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THE ESTATE PLANNING PROCESS
UPDATE 2009

I. The Estate Planning Process.

The goal of the estate planning process is to provide for the efficient and cost effective management and distribution of an individual's assets. If an individual does not actively engage in the estate planning process, there is a significant possibility that his or her assets will not pass to such person's intended beneficiaries or may be reduced by avoidable taxes and unnecessary costs of settling the estate.

The estate planning process requires the consideration of a distribution plan for assets, the implementation of tax savings techniques to enhance the net distributable estate, asset protection planning, elder law and medicaid planning and whether or not the intended beneficiaries will require additional financial protection in the future.

The summary below discusses several estate planning documents and concepts which every family member should consider:

1. Last Will and Testament.

With the execution of a Last Will and Testament which, in most instances is the cornerstone of the estate plan, an individual can accomplish the following goals and objectives:

- (i)** direct to whom and in what manner your assets should be distributed;
- (ii)** create trusts to protect a disabled spouse or child or prolong distribution of assets to minor or young adult children;
- (iii)** maximize use of the federal estate tax exemption (\$3,500,000 as of January 1, 2009);
- (iv)** maximize use of the federal gift tax exemption (\$1,000,000);
- (v)** consider various methods for utilizing the unlimited marital deduction;
- (vi)** reduce the harsh tax results which impact residents who are non - U.S. citizens;
- (vii)** reduce exposure to the generation-skipping tax;
- (viii)** select a Guardian for your minor children;
- (ix)** appoint an Executor or Trustee to supervise your assets and settle your estate.

2. Revocable Living Trust.

A Revocable Living Trust ("RLT") is a legal arrangement among three parties: the owner of the property ("Grantor"), a "Trustee" (the Grantor and/or third party), and the beneficiaries of the Trust (Grantor, spouse and children). An RLT is used as a "substitute" for a Will. That is, the RLT will direct the distribution of the grantor's assets upon such person's death. There are two (2) main reasons to consider the use of an RLT:

- (i) To safeguard an individual in the event of illness or incapacity; and
- (ii) To avoid probate.

Becoming disabled or incompetent and losing control of one's actions and assets is a valid concern for many individuals. Absent proper planning, a judicial proceeding may have to be commenced in which a guardian will be appointed for the incapacitated person. Such guardian's responsibilities may include care of both the person and property (assets) of the incapacitated person. A properly executed RLT can minimize the cost and emotional trauma of such an occurrence. Even though a RLT is a substitute for a Will, every person that uses an RLT must also execute a Pour-Over Will to account for assets not transferred to the RLT.

3. Disability/Incompetency Planning.

A. Living Will.

A Living Will is a document which states an individual's wishes and intentions regarding health care matters, such as restrictions on using life-sustaining equipment. New York recognizes the use of a Living Will. Therefore, the wishes of an individual with respect to objecting to life sustaining treatment will be upheld if such wishes are clearly and convincingly provided for in a written document.

B. Health Care Proxy.

A Health Care Proxy is a document which allows an individual to appoint another person as an agent to make health care decisions for the individual in the event he or she is not capable of making such decisions. New York has enacted specified statutes which recognize the Health Care Proxy. Under these laws, the health care agent, alone, possesses authority to act after an individual becomes incapacitated.

C. Durable Power of Attorney.

A Power of Attorney is a legal document recognized under law that allows an individual (the "Principal") to name an agent to manage and respond to financial and personal matters in the event that the Principal should become ill, incapacitated or just pre-occupied. Every individual should have a Power of Attorney regardless of age because illness or accident can strike at any time and bills still must be paid and documents may be required to be signed.

The most popular form of Power of Attorney is a "Durable" Power of Attorney which provides that the document is valid even if the Principal subsequently becomes incapacitated. Under New York law, a Power of Attorney is not considered durable and will be automatically revoked upon the Principal's incapacity unless the document clearly states that it is durable. The power granted to an agent under a Durable Power of Attorney is substantial. Accordingly, considerable care must be given to the choice of agent.

II. Life Insurance.

Life insurance is sometimes referred to as the last true tax shelter. This adage is especially true with respect to the use of life insurance as an estate planning tool.

Proper planning with life insurance can create tremendous estate tax planning benefits. The initial and most fundamental tax issue is that of ownership of the life insurance policy. If the insured owns the policy on his/her own life, the proceeds are included in his/her gross estate for federal estate tax purposes. If, however, the insured is not the owner, the life insurance proceeds will not be included in the insured's gross estate. The most effective method to prevent the inclusion of the life insurance proceeds in the insured's gross estate is to create an Irrevocable Life Insurance Trust to own the policy. The insurance trust not only creates estate tax benefits but can be used as a vehicle to insure proper management of the insurance proceeds. These tax sheltered proceeds can be used as a source of funds to enhance the wealth of a spouse and children, a source of liquidity to pay estate tax liability, and as a source of funds to create a dynasty trust. A dynasty trust is one that can provide liquidity for spouses, children and ultimately for grandchildren.

III. Gifts.

One of the easiest and most effective ways for an individual to reduce the size of his/her estate is to adopt a gifting program. Depending upon the size of the estate and an individual's willingness to gift, there are many strategies which may be employed to achieve estate tax savings by gifting.

The most common gift giving program involves the making of annual gifts of amounts not to exceed \$13,000 per year per donee. Spouses can make joint gifts and effectively distribute annual \$26,000 gifts to each donee. Less common, and more misunderstood, is the effect of making annual gifts in excess of the \$13,000 annual exclusion limitation. If an individual (the "donor") makes a gift in excess of \$13,000 to any other individual in one calendar year, the excess above the \$13,000 may be subject to gift tax liability (the federal gift tax system is unified with the estate tax system

and accordingly, gift taxes are imposed at the same rate as the federal estate tax). Annual gifts in excess of \$13,000 per year to any donee need not result in an immediate gift tax payment. Rather, the gift tax liability must first be offset by the gift tax exemption amount (\$1,000,000 as of January 1, 2002). Therefore, assuming that no other gifts were ever made, a parent could gift a child \$1,013,000 in one year with no resulting tax liability. In addition, annual \$13,000 gifts could continue to be made in each subsequent year with no adverse tax effect. If the gift tax exemption is fully utilized during a donor's lifetime, then the federal estate tax exemption would be reduced by that amount and to such extent be unavailable to shelter the assets upon such person's death.

The benefits of the tax planning just described must be evaluated in conjunction with asset distribution concerns that a parent or a grandparent may have in making gifts to minors or even young adults. Too often, gifts are simply made under the Uniform Transfers to Minors Act ("UTMA"). Unfortunately, the simplest method is not always the best. The problem with UTMA gifts is, that at age twenty-one (21), the beneficiaries of the UTMA accounts can demand distribution of the funds. Many people feel that a child or grandchild is, at age twenty-one (21) too young to receive what could be significant assets.

In the alternative, the creation and use of irrevocable gift-giving trusts can take advantage of the estate tax savings available through gifting, yet provide a vehicle for the parents or grandparents to effectively manage the gifted monies. The terms of an irrevocable gift-giving trust can be structured to enhance the likelihood that the monies will be available for the beneficiaries' college tuition. The ultimate distribution of any remaining assets may be made at an age when the parent or grandparent feels that the recipient of the gifts will be most able to appreciate and manage the funds.

Finally, it is important to note that gifts in the form of direct payments for educational and medical expenses are not subject to the gift giving limits set forth herein.

IV. Planning with Personal Residences.

One of the most exciting and beneficial estate planning techniques is what is referred to as a Qualified Personal Residence Trust ("QPRT"). In its most basic form, an individual's personal residence is transferred to the QPRT which is established for a specific term of years. During the trust term, the grantor has an unrestricted ability to use the residence. In addition, the QPRT can be structured to enable the grantor to continue to take all the tax benefits associated with home ownership, such as deductibility of real estate taxes. At the end of the trust term, the residence is distributed to the identified beneficiaries of the trust, usually, the grantor's children.

The tax benefits available with this technique are significant. Since the beneficiaries of the trust will not be receiving the trust assets (the principal residence) until sometime in the future (the end of the trust term), the Internal Revenue Service takes the position that a gift of something less than the current fair market value of the property was made to the beneficiaries on the date that the trust was funded. For example, if a grantor who is sixty (60) years of age could transfer his residence, with a fair market value of \$500,000, to a QPRT for a period of fifteen (15) years, the gift for tax purposes would be approximately \$121,100¹. In effect, an asset worth \$500,000 combined with all of the appreciation on the asset during the term of the trust, would be removed from the grantor's taxable estate in exchange for the amount of gift tax due on a \$121,100 gift.

Assuming that the grantor has not fully utilized his or her gift tax exemption on prior transfers (see Gifting section above) no actual tax dollars would be paid.

As with most estate planning techniques there are other issues involved in using a QPRT. These issues would be discussed as part of your initial consultation.

V. Family Limited Partnerships.

¹ This valuation is based upon interest rates supplied by the Internal Revenue Service which fluctuate on a monthly basis.

A family limited partnership is typically established to further non-tax based objectives, such as consolidating family investment strategies or creating a vehicle to protect assets from potential creditors. In addition to accomplishing such business objectives, a reduction in an individual's gross estate for tax purposes might result. This possible estate tax reduction is due to the use of valuation discounts. The use of valuation discounts for minority interests and lack of marketability are a difficult concept to understand. To illustrate the theory, consider that it is a well established principal under the estate tax law that in valuing asset transfers, the sum of the parts, in many circumstances, is worth less than the whole. In other words, if a piece of property owned by one person individually is worth \$100,000, the value to him is \$100,000. By virtue of being the only owner, that individual has the absolute discretion to maintain the asset, sell the asset, mortgage the asset, sub-divide the asset, and so forth. If, however, two individuals equally own the property, each would only have a fifty (50%) percent vote as to how the asset is to be managed. Therefore, neither individual could make any decision without the other. Accordingly, the Internal Revenue Service might allow each of these individuals to take a minority discount on and against the value of the property. Discounts of twenty (20%) to forty (40%) percent are not uncommon. Therefore, each of the individuals owning the \$100,000 property will be treated as owning an asset (assuming a forty (40%) percent discount) worth \$30,000 ($\$50,000 * (1-.40)$).

To apply these concepts in the context of a family limited partnership consider for example, that an asset worth \$1.5 million is transferred to a family limited partnership. The donors (usually the parents) retain a 1% general partnership interest and distribute ninety-nine (99%) percent of the asset in the form of limited partnership interests to the children and/or grandchildren. If the asset was distributed outright to the children (that is, without using a family limited partnership), the value of the distribution would be \$1,485,000 (99% multiplied by \$1.5 million). By applying the gift tax exemption amount (\$1,000,000) \$485,000 of gifts would be subject to gift tax. The benefits

achieved from using a limited partnership format are derived from the fact that the limited partners have no available market to transfer their limited partnership interests and have no ability to control the day-to-day activities of the partnership. This lack of marketability and lack of control would allow the donor to take a valuation discount on the transfer of the limited partnership interest. As before, assuming a forty (40%) percent discount on the \$1,485,000 asset transferred, the effect is that the gift being transferred is only worth \$891,000 ($\$1,485,000 * (1-.40)$). Accordingly, the entire transfer falls within the \$1,000,000 gift tax exemption and no amount would be subject to gift tax. The ability to leverage the gift tax exemption, and estate tax exemption by taking valuation discounts into account makes the family limited partnership, if implemented for appropriate business reasons, a valuable estate planning tool. Note, the Internal Revenue Service is not inclined to accept a family limited partnership as effective where estate tax planning is the only reason for the partnership.

VI. Business Succession Planning.

A great majority of the wealth in America is made up of small closely-held businesses. The ability to pass the business from one generation to the next is one of the most important estate planning objectives of many families. There are a number of ways to attempt to accomplish this goal without being forced to liquidate the business to pay estate tax liabilities.

Many of the techniques previously discussed herein are incorporated in business succession planning. For example, gifts of stock or the creation of family limited partnerships are ways to transfer the business from one generation to the next at a reduced estate tax cost. Other techniques include:

- Grantor Retained Trusts;
- Self-Canceling Installment Notes;
- Private Annuities; and

- Insurance Funded Buy/Sell Agreements.
- Installment Sale to Defective Grantor Trust

All of these techniques, and others, must be reviewed as part of the estate planning process.

VII. Asset Protection Planning.

A significant, yet often overlooked, aspect of estate planning is the issue of asset protection planning. Life is often filled with uncertainties, such as the success or failure of our childrens' (or grandchildrens') health, business or marriages. Children in high risk professions such as doctors, lawyers, accountants, architects and others, face the potential of claims for malpractice. Each of these contingencies can cause your children to lose their entire inheritance. By implementing an asset protection plan as part of your estate plan, you can protect your childrens' inheritance against any potential future creditors. Asset protection strategies, often have the added benefit of preventing the protected assets from being subject to estate tax in you childrens' estates, thereby greatly enhancing the inheritance for future generations.

VIII. Elder Law/Medicaid Planning.

Medical advances have allowed us to live longer, but not always healthier. The cost of care, especially long term care, can threaten a family's assets and negatively affect its financial independence. Working with an elder law attorney, you may discover, under the complex Medicaid rules, that there are opportunities to preserve your home and a substantial amount of liquid assets.

The Medicaid rules are very complex, and have been substantially modified in February, 2006 creating even further complexity and uncertainty.

Medicaid Planning, including the use of long term care insurance, is an essential part of everyone's estate planning needs.

IX. Conclusion.

The estate planning process must be engaged in by every single person. Whether you are trying to identify guardians for minor children, assure the accurate distribution of assets or reduce

estate tax liability, estate planning is an issue which must be addressed. This outline is, by necessity, brief and barely scratches the surface of the issues involved in the Estate Planning Process.

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Our firm is dedicated to helping our clients identify and achieve their estate planning, asset protection planning and elder law/Medicaid planning goals. The issues to be discussed can be difficult to address and to solve. Our approach to comprehensive estate planning is to take the process one step at a time at the pace you feel comfortable with.

If you want additional information about estate planning, or if you feel that you could benefit from the estate planning process, please do not hesitate to call us.

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