of wealth to younger generations without the imposition of income, gift or estate taxes.

Family Business Succession Planning

The estate planning goals for most owners of closely-held businesses are to preserve the value of the business, provide for the orderly transfer of the business to younger generations, and

minimize income and transfer taxes. Thus, effective estate planning must be coordinated with business succession planning in order to properly address the tax and non-tax considerations presented on the transfer of family businesses.

As noted previously, family business succession planning becomes increasingly complex when only some beneficiaries want to own or manage the business, or when beneficiaries have varying talents or disagree about the future of the business. Among other things, issues involving the compensation of family members who work in the business have the potential to cause significant discord among family members. Therefore, it is advisable for a business owner to try to resolve such issues prior to his or her death.

One method is to enter into a buy-sell agreement that specifies the terms of any future sales of interests in the business. Not only are such agreements useful in helping to determine the value of the business interest involved for gift and estate tax purposes, but they also have non-tax benefits. The two main purposes normally underlying buy-sell agreements are: (1) wealth preservation and providing liquidity for the deceased owner's estate, and (2) the remaining owners' maintenance of continuity and control without unwanted outside intervention. As discussed above, one of the most common ways to fund the

Effective use of intra-family gifts can significantly enhance wealth creation and reduce transfer tax liabilities. Attorneys in Wiggin and Dana's Trusts and Estates Department welcome the opportunity to assist you in implementing a systematic gift program for your family. Our names and telephone numbers are listed on the first page of this Advisory.

*continued***WIGGIN AND DANA***Counsellors at Law*

The Wiggin and Dana Estate Planning Advisory is a periodic newsletter designed to inform clients and other interested persons about issues and developments in the law affecting trust and estate administration and estate and tax planning for individuals and their families, fiduciaries, investment advisors and business owners.

Nothing in the Estate Planning Advisory constitutes legal advice, which can only be obtained as a result of personal consultation with an attorney. The information published here is believed to be accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues. If you would like to be added to the distribution list for the Wiggin and Dana Estate Planning Advisory, please contact Karen Osborn at 203.498.4449.

purchase obligation under a buy-sell agreement is through insurance on the individual's life whose interest is to be acquired.

Family Limited Partnerships and Limited Liability Companies

During the past few years, the Internal Revenue Service has been scrutinizing family limited partnerships ("FLPs") and limited liability companies ("LLCs") when such entities are created solely to minimize transfer taxes.

However, individuals who have non-tax reasons for creating FLPs or LLCs as part of their overall estate plan should still consider using such entities.

The way FLPs and LLCs work as an estate planning technique is that family members contribute property which is expected to appreciate significantly to an FLP or LLC in exchange for partnership or membership interests in the entity. The owners then make gifts of fractional interests to members of a younger generation (*e.g.*, to their children) during their lifetimes.

Because of the lack of marketability of these interests and the lack of control on the part of minority owners, the gifts may be discounted for valuation purposes. Thus, if such interests are transferred before the property appreciates, parents can transfer a significant amount of wealth to their children or grandchildren without the imposition of considerable estate, gift and generation-skipping transfer taxes.

Holding property in an FLP or LLC also has non-tax benefits, such as the following:

- Consolidating ownership of multiple property interests (thus reducing management costs);
- Creating a form of ownership which facilitates gifting (*e.g.*, dividing property into separate parcels is often unappealing);
- Allowing limited retention of control over the management of the transferred assets and the distributions to beneficiaries (but beware that too much control can cause the entity to be ignored for transfer tax purposes);
- Providing valuable business continuation planning;
- Providing asset protection for partners from creditors and divorcing spouses;
- Limiting liabilities for the entity's debts;
- Limiting the ability of a minority interest owner, such as a child, to access the property of the entity because of the restrictions included in the partnership agreement; and
- Avoiding the delay and expense associated with probate administration.

Conclusion

Things change. A major change in the federal estate tax law may dramatically alter your estate plan or may lead you to conclude that a change in your estate plan is appropriate. Likewise, your and your family's circumstances can change throughout your lifetime. So, even if you have a completed estate plan in place, it is advisable to periodically review the plan and assess whether it continues to address your family's needs and reflect your wishes.

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