Thomas D. Glascock

<u>Fact Pattern No. 1</u>: Victoria Smith

Dear Ms. Smith, this memorandum is intended to memorialize and confirm information received from you during our meeting earlier this month, to describe the current state of your planning and articulate suggestions for the possible update of your planning.

1. <u>Client background</u>: When meeting with you, we learned that you are 65 years old, and a retired attorney, having retired last year. Your husband died during 2010, and you have no immediate plans to ever remarry (although you have recently met an old friend from law school). No Federal estate tax return was filed for her husband's estate, and therefore there is no "deceased spousal unused exclusion amount" or "DSUEA" available to your estate upon your death, at least through your deceased spouse.[1]

You have e children, all adults, and 6 grandchildren, all minors.

Prior to his death, you and your husband had made reciprocal wills, so that when your husband died, his entire estate was transferred to you outright (i.e., he did not set up a bypass trust for you, and you did not exercise any disclaimer of the amount you received from her husband).

2. <u>Client Assets</u>: Your estate consists of the following assets (after liabilities):

- residence: $3,500,000.00
- life insurance $2,500,000.00
- vacation home: $2,000,000.00
- 401(k) plan benefits: $3,000,000.00
- Spousal rollover IRA: $ 500,000.00
- stocks and bonds: $1,000,000.00
- cash and savings: $ 200,000.00
- miscellaneous personal property: $ 50,000.00

The tax basis in the residence is $2,000,000, $1,000,000 in the vacation home, and $750,000 in the stocks and bonds – with potential capital gain if these assets were sold at their current fair market value of $1,500,000, $1,000,000 and $250,000, respectively (or $2,750,000, in the aggregate).

You receive approximately $200,000 annually in income from your investments and retirement plan distributions, and your only debts are recurring monthly expenses. As such, at present, your annual income satisfies your annual expenses, without the need to reduce your principal.

3. <u>Client Goals</u>: Your estate planning goals include the following.

[1] The "deceased spousal unused exclusion amount" or "DSUEA" is available for use by the surviving spouse, but only if an election is made by the executor of the estate of the first spouse to die on a timely filed estate tax return (Form 706). This requirement exists regardless of whether the estate of the predeceased spouse is otherwise required to file an estate tax return. As such, the executor must file a timely estate tax return even if the estate is well below the filing requirement. Moreover, portability may only occur with respect to the "last" deceased spouse of such surviving spouse.

a. You wish to: (i) enjoy the income from your assets during your lifetime; (ii) spend as little of the principal as is possible; and (iii) leave the remaining property to your children, equally, or the issue of any predeceased child in trust until the issue of that child has reached age 30.

b. You would like to save as much in taxes as possible.

c. You would like some asset protection for your property, due to the fact that you were an attorney.

The actuarial tables anticipate that you will live another 21 years.

4. Existing Planning.

a. You have a Last Will and Testament that is at least 11 years old, and which makes your deceased spouse your primary beneficiary. To the extent they exist pursuant to this original planning, your Power of Attorney and health care directives are very dated too and may be missing necessary language (such as language necessary to make a property HIPAA release). And, from the information received, it appears that you have no general durable power of attorney and no springing power of attorney in place, to protect in the event of your disability

b. To avoid a potential conservatorship / guardianship, an updated general durable power of attorney should be in place.

a. Concerning health care directives, it is critical that you let your family know what you want for medical care. For example, do you want life saving measures or life support?

5. Issues to consider:

a. Existing Planning. Your existing planning is more than a decade old, and it was made prior to your husband's death. Generally, existing estate planning should be reviewed periodically (every two (2) to five (5) years and with every major life event, for example, the death of a family member and the birth of a family member). Moreover, it is always recommended that a power of attorney, health care poxy and living will, and HIPAA Release be in place, in the event of incapacity and/or a medical emergency. Further, to make certain that it is respected by third parties, the Power of Attorney should not be more than two (2) years old.

b. Asset Protection. From the information provided, many or most of your assets are titled in your individual name. Moreover, while your Rollover IRA is regulated under ERISA, it is not a qualified plans under Federal law. As such, asset protection for your Rollover IRA is governed by state law, and in California, may be seized by creditors. California law shields funds in IRAs and Roth IRAs that are considered necessary to support the owner (and the owner's dependents) during retirement, but any surplus may be collected by creditors. Moreover, while the closer the owner is to retirement the more likely funds may be considered necessary for support in retirement taking into account all resources that are likely to be available for support, that determination is left to a Court in the event of a creditor action. See Code Civ. Proc. §704.115(e).

c. Probate in California.

While providing a thorough process in California, you may wish your estate to avoid probate for several reasons, including that a typical probate proceeding may last 9 to 24 months, it can be costly due to probate fees being based on the gross value of the probate estate and the fee amounts (which are based on statutory law), and the process being subject to public disclosure. These are considerations in a decision whether to continue utilizing last will and testament-based planning or to design and prepare a revocable living trust-based plan (and seek to avoid probate).

Generally, you can accomplish the same goals with either type of planning (that is, last will and testament-based planning or revocable living trust-based planning). However, if fully funded, a revocable living trust-based plan can permit the avoidance of probate. It may also arguably better facilitate disability planning and the update of your planning, as demonstrated by the more than decade long time period and life changes since you made your own last will and testament.

d. General Due diligence. The following questions should be answered, and appropriate action taken.

a. Do you have an updated schedule of assets, fully detailing the above described asset information, including

✓ for your bank and brokerage accounts, (i) the type of account, (ii) the name of institution, its location and relevant account number(s), (iii) in who's name the account(s) is(are) held, and (iv) the approximate value(s) of each account; and

✓ for stocks, bonds, and mutual funds, (i) the number of shares / face value of bond(s), (ii) a description, (iii) in who's name the account is held, and (iv) the approximate value(s) of each; and

✓ for retirement assets, (i) a description of the account / institution, (ii) the current beneficiary designation, and (iii) the current beneficiary designation and the approximate balance of each asset?

b. As indicated above, how are all of your assets titled? In your name only?

c. As indicated above, are your beneficiary designation forms completed, and up to date? For your life insurance, your 401(k) plan benefits, and your IRA?

d. Are any of your accounts held with a transfer at death or payable at death designation and direction, including your investment accounts and your bank account(s)? If the designated beneficiary predeceased you, will this still accomplish your planning goals?

e. Are any of your assets titled as a joint tenancy?

f. As to any assets held as a joint tenancy, does your joint tenant have any creditor concerns? If the joint tenant predeceased you, will it still accomplish your planning goals? Has this caused any gift tax consequences?

g. What type of life insurance policy(ies) do you own? For each, who is the insurance company, what is the policy's face amount, who is the owner, the insured, and the beneficiary? Does it have any cash surrender value, and have any loans been taken against it?

h. As indicated above, who are the designated beneficiaries of your life insurance policy, and are your beneficiary designations up to date?

i. A description of your tangible personal property (household furnishings, artwork, jewelry, collections, silver, and more). To whom do you wish to leave any specific special assets, for example, your wedding dress, wedding ring, and the like?

j. A description of any other significant or "special" assets, including interests in any lawsuit, copyrights, patents, mineral rights, and more.

k. Information on any gifts previously given, including information on the date, recipient, a description of the gift, and its value.

e. Estate Tax Concerns. As a background, the estate tax is a tax on your right to transfer property at your death. Your estate consists of everything you own or have certain interests in on the date of death (including the value of all property over which you hold a general power of appointment, or, if within three (3) years of the time of death, the value of such property when such power was relinquished during lifetime). The fair market value of these items constitutes your taxable "gross estate."

Given your net value ($12,750,000), your estate may be subject to an estate tax now, and unless it is reduced, definitely will be if the lifetime exemption amount is reduced. The currently increased exemption amount is temporary, and it is scheduled to sunset, or revert, to $5 million per person (adjusted for inflation) as of January 1, 2026. That said, it may be reduced before then, and to a lesser number.

With estate planning, there are four (4) types of taxes to consider, (i) the estate and gift tax, (ii) the generation skipping tax, (iii) income tax, and (iv) the real property tax consequences of your actions. Each is considered in this memo.

Concerning the estate tax and the anticipated reduction in the lifetime exemption amount, the conventional wisdom is that "if an afford to give away the extra $5,000,000", do it now, as the opportunity will go away. What is meant by that is the currently increased exemption amount allows the opportunity to gift away an increased $5,000,000 tax free, but (as indicated) the exemption amount is due to sunset, and it may be decreased before then pursuant to proposed or contemplated Federal legislation. Moreover, an added incentive to act now is that the IRS has communicated that it will not seek to "clawback" gifts made under the increased estate and gift tax exemption amounts.

i. The Estate and Gift Tax. The applicable Federal exemption amount is $11,700,000 for 2021, which amount will be automatically applied to an estate at death (subject to activity which may have reduced it).

Please note, advanced estate tax planning techniques aim to reduce the taxpayer's tax liability, and they include valuation discounts (to reduce the taxable value of the estate), tax freezing (particularly for assets that are likely to increase in value), actuarial techniques (only paying taxes on a portion of the value transferred, using the IRC §7520 tables), and charitable contributions.

The Federal lifetime exclusion amount for gift tax purposes during 2021 is also $11,700,000 for 2021, with an annual gift tax exclusion of $15,000 per grantee. To the extent a gift is given in an amount greater than the annual gift tax exclusion amount, the excess is reduced from the lifetime exclusion amount. And, in the event the lifetime exclusion amount is completely used up, gift taxes are imposed on an exclusive basis (meaning, the done receives the property unreduced by the gift tax paid by the donor). Because estate taxes are inclusive (meaning, the done receives the property less the estate tax paid on it), a gift tax will cause a lower effective tax rate, meaning more can be transferred given the same dollar amount. Setting aside the loss of basis adjustment[2], gifts give you more “bang for your buck” than with transfers at death. [Note, to remove the asset from your estate, the gift must be a completed gift, with no strings retained. A grantor may not retain strings; otherwise, IRC §2035 brings a gift back into the estate if death occurs within three (3) years.]

In addition to the annual exclusion, you can pay tuition and/or medical expenses during life, but not following death. You can also make a contribution to a 529 Plan, and you can frontload a 529 Plan with five (5) years of annual exemption amount (that is, $75,000).[3]

An effective planning tool is to gift away appreciating property, if it can be afforded, to get the asset (and future appreciation) out of the estate, i.e., shares of stock in a start-up that may appreciate significantly in value if the corporation goes public. By this technique, you can instead let someone else benefit from the appreciation (for example, a child), and someone who might be a lower income tax bracket than you (thus, perhaps lowering the overall taxation of income from the appreciating property). Or as a “freezing technique”, you can also sell the appreciating asset at a fixed value, and then take back a promissory note for today’s fixed value amount with a security interest and reasonable interest rate. This will shift future appreciation, and perhaps shift value to a lower tax bracket, as well.

For taxable estates, another effective planning tool is to create entities (i.e., a Limited Liability Company, Family Partnership, “S” Corporation, and “C” Corporation), to obtain asset protection and also achieve a valuation discount. To accomplish this, you properly form the entity (following the necessary legal and administrative requirements and procedures under state and Federal law), to form an entity separate from its member, partner, or shareholder (as the case may be), and you then fund it with assets, including cash, personal bank accounts, and marketable securities. Capital contributions must be carefully recorded (including by a description of the asset, its value, the date of contribution, and the adjusted basis of the asset). But, to be effective, the transfer <u>cannot</u> be a fraudulent transfer (that is, a transfer when there is a claim against you – whether involving actual fraud with the intent to hinder, delay or defraud the creditor <u>or</u> constructive fraud made without intent but even so leaving you insolvent).

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[2] IRC §1014 provides for a basis adjustment to Fair Market Value on the date of death, or if elected for all estate assets, that value on the alternate valuation date six (6) months later. If the property is community property, both halves get an adjusted basis.

[3] A 529 Plan makes available a tax-advantaged savings plan that is exempt from Federal taxes and is designed as a way for families to save for college expenses on behalf of a beneficiary (typically, a child). The moneys from a 529 Plan must be used for qualified education expenses in order to be withdrawn tax-free, with eligible contributions possible up to the annual exemption amount ($15,000 for 2021). Five (5) years of gifts possible at one time (for a total of $75,000 for 2021) is possible, but then additional gifts cannot be made into the plan for the ensuing five-year period without gift tax consequences.

Discounts are made possible by the inherent separation of control from equity ownership, and they can permit the maximum leverage of a gifting program using either the annual exclusion or the lifetime exclusion, or both, thereby permitting more interests to be transferred. Use of a created entity can also allow the write-off legitimate business expenses, such as transaction costs, management fees, and research materials.

For entities, valuation discounts including a lack of marketability (with restrictions on the transfer of ownership) and a lack of control (for a minority interest).

The restriction on the transfer of the entity, along with other factors, provides for the discount of the value of the interest because of the reduced marketability. As such, these discounts relate to ownership of the entity. A non-publicly traded entity causes a lack of marketability, and with an agreement, you can further restrict the transfers and lack of marketability. The standard to achieve is a 20% to 30% discount. By just putting real property into a limited liability company, for example, you can create a discount.

Lack of control, the best entity is a limited partnership. The limited partners have no management control (and have no personal liability either, being the "silent partner"), and a buyer will want a discount because of the lack of control. As such, a 35% combined discount with lack of marketability and lack of control as possible. The IRS will not challenge such a discount, if you do not take more than a 35% discount. Therefore, by putting commercial property into a limited liability company, you can effectively reduce its value by 35% for tax purposes.

A built-in capital gains discount may also be possible when capital gains are built into an entity, whereby if you sell the entity tomorrow a capital gains tax will be due. While the standard is a dollar per dollar discount, the amount of available discount will be reduced if there is no likelihood / probability that the property will actually be sold.

Fractional shares may also be used with assets. For real estate (not personal property), a fractional share discount might be available, for the transfer of a percentage interest (with the discount being what it would cost to partition the property). Typically, the IRS will not challenge a 10% to 15% discount. Thus, a tenancy in common agreement (effectively, a partnership agreement), and the waiver of a right to partition might allow a 40% to 50% discount.

Another benefit to the creation of an entity is asset protection. It is possible to protect against inside creditors by using an entity, and to combine this with insurance. Inside creditors are creditors of the entity, with the creditor's recovery generally limited to the entity's assets that are owned and operated by that entity. Otherwise, the creditor does not have many other options when filing a claim. The creditors of the entity are, for the most part, limited to the remedy of a charging order for distributions, if or when the person or persons with the authority to determine distributions choose to make one. Moreover, the general partner or manager can retain control over distributions, and may determine to instead continually reinvest moneys back into the entity, leaving little or nothing for distributions to the partners, members, or shareholders (as the case may be) – or, effectively, to the creditor. This gives the debtor great leverage in working out a settlement. In addition, under Rev. Rul. 77-137, a creditor who obtains a charging order and an assignment of a

limited partnership or LLC economic interest is treated as a partner for tax purposes and must report "phantom income" attributable to such interest, even though no distribution from which to pay taxes is actually received.

ii. The Generation Skipping Tax (the "GST").

A GST is imposed on any transfer to a skip-person, that is, to a relative two (2) or more generations below the transferor (such as to a grandchild or great-grandchild) or to an unrelated person 37 ½ years younger than the transferor. A "skip" transfer can be made in three (3) different ways, a taxable termination (a trust makes payment to a skip-person), a taxable termination (all interests in a trust passes to a skip-person), or a direct skip (assets pass directly to a skip-person). The above said, there is a predeceased child exception if the transfer is a direct skip but the transferor's child has (the transferee's parent) died prior to the transfer. In such circumstances, the transfer to a grandchild (the child of the predeceased child) would qualify for an exception to the GST.

The above said, a GST lifetime exemption of $11,700,000 exists for 2021. This can be utilized to make gifts to grandchildren. Moreover, you can provide for your grandchildren under your last will and testament or under a revocable living trust, by creating exempt and non-exempt trusts and providing for an order of trust distributions. The recommended order of distributions is, first, to non-skipped persons from non-skip trust until the non-exempt trust is exhausted, and then to non-skip persons from exempt trust until exhausted, and then to skip persons from exempt trust until exhausted, and then to skip persons from non-exempt trust. The exempt trust should have an inclusion ration of 0 (meaning, it is non-taxable) and the non-exempt trust should have an inclusion ratio of 1 (meaning, that it is fully taxable), for Federal generation-skipping transfer tax purposes. This will utilize your generation-skipping tax exemption, to help avoid a generation-skipping tax. Further, it should be noted, IRC §2632 (e) provides that to the extent the trustee does not allocate the generation-skipping exemption, it is automatically allocated to the skip-person.

You can also make gifts using the annual exemption amount without causing a skip. You can also open a 529 Plan for a grandchild, and frontload it with five (5) years of annual contributions (that is, with $75,000) without causing a skip.

iii. Income Tax

The capital gains tax rate for 2021 is twenty (20%) percent for taxable income over $445,850 and fifteen (15%) percent for income from $40,401 to $445,850. However, this is in contrast to the tax rate for estates over the exemption amount, which is forty (40%) percent, and which will cause a significantly greater tax for the same taxable dollar amount.

iv. Real Property Tax Consequences -- Careful transferring a residence.

Under California Proposition 13, every time there is a change in the ownership ("CIO") of real property, the real estate becomes subject to reassessment, which can have significant real estate tax amount consequences. However, under prior law (Proposition 16), an unlimited parent-child exclusion existed. That said, recently enacted Proposition 19 has

significantly altered this exclusion, with the exclusion for non-residential property now gone and the remaining exclusion now limited to the parent's primary residence and to a value of $1,000,000 (above which amount the property is subject to reassessment). Moreover, to qualify under the altered exclusion, a child must live at the property as the child's primary residence.

It should be noted, a transfer to a revocable living trust is not considered a CIO, and a new state bill has been introduced to postpone the effective date of Proposition 19 to a date in 2023. Further, a transfer of title to the real estate into a limited liability company and then into a revocable living trust may defer the reassessment for one generation. And where title to the property is held in a joint-tenancy, if the owners are considered original transferors, and until the death of the last original transferor there will be no reassessment

In additions to concerns with triggering a reassessment, you should also be careful with putting a principal residence into an entity (including a limited liability company) and an irrevocable living trust as the IRC §121 exclusion will be lost. A limited liability company and an irrevocable living trust cannot have a principal residence, and therefore they are not eligible for the exclusion on capital gains. [Moreover, to the extent applicable, a limited liability company and irrevocable living trust are not eligible to take a mortgage interest deduction, and to the extent there is a mortgage loan secured against the premises, the transfer will technically violate its due on sales clause.]

f. Asset Protection Planning. Asset protection is very important to estate planning, as estate planning typically involves transfers of assets (to a revocable living trust or a irrevocable living trust, grantor trust, or business entity). That said, planning for a potential claim is permissible, but not a fraudulent transfer (following when a claim, including potential claim, arises – which is not permitted under law). Rather, the transfer can be reversed by a judge under the Uniform Fraudulent Conveyance Act (UFCA), and it can result in criminal penalties (California Penal Code §154). Moreover, it can cause a professional (including a licensed attorney) to lose his or her license.

The number one asset protection planning device is personal liability insurance, to make certain that you have sufficient liability insurance. This includes having an umbrella policy. Most liability claims are under $1,000,000, which insurance can protect against. Umbrella policies are available in the event a liability exceeds the underlying policy amount (for example, $1,000,000 of coverage), and they can be obtained up to the amount of $5,000,000. Because such liability is infrequent, umbrella policies are generally very inexpensive (often only approximately $400 to $500 per year).

As described above, another technique is to put your assets outside of the reach of future creditors, by the creation of an entity and the transfer of assets to the entity. By putting assets into an entity, even with your retention of an interest in the entity, you can protect yourself from both insider creditors and outside creditors. You will only own an interest in the entity (not in the assets of the entity), and therefore creditors may not attach the assets of the entity. In addition to being an asset protection vehicle, as described above, an entity can make valuation discounts possible too.

The above said, your principal residence and vacation home should not be placed into an entity, as an entity cannot have a principal residence or vacation home and is, therefore, not eligible for the IRC §121 exemption against capital gains.

Further, California law does not permit the creation and transfer of assets to a self-settled trusts to hide them from creditors, and the transfer of assets to a revocable living trust leaves the transferred assets subject to the trustmaker's creditors. However, you can create an irrevocable living trust with spendthrift provisions preventing assignment or hypothecation of an interest for the benefit of a third party, for asset protection purposes. Assets transferred to the trust would no longer be owned by you, and the trust beneficiary(ies) will not own the trust assets until they are distributed. Moreover, you an provide or direct the trustee discretion in the face of creditors to not make a distribution (even if required under the terms of the trust), save for child support and spousal obligations. You can also authorize indirect distributions, to pay the beneficiary's bills (for example, mortgage, insurance, and the like), without direct distributions to the beneficiary.

As stated above, while your Rollover IRA is regulated under ERISA, it is not qualified plans under Federal law. As such, the Rollover IRA's creditor protections is governed by state law, and in California, may be seized by creditors. California law shields funds in IRAs and Roth IRAs that are considered necessary to support the owner and the owner's dependents during retirement, but any surplus may be collected by creditors.

In addition, because Federal law considers contributions to a 529 Plan to be gifts made on behalf of the beneficiary, funds kept in these accounts are not considered part of the donor's estate and (if not part of a fraudulent transfer) are safeguarded from the donor's creditors. Because Section 529 Plans are not Federally regulated, but instead state regulated, each state can set its own requirements, and some states have provided protection of Section 529 Plans from creditors.[4] However, California is not one of the states that has passed legislation, leaving the level of creditor protection afforded by Section 529 Plans uncertain.

The above notwithstanding, asset protection measures on their own are no replacement for insurance. However, if strategically integrated, the best protections can be realized.

g. <u>Life Insurance</u>. Life insurance can play in important role in estate planning, by providing funds to pay taxes, increased liquidity, the fuel of now available funds, and more. Moreover, it is received income tax free. However, pursuant to IRC §2042, if owned by the decedent, it will be included in the decedent's gross estate.

When there is a taxable estate or there may be a taxable estate (given an anticipated increase in the value of assets and/or knowing that the exemption amount will be going down in the future), the creation of an irrevocable life insurance trust ("ILIT") or a gift of the insurance policy to children should be considered. Even if some of your lifetime exemption is used, gifting is a more tax efficient option than leaving the insurance in the owner's gross estate (provides a lower effective tax rate). Further, if an ILIT is created, crummy gifts can be made to qualify the

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[4] For example, New York State will protect all assets in a 529 Plan if the account is owned by the child, but only $10,000 if it is owned by someone else, for example, a parent or grandparent.

gift as a present interest gifts and thereby qualify for the annual exemption amount, without further reduction in the exemption amount.

h. Planning for digital assets – It is encouraged that you organize and inventory your digital assets, listing your various accounts, usernames, passwords, and personal verification questions necessary to access them, as well as any password necessary to access your personal computer, smart phone, or other hardware devices. You should also consider taking advantage of any legacy access services provided by used platforms (for example, Google, Amazon, and Facebook). And you should consider specifically granting fiduciary powers of administration over your digital assets, and consent to disclosure of the contents of electronic communications to fiduciaries.

i. Advanced Planning. For taxable individuals, once foundational planning is in place (that is, you have a last will and testament or a revocable living trust with a pour-over last will and testament, a power of attorney – general durable or springing, health care proxy and living will, and a HIPAA Release), you may wish to utilize valuation discounts, tax freezing, and actual techniques to reduce your net gross estate to below the lifetime exemption amount. As indicated above, these strategies may involve the creation of a business entity(ies) and/or a grantor trust(s). Intentionally Defective Grantor Trusts, are popular with sales, with taking back a note. Or use of a trust to make a transfer, rather than an outright sale (i.e., for minors). As are private annuities with the transfer of property in return for annuity payments for life, with the transferee receiving all future appreciation. Self-cancellation installment notes ("SCINs") are cancelable upon death, with nothing in the seller's gross estate. With SCINs, the buyer pays a premium for the right to cancel. [Note, the downside to a private annuity or a SCIN is that the basis is only what is paid for the property prior to death; there is no adjustment under IRC §1014.] With these techniques, the 7520 table rules require use of their values, unless death is clearly imminent. As such, if death is not imminent, but all people in the family die young, you may wish to use these tables -- effectively betting that the taxpayer will die young. Annuities are determined based on life expectancy calculated using the 7520 tables, which are actuarial tables for the average life expectancy of a person.

Similar "freezing" techniques include Grantor Retained Annuity Trusts (GRATs), Grantor Retained Uni-trusts (GRUTS), and Grantor Retained Income Trusts or GRITs for a house (a Qualified Personal Residence Trust or a "QPRT") – with the transfer of an interest in certain property, retention of an interest the property, and the transfer of ownership to the property at the end of the term. That said, pursuant to IRC §2036, by the grantor's retaining an interest for the period, it is only after that period when the property will not be includable in the grantor's estate. Still, if the transferor does not outlive the term, the grantor will only be "out" the attorney's fees and costs, because the property would have been included in the gross estate to begin with. Again, the drawback with these techniques is that there is no adjusted basis at death. [Note, as indicated above, if death is imminent, giving away property may not work as the IRC §7520 Tables are not available if death is imminent.]

With a GRAT, the trustmaker establishes the GRAT and then makes a contribution to it. In return, the GRAT pays the trustmaker an annual annuity payment for a fix period of years. At the end of the term, the remaining assets of the GRAT pass to the beneficiary(ies) of the trust.

The strategy is that the principal will increase in value with that the minimum interest paid by the GRAT will be less than the appreciation. The appreciation will pass on to the beneficiary(ies) without incurring any gift tax. Moreover, the assets inside the GRAT are protected from creditors.

Likewise, a QPRT can be a technique to not only save estate taxes, but also realize asset protection for a principal residence and second residence. A QPRT is an irrevocable split-interest trust, based on the right of the grantor to live in the residence for a number of years rent free, with the beneficiaries of the trust to become owners of the residence at the end of the term. Because the donor retains an interest, the value of the transfer or gift the trust is reduced to take into account the life interest retained by the grantor, with all appreciation passing without incurring any further gift tax. Again, a QPRT can be an effective tool for asset protection planning too, with the trust asset(s) protected from creditors absent of finding of fraudulent conveyance.

As with a private annuity or a SCIN, no basis adjustment under IRC §1014 is available with use of a GRAT or QPRT. At the end of the term, the beneficiaries' tax basis in the trust property will be equal to the donor's tax basis at the time the assets were transferred into the trust. That said, the capital gains tax rate for 2021 is twenty (20%) percent for taxable income over $445,850 and fifteen (15%) percent for income from $40,401 to $445,850. This is in contrast to the tax rate for estates over the exemption amount, which is forty (40%) percent. As such, taxation for capital gains is significant less than for the estate tax for the same taxable dollar amount.

j. Financial profile. If you have a concentrated profile (for example, you are heavily weighted in real estate) rather than a diversified profile, you must waive the requirement that the trustee diversify assets, as required under the Uniform Prudent Investor Act.

k. Retirement assets — Retirement assets include qualified plans (401(k) plans and 403(b) plans) that are taxed only when money is withdrawn, at the ordinary income tax rate (not capital gain) as the money deposited was ordinary income. Retirement assets are includable in your taxable estate for estate tax purposes. However, if an estate tax is paid, the beneficiary will receive a deduction for the estate tax amount that is paid, so that these monies are not subject to a double taxation (that is, to an estate tax and then an income tax).

Pursuant to the SECURE Act, to the extent you have not already done so, you must commence distributions from your qualified plans by or before age 72 (an increase from age 70 and one-half). Moreover, distributions from an inherited IRA to its beneficiaries with all taxes paid must be fully made within a ten (10) year period from the date of the plan participant's death. As such, the "stretch" is no longer available to your beneficiaries, as was permitted under prior law.

With regard to retirement assets, a first question is whether the asset is an ERISA qualified plan. As stated elsewhere, while IRAs are regulated under ERISA, they are not qualified plans under Federal law. For ERISA qualified plans, there are two (2) types of designated beneficiaries (an individual and a trust meeting certain requirements), with a different set of rules for each. To qualify as a designated beneficiary, the trust (i) must be valid under state law, (ii) must be irrevocable as of the date of the plan participant's death, (iii) must have identifiable beneficiaries as of the year following the plan participant's date of death, and (iv) must have an available copy of the plan. If satisfied, the trust qualifies as a designated beneficiary.

You will want your beneficiaries to be designated beneficiaries. If not a designated beneficiary (an estate or charity), distributions must be made within five (5) years of death.

If an individual, there are three (3) options for distributions – (i) a lump sum distribution, (ii) distributions made in installments but subject to the SECURE Act requirements, and (iii) if the designated beneficiary is a spouse, that person can roll the monies over into his or her own IRA (a spousal rollover IRA) and start all over again with required minimum distribution beginning when the money is distributed to the spouse's plan. That said, the SECURE Act changed the minimum distributions rules, including when distributions must be started (now, as stated above, by 72 years old).

By way of background, under the Setting Every Community Up For Retirement Enhancement (the "SECURE Act"), except for Eligible Designated Beneficiaries (the "EDB"), the life expectancy method is no longer the default method for determining required minimum distributions ("RMDs"). The new rules require RMDs to be distributed to non-EDBs beginning at the plan participants death, the EDB's death or the minor child's attaining the age of majority. [Prior to the SECURE Act, the Stretch IRA planning technique to optimally dribble out RMDs over the designated beneficiary's life expectancy, but it is no longer available, and in its place a 10-year (versus life expectancy) pay-out is now required.]

The SECURE Act and its 10-year payout requirement commence once the age of majority (age 18) is reached. Prior to then, the minor child is an EDB and tell majority, using the life expectancy method for the pre-majority.

Importantly, every designated beneficiary (an individual or a qualified trust) other than a spouse, a minor, or a chronically ill or disabled designated beneficiary, must now take out over a ten-year period from the death of the plan participant all monies from the qualified plan. As stated, no "stretch" over the beneficiary's life expectancy is now available, except (i) spouses may still stretch over their life expectancy, (ii) minors must start taking a distribution within ten (10) years of turning the age of 18 years old, and must take out all monies (be taxed) within 10 years (that is, by age 28 years old), and (iii) disabled or chronically ill persons can still get a stretch based on their life expectancy. Moreover, as indicated above, if the beneficiary is a non-designated beneficiary (that is, an estate or a charity), the beneficiary is left with the five-year rule. That said, a charity is likely to take out all monies immediately, as it is not subject to taxation (there are no tax consequences for the charity). The biggest issue is, therefore, elimination of the stretch.

In light of the above, you may wish to have a trust as a designated beneficiary, if you have concerns with an individual beneficiary receiving moneys immediately (or because of age or otherwise, he or she cannot receive the moneys immediately). This might be in the case with a minor, or someone with spendthrift problems. Still, while moneys must be taken out of the plan within the 10-year period and be subject to tax, they need not be distributed from the trust to the beneficiary. Therefore, use of a discretionary trust can still be utilized for creditor protection and spendthrift protection.

While there is some thought that naming a charitable remainder trust as a beneficiary may still allow for a “stretch”, as a different set of rules apply to them. In such event, moneys may be left to a charitable remainder trust, with a “stretch” available. However, the IRS has not yet approved this technique. Further, while moneys might also be left to a special needs trust, under the SECURE Act an exception already exist for chronically ill and disabled persons.

Given the above, with the SECURE Act, planning options are no more limited than under prior law.

l. Charitable Gifts -- a charitable contribution made to a qualifying public charity will qualify for an estate tax charitable deduction, whether made during life or following death pursuant to a last will and testament or a revocable living trust. However, if made during life, the donor is also eligible for an income tax deduction. Under the Consolidated Appropriations Act, an income tax deduction of up to 100% of adjusted gross income is available during 2021. Further, if the charitable donation exceeds the charitable deduction amount for a year, the excess may be carried forward for a deduction during future tax years for up to five (5) years. No such income tax deduction is available for a charitable donation made at death.

Because charities do not pay taxes, the donation of assets that would be taxable is appropriate, for example, retirement plan assets (401(k) and IRA assets). By combining the donation with the creation of a trust (a charitable lead trust or a charitable remainder trust), additional benefits can be available for you and your beneficiaries too, by realizing an income tax deduction, pushing any tax do over a lifetime, and possibly causing some income to never be taxed. Moreover, if combined with life insurance, your beneficiaries may receive a bequest in the same amount as if the charitable donation had never been made, yet with the benefits of the charitable good caused by the donation. [The income tax savings, with part of the income received from the charitable remainder trust perhaps utilized to pay the insurance premiums of an ILIT. The trustee of the ILIT can then purchase enough life insurance to replace the full value of the asset for the benefit of the trustmaker’s children and other beneficiaries.] By use of a charitable remainder trust, donation of retirement assets, receipt of an income tax deduction, and receipt back of annual payments can be accomplished. As stated, with these payments, life insurance might be purchased and left to the charity to cause a bigger deduction. Or, by use of an ILIT, the insurance proceeds might be left to the donor’s children and other beneficiaries, who will receive the insurance proceeds tax free and outside of the donor’s estate. Highly appreciated property might also be utilized, to avoid capital gains tax while simultaneously making a valuable donation to a charity.[5]

The advantages of a charitable remainder trust include (i) an income tax charitable deduction on the transfer of property to the trust, (ii) the tax-free sale of appreciated property by

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[5] With a charitable lead trust, an appreciated asset can be donated to the charitable trust and then sold by the trust tax fee (no capital gains tax), the sales proceeds invested with annual payments to the charity, and then the principal given to the ultimate non-charitable beneficiaries as the end of the term of years (the trust term). By this method, if invested “well”, the principal paid to the ultimate non-charitable beneficiaries may be in nearly the same (or more) amount as the initial value of the appreciated assets but without the payment of capital gains tax. With a charitable remainder trust, the donor transfers property to the trust, and then one or more non-charitable beneficiaries receive a specified dollar amount each year from the trust for a specified term. At the end of the term, the charity receives the remaining trust assets.

the trust, (iii) tax-free accumulation of income inside the trust, and (iv) deferral of income taxation to the individual non-charitable beneficiary until the income or gain is actually received by the beneficiary.

Charitable remainder annuity trusts and charitable remainder unitrusts differ in how the annual payout is determined, whether based on the initial value of the trust or the value of the trust determined annually. The annual payout from the charitable remainder trust must be at least 5% and not more than 50% of the value of the trust assets. The trust term can be (i) a term of years (not to exceed 20 years), (ii) a term measured by the life or lives of the designated recipients (who must be in being at the creation of the trust), or (iii) a term defined as the shorter of the term of years (not to exceed 20 years) or the life or lives for the designated recipient. At the end of the term, the charitable remainder trust's remaining assets pass to the charity or continue in trust for the charity. Generally, a non-charitable beneficiary of a trust with a non-charitable term that could last more than 20 years must be an individual.

The donor is entitled to an income tax charitable deduction in the year of the transfer equal to the actuarial value of the charity's remainder interest in the trust. This is determined based on such factors as the non-charitable term, the amount of the non-charitable payment, and the applicable IRC §7520 rate. The charitable remainder trust allows for tax-free accumulation of income in the trust to the extent distributions are not required.

A classic time to consider the transfer of property to a charitable remainder trust (or charitable lead trust) is when the donor is contemplating the sale of highly appreciated property. In lieu of selling the property and paying tax on the gain that is realized, the donor can transfer the property to the charitable trust and let the charitable trust sell it tax-free. Another circumstance might be the donation of retirement funds. The donor can be non-charitable beneficiary and purchase life insurance to be held in an ILIT for the benefit of her children. Or the donor can designate a child as the non-charitable beneficiary, and a "stretch" the annual payout over the child's lifetime.

Another benefit of the charitable trust is asset protection. The transfer to the trust preserves the trust assets from creditor attack.

6. Recommendations

First, it is recommended that your foundational estate planning be updated. For the reasons described above, we recommend that you make a revocable living trust with a pour-over last will and testament. You can serve as trustee of your trust, but thought should be given as to whether you would like a co-trustee and who should serve as your executor under the pour-over last will and testament. Further, consideration should be given as to who could serve as a successor trustee and successor executor. In addition, a general durable power of attorney, healthcare proxy and living will, and HIPAA release are recommended, to plan in the event of your capacity and thereby avoid the need for a conservatorship proceeding. In making these documents, the below-described trust provisions should be considered.

As to whom might serve in the above roles, you might consider your grown children. However, in doing so, kindly consider the demands of being a trustee and the potential length of the trusteeship. As mentioned above, your life expectancy is another 21 years, and there is the potential that one of your minor grandchildren might take under your estate planning documents (you outlive one or your children). This means, there is the potential for a long-term trusteeship. Fortunately, your children (while grown) are young and could serve for the contemplated trusteeship period.

Concerning your grown children, as stated, please consider who might be most appropriate for the different roles that are necessary (as a co-trustee or successor trustee, executor or successor executor, agent and successor agent under a power of attorney, and agent on your healthcare directives). These roles demand differing sets of skills, from financial skills and attention to detail, the ability to make tough emotional decisions. Further, you might consider whether any rift would be caused by the selection of one child over another.[6] If that is a concern, outsiders might be considered for certain roles (including the role of trustee). For example, your accountant or a professional trustee you might be available, with one or more of your children serving as a trust protector with the ability to remove and replace a trustee. [A trust protector is a person you can appoint a trustee with certain limited powers, for example (as indicated), the ability to remove and replace trustees, or even to make minor changes to the trust in light of changes in the family and or changes in the law.]

With regard to asset protection, your obtaining additional personal insurance (including an umbrella policy) should be considered. Such insurance would provide potentially needed protection, and at an affordable cost.

Your articulated concerns with potential liability arising from your law practice would need to be addressed by different means. Because no actual or potential claims are known and we do not contemplate any transfers that might make you insolvent, the possibility that a transfer by you of assets would be fraudulent is not contemplated. That said, you might consider transfer of your stocks, bonds, cash and savings into an entity created by you, to provide asset protection and potential discount opportunities. By your following the proper "corporate" formalities, you could potentially shelter your assets from creditors, who could only obtain a charging order and any monies that are actually distributed by the entity to you. You could also write off certain administrative expenses as business expenses for income taxation action purposes. Likewise, your establishing a GRAT funded by appreciated assets for the benefit of your children might be considered, for estate freezing and asset protection purposes. [If structured with the right assets, an income stream from the contributed assets could be created too.]

The above said, transfers to a QPRT of your residence or vacation home might be considered, for estate freezing and asset protection purposes. Otherwise, however, it is not recommended that you make a transfer of them. A transfer might cause reassessment of the transferred properties, and it would disqualify the property from eligibility for an exemption from capital gains under IRC §121. Moreover, if transferred, unless care is taken you might risk loss of the adjusted basis under IRC §1014. [These sections would not be available if a transfer was made

[6] If a child is a trustee, there can sometimes be conflict with other remainder beneficiaries.

to a QPRT.] That said, a transfer to a revocable living trust should not disqualify you from eligibility under either IRC §121 or IRC §1014.

While the exemption amount remains high, you might also consider a transfer of your life insurance to an ILIT, with you retaining no incidence of ownership. Purchase of a rider to cover the three-year period in which inclusion in your estate might still be possible might be available, and at an affordable premium. Or, alternatively, you might consider gifting the life insurance policy to your grown children.

In recent conversations, you have described your charitable inclinations towards your college alma mater. With the potential estate tax to your estate (due to its size) and the contemplated reduction in a lifetime exemption amount, given your charitable inclinations, you might consider charitable planning. While a donation could be made at your death, which would reduce your estate by providing an estate tax deduction, greater impact can be caused by lifetime donations. As described above, they can provide an income tax deduction to you, and if leverage with charitable trust planning, could provide you a stream of income, eliminate potential income tax for you (ordinary and capital gains), and if paired with life insurance could provide your children a greater inheritance than without the charitable donations. Further, with donation to a donor advised fund, which because of the cost and complication is recommended in your circumstances over the creation of a family foundation, personal benefits could inure to your children and grandchildren with their future involvement in charitable activities. As such, we recommend considering the creation of a charitable remainder trust, your donation of part or all of your 401(k) plan benefits and/or spousal rollover IRA to it, and your possible purchase of additional life insurance. [As indicated above, it is recommended that your residence and vacation home stay in your estate, for adjusted basis purposes and other reasons.] Given the technical requirements for a charitable remainder trust (including its distribution to the noncharitable lead beneficiary of not less than 5% of its fair market value annually), calculations should be made to determine how this would affect your income stream and whether it would provide you sufficient liquidity to meet your existing and contemplated living expenses.

You have also mentioned your wish to potentially leave bequests to your grandchildren, rather than to your children. If you wish to do so, it is recommended that we engage in GST planning, and that in your recommended revocable living trust we create exempt and nonexempt trusts to utilize your GST lifetime exemption. These trusts should have the inclusion ratios described above, and distributions from them should be ordered in a manner described above. Moreover, you might consider making gifts to your grandchildren by way of frontloading Section 529 Plans created for them, which would be exempt from the GST.

7. <u>Recommended Trust Provisions</u>

a. Because the trust would survive you, it is recommended that you avoid using the word “revocable” in the name of the trust, as a trust becomes irrevocable upon the trustmaker’s death.

b. The effective date of the trust should be immediate, to be effective immediately in the event you became incapacitated, as the trust will provide for you during your lifetime

(including during a disability.) This can help avoid the necessity of a conservatorship, by providing provisions for your care.

c. As with a Last Will and Testament, you will want to have: (1) distributive provisions and (2) tax provisions. Who gets what, when, and where? And the tax provisions addressing estate tax (perhaps generation-skipping tax) concerns, and perhaps provisions concerning income tax considerations.

d. It is recommended that the trust identify your children, because not every potential trustee may know who they are, to make easier exercise of the successor trustee's duties.

e. Intentions – Under the California Probate Code, a trustee is required to follow the intentions of the trustmaker. It is therefore helpful and recommended to put into the trust instrument the trustmaker's intentions, particularly any particular wishes.

f. Trustee -- With the revocable living trust, the trustmaker should generally be the trustee until such time as he or she has become incapacitated or has passed away.

g. Successor Trustee -- You should not pick someone just because he or she is a friend or family member. You need someone who has good attention to detail, is diligent, can handle the pressure, can handle the details (including making necessary filings, such as tax returns and tax elections), and will be around for the entire period of the trust. [Note, your life expectancy is for another twenty-one (21) years.] You will need someone ready, willing, and able to manage the trust assets, and who can say "no" when appropriate and not be coerced by beneficiaries.

h. Powers of the Trustee –

✓ The powers of the trustee should be broad, to address life changes and changes in the law changes, to permit the trust to grow and change as the trustmaker's life changes. The power to amend and revoke the trust is critical.

✓ With a third-party trustee, a general testamentary power of attorney will cause estate inclusion. So, care must be taken, and in such circumstances, you will want trustee powers to be limited by standards to prevent inclusion for certain types of trusts and certain trustees.

✓ The power of the trustee should include the power to invest property. California has the uniform prudent investor act, which under modern portfolio theory requires diversification, unless the trust instrument provides otherwise. If the trustmaker is heavily invested in a single class of assets (for example, real estate), this can cause a problem. In such circumstances, the trustee will have to liquidate assets, to diversify.

✓ Power over unproductive property – by granting the trustee power to retain or acquire unproductive or under productive property, this can prevent the forced sale of the family residence (even though it is not productive property).

✓ The power to operate a business -- the trustee has the power to hold and operate any business or enterprise that is or becomes trust property. This is an important provision, as trust generally do not have the power to operate a business.

✓ Power to determine, for trust purposes, whether moneys are income or principle.

✓ The discretion to make distributions of income and principal, and the standard for distributions (i.e., 5 x 5 powers[7] or "health, education maintenance and support", which includes more than just medical bills and permits consideration of the beneficiary's standard of living, or a broader "comfort, welfare, and happiness" standard).

[7] A right to the greater of $5,000 or 5% of the trust assets.

✓ Payments for legally incapacitated persons, which permits the trustee to give the guardian (rather than the incapacitated person) payments.

i. Funding (Schedule A) -- A trust is not valid under law unless it has assets. It is therefore critical to identify the trust assets by listing them on a Schedule A to the trust. Applicable case law (Estate of Heggstead and Estate of Ukkstead) holds that a general assignment is acceptable (the attachment of a schedule of assets to the instrument and reference to it in the instrument) to qualify the scheduled assets as trust assets. Thereafter, if necessary, a Heggstead petition can be made to the Court for a Heggstead order permitting, i.e., the filing of a new deed, which generally can be obtained within sixty (60) days. The asset schedule must be up to date, with the schedule being one of the most important sections of the trust.

j. Funding with Additional Assets – a provision permitting additions to the trust is recommended for a revocable living trust (which is generally amendable), to permit the addition of assets to the trust. This permits flexibility, and is different from an irrevocable living trust, where the addition or subtraction of assets is not permitted.

k. Beneficiaries -- You might define the "primary beneficiary" as yourself, and not your issue. This can help avoid contingent beneficiaries (i.e., children) from complaining that the trustee is wasting their inheritance by unnecessary distributions to you, particularly in the event you are no longer trustee (and even incapacitated).

l. Revocation and Amendment

✓ Because at some point you may become incapacitated or simply no longer wish to act as trustee, it is recommended that you (i) grant a successor trustee the power to make distributions during your lifetime and (ii) articulate your rights to distributions in those circumstances.

✓ It is suggested that this be paired with designated powers under a power of attorney, to avoid the need for a conservatorship.

✓ It is also recommended that you allow the exercise of changes to the trust by third parties, in the event you are incapacitated. Correspondingly, among the powers given in the power of attorney, the agent should be authorized to amend the trust, for example, because of changes in the family and changes in tax laws. [Absent the power of attorney, a petition to the probate court for appointment of a conservator would be necessary, to permit changes in the trust in the event the trustmaker's disability. Under California law, if you put the provision in the trust, you also need to put it in the power of attorney document.]

m. Distributions – It is recommended that you give the trustee the power to defer distributions, to give the trustee a reasonable period of time to make distributions and not be forced to make distributions (for a 6-month to 9-month period). This will address circumstances when beneficiaries immediately start to spend money and therefore demand distributions.

n. Grandchildren -- per stirpes versus per capita by each generation. Do you want all grandchildren treated the same or differently (depending on the circumstances)? To the extent a beneficiary might be a minor, it is suggested that separate shares be created, with instructions to not make distributions until age 30 years, as per your stated wishes.

o. Incapacity and Disability Planning – It is suggested that you have a provision providing that in the event of your in capacity, the agent under a power of attorney can demand distributions of income and principle. This will be particularly important if the agent is a different person than the trustee; and it can avoid the need to petition the court for appointment of the conservatory. The provision should also recognize the agent acting for you under a valid healthcare directive or comparable instrument.

p. Debts -- A provision directing the trustee to pay debts (including taxes) is recommended, to pay taxes, debts, expenses of administration, and the like. With that, distributions can be free and clear of debts, and you can prevent the possibility of creditors seeking to collect from your beneficiaries.

q. Account – The time period for objecting to account, if stated in bold language, can be reduced from three (3) years to 180 days, with everyone getting a prompt accounting. It is recommended that such language be stated, but that the right to an accounting not be waived.

8. Summary

We have reviewed the information you have provided, including your articulated goals. In light thereof, we recommend update of your foundational estate planning, by the making of a revocable living trust with a pour-over last will and testament a general durable power of attorney, healthcare proxy and living will, and HIPAA release. In making these documents, certain provisions should be considered. Moreover, thought should be given as to who might be qualified to serve as your successor trustee, including possibly who among your grown children.

As stated, it is recommended that your foundational estate planning be updated. For the reasons described above, we recommend that you make a revocable living trust with a pour-over last will and testament. You can serve as trustee of your trust, but thought should be given as to whether you would like a co-trustee and who should serve as your executor under the pour-over last will and testament. Further, thought should be given as to who could serve as a successor trustee and successor executor. In addition, a general durable power of attorney, healthcare proxy and living will, and HIPAA release are recommended, to plan in the event of your capacity and thereby avoid the need for a conservatorship proceeding. In making these documents, the above-described trust provisions should be considered. With regard to asset protection, your obtaining additional life insurance (including an umbrella policy) should be considered. As to concerns with potential liability arising from your law practice, transfer of your stocks, bonds, cash and savings into an entity created by you should be considered, as a creditor could only obtain a charging order for any moneys actually distributed by the entity to you. Establishment of a GRAT and/or a QPRT might be considered. Otherwise, transfers of your residence or vacation home is not recommended. While the exemption amount remains high, you might also consider a transfer of your life insurance to an ILIT, with you retaining no incidence of ownership (and your purchase of a rider for a three-year period), or, alternatively, you might consider gifting the life insurance policy to your grown children.

You have described your charitable inclinations towards your college alma mater. In light thereof, you might consider charitable planning. While a donation could be made at your death, which would reduce your estate by providing an estate tax deduction, greater impact can be caused by lifetime donations by providing an income tax deduction to you and, with leverage, additional tax planning opportunities.

You have also mentioned your wish to potentially leave bequests to your grandchildren, rather than to your children. If you wish to do so, it is recommended that we engage in GST planning, and by the creation of exempt and nonexempt trusts to utilize your GST lifetime exemption with specifically ordered distributions from these trusts. Moreover, you might consider

making gifts to your grandchildren by way of frontloading Section 529 Plans created for them, which would be exempt from the GST.