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ESTATE PLANNING THE RIGHT WAY

University of Texas at Arlington Accounting Department's 2015 Annual CPE Day
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by Marvin E. Blum

Overview of Current Gift and Estate Tax Rates and Exemptions Amounts

- The annual exclusion amount for gifts in 2015 is $14,000. The lifetime exemption amount for gifts is $5,430,000 ($10,860,000 if married) for 2015. Therefore, you can give away up to $5,430,000 during your lifetime—above the annual $14,000 exclusion and any payments you make directly to educational or medical providers on someone else's behalf—and avoid gift tax.

- The estate tax exemption for estates of decedents dying in 2015 is also $5,430,000. The estate and gift tax exemptions are a unified exemption, meaning that whatever exemption you use for gifting will reduce the amount you can use for estate tax. In excess of the exemption amount, a 40% estate tax rate applies.

- The 40% estate tax is due nine months after death.

The Walton Family's Tax Avoidance Brilliance

- "How Wal-Mart's Waltons Maintain Their Billionaire Fortune: Taxes" *(available at http://www.bloomberg.com/news/articles/2013-09-12/how-wal-mart-s-waltons-maintain-their-billionaire-fortune-taxes).* The Walton family is worth a collective $152 billion. They are the wealthiest family in the world.

- Sam Walton was very forward-thinking. In 1953, when Sam opened his five and dime store, he retained 20% and gifted 20% to each of his four children.

- When Sam died, he left his estate to his wife Helen, qualifying for the marital deduction and completely avoiding estate tax.

- After Sam died, the Waltons began utilizing **Charitable Lead Annuity Trusts (CLATs)** to pass a tremendous amount of wealth to heirs tax-free. CLATs gained new interest in 1994 when Jackie Kennedy Onassis's will revealed that she included CLATs in her estate plan. CLATs are sometimes referred to as "Jackie O Trusts."

- Before transferring Wal-Mart stock to the CLATs, they put the stock in an LLC and then transferred LLC units, qualifying for a valuation discount.

- A CLAT makes annual payments to a charity for a set number of years and then the remaining trust assets pass to your heirs. Structured correctly, there could be no estate or gift tax on the portion of the assets passing to the heirs. Helen Walton (died in 2007) created the first of the Walton's 21 CLATs. She was an advocate for donating to charitable organizations and was quoted as stating, **"It's not what you gather, but what you scatter that tells what kind of life you have lived."**

- Sam's brother Bud left his estate to his widow Audrey, who utilized zeroed-out **Grantor Retained Annuity Trusts (GRATs)** to pass Wal-Mart stock to her and Bud's children free of tax. GRATs are similar to Jackie O CLATs except that the annual payment is made to the person who set up the trust rather than to a charity. GRATs are a no-lose bet with the IRS: **"Heads I win, tails we tie."** If excess is left over after the GRAT term ends, it passes to heirs tax-free. If there is no excess, nothing is lost.

- The Walton children are also saving estate tax by making gifts to the Walton Family Foundation. Famously, Sam's daughter Alice Walton founded the Crystal Bridges Museum in Bentonville, Arkansas, funded with more than $1 billion in donations from the family's foundation.

- The Waltons illustrate that **the estate tax is a "voluntary tax"** because there are ways to reduce the tax to zero, regardless of the size of the estate. The key is to start planning early, before payday hits. If you don't plan, the government gets 40%.

Your Estate Plan

- The Walton article leads to two important questions:

    1) If I died now, would my family owe any estate tax?

    2) Other than retirement assets, do I own anything in my own name?

- <u>Handout</u>: *Do I Need to do More Estate Planning?*

- <u>Handout</u>: *The Blum Firm's Tax Fence*. The assets on the left side of the tax fence are included in your taxable estate at death and are generally subject to your creditors. In contrast, the assets on the right side of the tax fence are not subject to estate tax and cannot be reached by your creditors. The goal is to move assets from the left side to the right side. The assets remaining on the left side are spent down while assets on the right side grow.

Remember to Prepare Your Family

- <u>Handout</u>: *A Tale of Two Families*. Consider the example of the Rothschilds versus the Vanderbilts. In addition to planning for any wealth that you will leave behind, remember to plan for the heirs to have the skills to manage it. Few of us would know how to operate a nuclear power plant and keep it running smoothly without any instruction or practice. Don't hand your children a nuclear power plant at your death with no instruction manual and expect them to keep it running.

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DO I NEED TO DO MORE ESTATE PLANNING?

IF YOUR ESTATE PLAN HAS NOT BEEN DUSTED OFF IN A WHILE, YOU MAY WANT TO CONSIDER A CHECK-UP. HERE ARE SOME HELPFUL QUESTIONS TO CONSIDER.

1. **DO I NEED TO UPDATE ANY OF MY BASIC ESTATE PLANNING DOCUMENTS (WILL, LIVING TRUST, POWER OF ATTORNEY, MEDICAL POWER OF ATTORNEY, DIRECTIVE TO PHYSICIANS, HIPAA WAIVER, DECLARATION OF GUARDIAN, HANDWRITTEN CODICIL TO DISPOSE OF PERSONAL EFFECTS)?**

   We recommend reviewing your estate plan every four years to make sure all fiduciary appointments and bequests are up to date. Watch for changes in your family or your assets. A good rule of thumb is to review your estate plan each presidential election.

2. **DO I NEED TO UPDATE ANY BENEFICIARY DESIGNATIONS OR BANK/BROKERAGE ACCOUNT STYLINGS TO COORDINATE WITH MY ESTATE PLAN?**

   Certain assets pass outside of your will, such as life insurance and retirement plans. Be sure you update the beneficiary designations when you make changes to your estate plan or upon changes in your family or financial situation. Also watch for JTWROS and POD accounts. They override the provisions of your will and often negate the benefits that your estate plan was designed to achieve.

3. **DO I LEAVE ANY INHERITANCE OUTRIGHT TO MY FAMILY?**

   If you leave an inheritance outright to your children, it is unprotected from their creditors, divorcing spouses, and estate tax. Instead, leaving it to a Dynasty Trust will allow the assets to be protected and pass from generation to generation. If desired, the child can be named as the trustee of the trust. With this planning, the trust assets are protected from a child's divorce. This may avoid the need for children to enter into prenuptial agreements because the child's inheritance will be owned by a trust and not by the child.

4. **AT MY DEATH, DO MY RETIREMENT ASSETS PASS OUTRIGHT TO MY FAMILY?**

   Retirement assets left outright are susceptible to creditors, divorcing spouses, and estate tax. Instead, naming a special retirement trust as the beneficiary of your retirement assets allows a child to defer the income taxes and protects the assets from a child's creditors, divorcing spouses, and estate tax.

5. **DO I OWN ANY LIFE INSURANCE THAT IS NOT IN AN IRREVOCABLE LIFE INSURANCE TRUST ("ILIT")?**

   Life insurance can be a good source of liquidity to provide for your family, the education of your heirs, and funds to pay estate tax. If you own a life insurance policy in your name, the proceeds will be taxed in your estate when you die. A $1 million policy may only provide coverage of $600,000. If an ILIT owns the policy, you avoid the 40% estate tax.

6. **HAVE I PROTECTED ASSETS TO PROVIDE FOR THE EDUCATION OF MY CHILDREN AND/OR GRANDCHILDREN?**

   Consider making an annual contribution to a 529 Plan such as the Texas College Savings Plan or to an Irrevocable Trust so that assets are set aside for this purpose and protected from both your creditors and your child's/grandchild's creditors.

7. **IS THERE A CHARITABLE CAUSE MEANINGFUL TO ME THAT COULD BENEFIT FROM TAX-EFFICIENT GIFTING?**

   Consider making a charitable donation at your death using your IRA or retirement accounts. Retirement assets could be hit with both a 39.6% income tax and a 40% estate tax, leaving just a fraction of the assets to the heirs. If you leave your retirement assets to a charity instead, the charity receives the full 100 cents of each dollar. Consider a "Jackie O" Charitable Lead Trust to benefit a charity for a specific number of years with the balance then passing to your heirs.

8. **DO I OWN ANY ASSETS (OTHER THAN RETIREMENT ASSETS) IN MY OWN NAME?**

   To minimize estate tax and protect assets from creditors, never own assets in your own name (other than retirement assets). Assets should be owned by an entity such as a family limited partnership, and the entity should be owned by a trust such as a 678 Trust, an Intentionally Defective Grantor Trust, or a Spousal Lifetime Access Trust.

9. HAVE I ENGAGED IN "SQUEEZE" PLANNING TO QUALIFY FOR OPTIMAL VALUATION DISCOUNTS?

By transferring assets into an entity such as a limited partnership that qualifies for valuation discounts for lack of control and lack of marketability, you can "squeeze" down the value by approximately 30-40%. There is no assurance these discounts will always be available. Act now to benefit from today's favorable legal environment for discounts.

10. HAVE I CONSIDERED A 678 TRUST FOR MY ESTATE PLAN ALLOWING ME TO REMOVE ASSETS FROM MY TAXABLE ESTATE WHILE RETAINING ACCESS TO THE ASSETS IF I NEED THEM?

Few are aware of this unique planning technique that benefits you as well as your family. Placing assets in a 678 Trust freezes the value of the estate at its current, discounted value but still allows you access to the assets. The assets are generally protected from creditors, protected from a beneficiary's divorce, and protected from estate tax at your death and when future generations die for as long as the 678 Trust lasts. You can be the trustee. You can also direct where the trust assets pass upon your death by exercising a special power of appointment.

11. IS MY ESTATE PLAN SET UP IN THE BEST WAY TO MINIMIZE INCOME TAX?

Certain estate planning techniques also impact your income tax. Explore ways to get the most income tax benefit from charitable gifts, save on the 3.8% NII tax, and help your heirs avoid capital gains tax by strategizing to get the best possible income tax basis step-up at death.

12. AT MY DEATH, DO I EXPECT TO HAVE ASSETS (INCLUDING LIFE INSURANCE OWNED BY ME) GREATER THAN $5,430,000 ($10,860,000 IF MARRIED) CAUSING MY FAMILY TO PAY A 40% ESTATE TAX ON MY ESTATE?

Bottom Line: The estate tax has been called a "voluntary tax." Even the Walton family, the world's richest family, has completely avoided the estate tax by employing a variety of techniques. Given enough time, a proper plan will not only benefit your family but may also reduce your estate tax to zero. The earlier you start the planning process, the more wealth you can shift out of your estate. If your estate is growing, now is the time to start planning so that future growth will be outside of your taxable estate.

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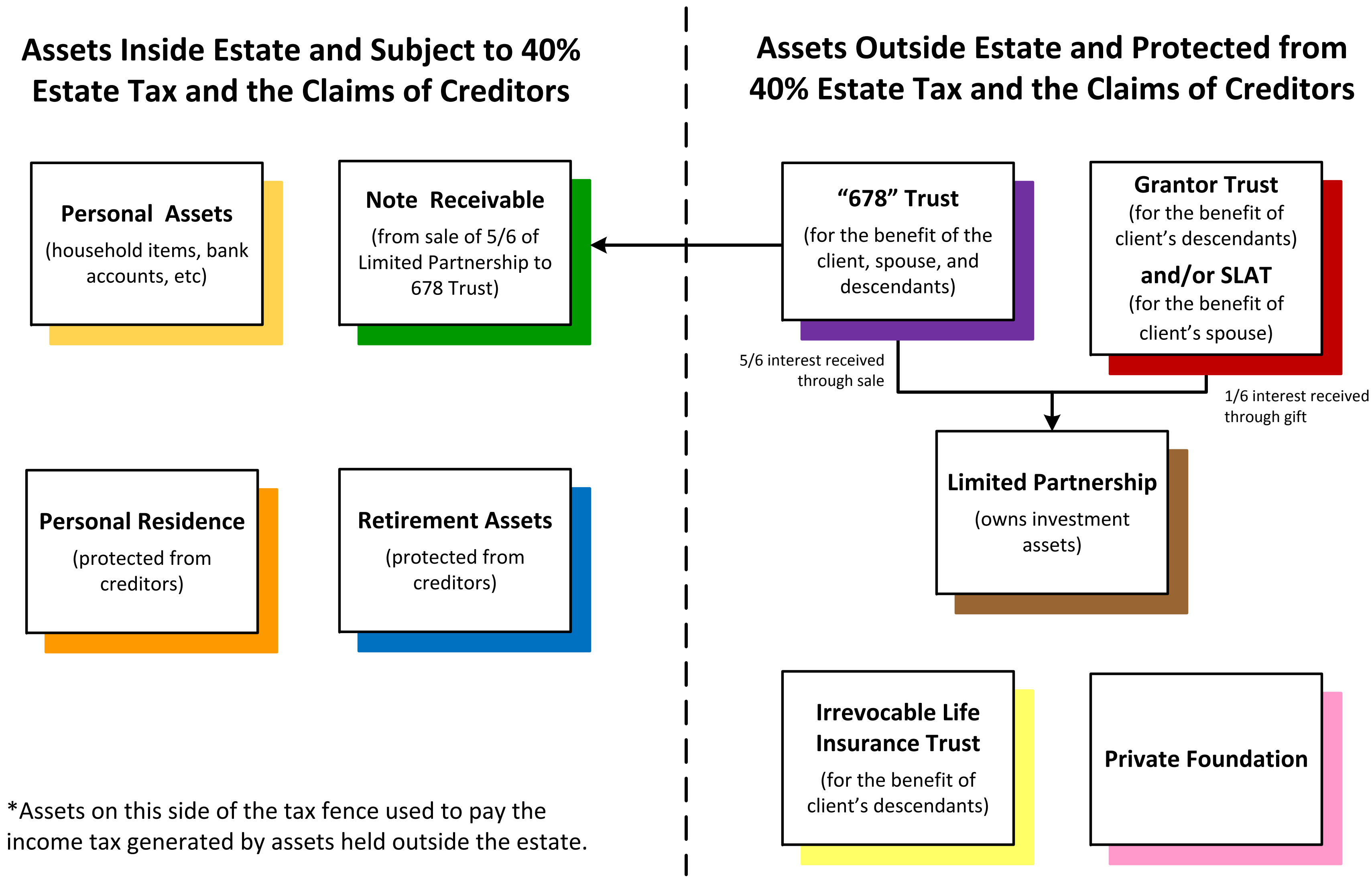
"TAX FENCE"

Assets Inside Estate and Subject to 40% Estate Tax and the Claims of Creditors

Assets Outside Estate and Protected from 40% Estate Tax and the Claims of Creditors



A Tale of Two Families

Two of the greatest family fortunes in history were created in the 19th century. One family thrives and prospers to this day. The other collapsed. Why? It's all a matter of preparation.

Cornelius Vanderbilt
1794-1877

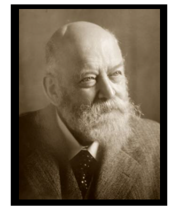
Cornelius Vanderbilt created one of the greatest fortunes in world history, valued at his death (in 2007 dollars) at $167 billion. He left 95% of his estate to one son, and divided the rest among his eight daughters and his wife, leaving a tiny portion to charity. Four of his children contested the will, and one ultimately killed himself over the escalating feud about the financial inheritance.

Economist John Kenneth Galbraith said that the Vanderbilts showed *"both the talent for acquiring money and the dispensing of it in unmatched volume,"* adding that, *"they dispensed their wealth for frequent and unparalleled self-gratification and very often did it with downright stupidity."*

Confirmation of that view came only forty-eight years after Cornelius' death: one of his direct descendants died penniless. And, within seventy years of his passing, the last of the ten great Vanderbilt Fifth Avenue mansions in New York City was torn down.

So great was the destruction of the Vanderbilt family and its wealth that for decades through the mid 1900's the press referred to it as 'The Fall of the House of Vanderbilt.' William K. Vanderbilt, grandson of Cornelius, said of his inheritance: *"It has left me with nothing to hope for, with nothing definite to seek or strive for. Inherited wealth is a real handicap to happiness. It is as certain death to ambition as cocaine is to morality."*

Cornelius employed a legion of attorneys and accountants. In fact, his planning was based completely upon the 'two-legged stool' of estate and financial planning that dominate the planning arena to this day. He did not consciously prepare his children to receive their inheritances, create a pattern of communication amongst the family, or organize them for ongoing success. Simply stated, he did not prepare his heirs for their inheritance before dropping one of the world's great fortunes into their laps. The result: when the Vanderbilt family held a reunion in 1973, there we no millionaires left among them.



Sir Nathan Mayer Rothschild,1st Baron Rothschild
1840-1915

The story of the rise of Europe's Rothschild family in the 19th and 20th centuries is far more than a tale of banking or politics. It is also the story of how one family has intentionally prepared and organized its children to be strong, independent and successful on their own, apart from the family and its vast fortune.

The family first rose to prominence in the late 18th century under Mayer Amschel Rothschild, and, by the time Sir Nathan Rothschild (pictured above) came to lead the family's enterprises at the turn of the 20th century, the name Rothschild was synonymous with banking and finance. So great was their power that on several occasions the House of Rothschild, as it came to be known, actually bailed Germany and England out of economic catastrophes that could have lead to their collapse.

The Rothschild family philosophy on passing inheritances from one generation to the next is very different than Vanderbilt's. They actively mentor the children. For example, they establish 'family banks' to lend money to those children who wish to start businesses or pursue other careers, and they monitor and advise the ventures in which the children participate. At the annual family gatherings (which have been held for over 200 years), the values which have sustained the family for generations are affirmed even as their vision for the future is sharpened and clarified. (And, if a family member fails to attend the annual family gathering, they are locked out of the family bank!) As part of that vision, the family supports a program of philanthropy in the arts, medicine, science and education.

Vanderbilt did Financial Planning, which grows and protects the money, and Estate Planning, which prepares the money for the heirs. The Rothschilds added a third 'leg': they use Heritage Planning, which *prepares* the heirs to receive their inheritance. Building on that very stable platform has been the key to keeping individual family members–and the family as a whole–unified, strong and prosperous for generations, no matter what is happening in the world around them.

"It requires a great deal of boldness and a great deal of caution to make a great fortune; and when you have got it, it requires 10 times more wit to keep it."
Nathan Rothschild