

## BASIC ESTATE AND GIFT PLANNING

*The Most Important First Step*

### **The Wealth Strategies Group**

at Atlantic Trust integrates estate, financial and investment planning through sophisticated assessment of goals with the objective of multigenerational capital preservation, family business continuity and strategic philanthropic objectives.

The heart of every estate plan is providing for those you love. That means not only distributing the assets accumulated during your lifetime, but also minimizing what goes to taxes.

Under the current system, two federal taxes—estate tax and generation skipping transfer (GST) tax of up to 35% each—can both reduce an inheritance. On top of that, about half the states impose a separate estate tax of their own. In the worst-case scenario, these three taxes together could consume a huge portion of what you want to leave to your family.

Fortunately there are some basic ways to stop that from happening: Take full advantage of the amount that is exempt from estate and GST tax, make tax-free lifetime transfers and prevent oversights that could result in your estate paying more tax than absolutely necessary.

### **Maximize the Exemption Amount**

Currently, the federal exemption amount—what each individual can give away at death without triggering estate tax—is \$5M. It is scheduled to remain at this level in 2012 and revert to \$1M in 2013.

Assets inherited from a spouse who is a United States citizen qualify for an unlimited marital deduction and are not taxed. However, if the property remains when the survivor dies—say the wife inherited money but never spent the funds—it would be taxable as part of the survivor's estate. "Therefore, a spouse who left everything to the other, in what are called I-love-you wills, would lose the ability to use his or her federal estate tax exemption," says Rebecca W. Milliman, senior vice president.

To preserve the exemption for both spouses, many people divide their estates into two parts. This is how it typically works: When the first spouse dies, an amount up to the federal exemption goes into a bypass- or credit-shelter trust. It can distribute

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income and principal to family members (typically the surviving spouse, although it can also benefit children and grandchildren) for as long as the spouse is alive, and after that pass on whatever is left to the children. The remainder of the estate, known as the marital share, goes to the surviving spouse outright or in a marital trust.

Since funds in the bypass trust are covered by the exemption amount, they will not be taxed on the first spouse's death. Nor are they considered part of the surviving spouse's estate, so they will not be taxed when he or she dies either. The rest of the estate qualifies for the unlimited marital deduction and is not taxed when the first spouse dies. But because it is considered part of the survivor's estate, it is subject to tax when the surviving spouse passes away. That is true whether the property goes to the spouse outright, or in trust.

Retirement assets pose special concerns. Although we see a growing number of clients who cannot fully fund a bypass trust without using retirement assets, those who do lose certain income tax benefits. In such cases you need to weigh the potential estate tax savings against the income tax cost. (For additional discussion on retirement benefits, see the Atlantic Trust White Paper "Estate Planning with Retirement Assets".)

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### **Hold at Least Some Assets in Your Own Name**

Traditionally, in order to make the best use of the exemption amount, each spouse held assets worth at least that amount in his or her own name and reviewed their balance sheet to determine how property was titled. "Property that is held jointly with rights of survivorship will automatically pass outright to the survivor at death, and will not be available to fund the bypass trust," says Milliman. For estate planning purposes, it made sense to change the way assets were titled.

"One alternative was holding property as tenants in common, which made each spouse the owner of half the property," Milliman notes. In that case, half the value of the property was available to fund the bypass trust.

Another possibility was for the wealthier spouse to shift assets to the other during life. Again, when both spouses are U.S. citizens, there was no gift tax. For spouses who are not comfortable with making such a transfer, "there were additional creative strategies to enable each to use the full exemption amount," Milliman says.

However, for 2011 and 2012, Congress has provided that spouses can share one another's exemption. Portability under the law through 2012 allows flexibility for a surviving spouse to allocate the deceased spouse's unused exemption at the survivor's subsequent death. Please note there are several rules and pitfalls to be mindful of. Please review your situation with your advisor.

### **Make Annual Tax-Free Gifts**

Currently, you can give up to \$13,000 each year to as many recipients as you would like without incurring a gift tax. Spouses can combine this annual exclusion to jointly give \$26,000 to any person tax-free—a practice known as gift-splitting. (If you choose to gift-split in a given year, you must file a gift-tax return by April 15 of the following year.) These gifts do not count against the \$1M lifetime gift-tax exemption. Once you have passed that limit, you must pay gift tax of 35%.

"Annual exclusion gifts are a simple but potentially powerful estate planning tool," says Linda S. Beerman, chief fiduciary and risk officer. For example, a couple with a combi-

One caveat when making gifts outright to grandchildren and more remote descendants: annual exclusion gifts do not typically count against the \$5M GST tax exemption that applies to transfers during life or at death.

nation of 10 children and grandchildren who gift-split can give away \$260,000 per year (\$26,000 per person times 10 people) using their annual exclusion. Assuming a growth rate of 6%, that sum would be worth \$10,138,108 in 20 years, with all of the appreciation free of estate tax. At a tax rate of 35% (the rate currently in effect), that represents a federal estate tax savings of \$3,548,337. Another advantage of annual exclusion gifts is that you have the flexibility of giving away property when you can afford it, without compromising your own standard of living. “Clients of moderate wealth who may not be in a position to give away large amounts of assets at one time may be comfortable making smaller gifts that come within the annual exclusion,” Beerman says.

Many of our clients use the annual exclusion to fund state-qualified tuition programs. Known as Section 529 plans, a reference to the Internal Revenue Code section that permits them, these plans are available in all 50 states plus the District of Columbia. They allow you to set up a separate account for each child or grandchild (or anyone else you want to benefit), earmarked for higher education.

Cash gifts made directly to family members or to trusts for their benefit are by far the most common way of using the annual exclusion. But it is also possible to give away tangible personal property like art, jewelry, or automobiles.

“An even more tax-efficient strategy is to make gifts of appreciating assets such as marketable securities or interests in a business start-up,” says Milliman. That way, if the assets appreciate after you have made your gift, that subsequent increase in value is also removed from your estate.

When minors are concerned, outright gifts of cash must be made to a custodian under what is known—depending on the state—as the Uniform Transfers to Minors Act (UTMA) or the Uniform Gifts to Minors Act (UGMA). “The main drawback of these accounts is that by law the child is entitled to the funds upon reaching majority—typically at 18 or 21, depending on the state,” Beerman says.

A practical alternative to UTMA and UGMA accounts is a 2503(c) trust, named for a section of the Internal Revenue Code. Although the trust must officially end at age 21, it can do that by giving the beneficiary a window of opportunity—usually 30 or 60 days—to terminate the arrangement. Often the trust provides that if the beneficiary does not exercise that right, the arrangement will continue for a preset number of years.

## Gift and Estate Taxes

The following chart summarizes the Estate, GST and Gift Tax exemptions under The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 signed into law on December 17, 2010.

	Estate & GST Tax	Gift Tax	Top Rate	Notes
<b>2011</b>	\$5M exemption	\$5M exemption	35%	Deduction for state death taxes; Portability of deceased spouse’s unused gift and estate tax exemption
<b>2012</b>	\$5M exemption (Indexed for inflation)	\$5M exemption (Indexed for inflation)	35%	Deduction for state death taxes; Portability of deceased spouse’s unused gift and estate tax exemption
<b>2013</b>	\$1M exemption (GST indexed for inflation)	\$1M exemption	55%	State death tax credit reinstated

The simplest way to finance the premium is to add enough funds to the trust each year so it can meet the annual outlay. There is no gift tax as long as you stay within the annual exclusion amount.

One caveat when making gifts outright to grandchildren and more remote descendants: annual exclusion gifts do not typically count against the \$5M GST tax exemption that applies to transfers during life or at death. However, if gifts are made to certain trusts, you may need to allocate a portion of your GST exemption to the transfer, even if there is no gift tax associated with these transfers because they fit within the annual exclusion. "It is therefore best to notify advisors of all transfers you contemplate involving grandchildren so they can check for possible GST tax implications," Beerman says.

### Pay Medical and Educational Expenses

Without using your annual exclusion, you can pay for education, dental and medical expenses (including health insurance premiums) of family members or friends. When payments are made directly to the providers of those services, they are exempt from both gift tax and generation-skipping tax no matter how much you spend.

Unlike Sec. 529 plans, which can only be applied to higher education, direct payments for education can cover any stage of the process—from preschool to college. "For clients who have the money and expect they will be around to foot the bill, we often recommend direct payments for education in lieu of funding Sec. 529 plans," Beerman says. "This frees them to use their annual exclusion for other purposes."

### Create a Life Insurance Trust

It is often advisable that neither you nor your spouse are the owners of policies that name either of you as insureds. If you are, the proceeds could be subject to estate tax. To avoid that result, you can set up an irrevocable life insurance trust (ILIT)—one in which you do not retain any ownership over the assets or the power to change the trust terms.

Typically the ILIT buys the policy and, when you die, holds the proceeds for whomever you've named as beneficiary. If you already own the policy, you can transfer it to the trust, but if you die within three years of making the transfer, the proceeds would generally be included in your estate. You can avoid that result with term policies by letting the original policy lapse and having the ILIT buy a new one.

The simplest way to finance the premium is to add enough funds to the trust each year so it can meet the annual outlay. There is no gift tax as long as you stay within the annual exclusion amount. However, you must give each ILIT beneficiary the right for a limited time (usually 30 days) to withdraw from the trust the yearly gift attributable to him or her and send annual Crummey notices informing them of the right. Without giving beneficiaries of these trusts Crummey powers, your gift to the trust would be considered a future interest (something beneficiaries cannot use right away) rather than a present one and would not qualify for the annual exclusion.

**Note:** Life insurance policies pass according to the terms of beneficiary designation forms that you fill out, rather than under other documents in your estate plan. Therefore, after setting up an ILIT, do not omit the necessary step of naming the ILIT as the beneficiary of the policy.

### Consider Putting Your House in a Trust

A qualified personal-residence trust (QPRT) removes part of the value of a home from your estate and shelters future appreciation. To do that, you put a primary residence or vacation home into an irrevocable trust, retaining the right to live there for a specified number of years. During that time the trust, of which you or your spouse would typically be trustee, owns the property. When the term expires, ownership can

## ESSENTIAL ESTATE PLANNING DOCUMENTS

Certain documents, while not designed specifically to save taxes, should be part of every estate plan.

**Will** – The cornerstone of most estate plans, this document can be used to distribute property to heirs and charity, create or fund trusts, and name guardians for minor children. It should also name an executor or personal representative—the individual or institution that takes charge of your estate after you die and distributes property according to your wishes.

**Living trust** – or revocable trust, holds assets for your benefit while you are alive and names the people who will receive the property when you die. These trusts are especially important in planning for incapacity, since the trustee will be available to manage and distribute the funds. In some states they are also used to simplify probate—the process of closing an estate after someone dies. Even then, a living trust is not a will substitute, however. While the living trust has certain advantages (most notably privacy, since unlike a will it is not a public record), some matters, including your funeral wishes, can only be covered in a will.

**Personal Property Memorandum** – provides guidance or direction (depending on the state) to your executor regarding your desires concerning those whom you wish to receive particular items of personal property. Since this memorandum does not need to be executed with the formalities of a will, you can change it whenever you wish.

**Durable power of attorney** – appoints a trusted family member, friend or advisor as an agent to act on your behalf in a variety of financial and legal matters if you are physically or mentally unable to handle them. The power of attorney may be effective from the moment you sign it, or be activated by a specific event, such as when you become incapacitated. A broadly drafted power of attorney could give an agent the authority to implement a variety of tax-saving strategies, such as making gifts, adding assets to a trust, and amending IRA beneficiary designation forms.

**Health-care proxy** – known in some states as a health-care agent or health-care power of attorney, appoints someone you trust to make medical decisions for you when you can no longer make your own choices. This also automatically gives him or her access to your medical records. If you want anyone else to have that particular right, it is also advisable to sign a HIPAA release (a reference to the federal Health Insurance Portability and Accountability Act), giving doctors and hospitals permission to share medical records with the others who you designate.

**Living will** – a written statement that expresses specific wishes about certain aspects of end-of-life care, rather than simply leaving them up to the person named in your health-care proxy. Although it is difficult to address every contingency, living wills typically cover pain relief and whether you would want life-prolonging treatment such as a ventilator, feeding tube and resuscitation. ■

Minimally, the forms should name a contingent beneficiary who will receive the assets if the primary beneficiary is unable to do so. If you have named minors as beneficiaries, consider whether assets should be left to them either in custody, or in a trust.

pass to the beneficiaries (usually children) or, better yet, go into another trust for the rest of your life.

The value of the gift to family reflects the value of the right to receive the personal residence (the remainder) a certain number of years from now. Figuring the discounted value of the gift involves a complex actuarial calculation based on the Sec. 7520 rate, which is set each month by the U.S. Treasury. If you die during the trust term, the benefits of this estate-planning tool are wiped out, but there are no adverse tax consequences.

If you want to continue living in the house when the QPRT ends, you would need to pay rent at fair market rates, or the Internal Revenue Service might decide after you

die that you retained an interest in the house. Should that happen, the house will be included in your estate and will be subject to tax at its appreciated value.

### Coordinate Retirement Accounts with the Rest of Your Estate Plan

Money in these accounts passes outside of a will or living trust and is distributed according to beneficiary designation forms that you fill out when you open the accounts and can later amend. Who you name as beneficiary determines who gets the money after you die and how quickly your heirs must withdraw it.

Given the importance of these forms in disposing of your assets, it is important to have an advisor who is knowledgeable about the rules that apply to retirement assets at least review the forms and integrate them with the rest of your estate plan. Some clients go one step further, and have their advisors draft a document that spells out many different conditions and contingencies about how the funds should be distributed. Minimally, the forms should name a contingent beneficiary who will receive the assets if the primary beneficiary is unable to do so. If you have named minors as beneficiaries, consider whether assets should be left to them either in custody, or in a trust.

Another issue to consider is who to name as beneficiaries. Although the natural inclination for married couples is to name their spouse, that may not make the most sense from an estate planning perspective.

### Update Your Plan as Necessary

There is support in Congress for estate tax reform, including proposals to raise the exemption amount and lower the estate tax rate. Given these potential changes on the horizon, we encourage clients to review their existing estate plans and make them as flexible as possible. Changes in personal circumstances, such as marriage, divorce, or the birth or death of a family member, may also make it necessary to revise the plan. ■

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