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OPTIONS IN ESTATE PLANNING

This Memorandum presents various options you should consider in planning your estate. The ultimate choice of estate plans depends not only on financial considerations, but on personal and family considerations as well. The options discussed here are by no means all-inclusive of estate planning techniques. They do, however, present the basis for any family's estate plan.

QTIP Trust to Provide Asset Protection for Surviving Spouse

You are already aware how a living trust provides you with estate tax savings, protection against probate and conservatorship proceedings, and flexibility in determining how assets will pass to your children. In addition, you may use the trust to provide additional asset protection for the surviving spouse and your children and additional protection from estate taxes for your children's estates.

When the first spouse dies, most living trusts divide into at least two trusts:

1) a revocable trust over which the survivor retains full control and discretion (the "survivor's trust"), and

2)an irrevocable trust to hold the deceased spouse's assets that can be sheltered by the estate tax credit. Currently, that credit will be $1,500,000 for most people. The assets held in that irrevocable trust bypass the surviving spouse's estate, so we often refer to it as the "bypass" or "credit-shelter" trust.

Although the bypass trust assets are not part of the surviving spouse's estate, the surviving spouse typically receives all the income from the property. If the income is not enough for the surviving spouse to maintain their standard of living, then after exhausting his or her own assets, the surviving spouse can use the principal of the bypass trust as well. The surviving spouse typically controls the investment of the bypass trust assets as the sole trustee. As the trustee, the surviving spouse also decides how much is needed for his or her support. Therefore, even though the decedent's property is in an irrevocable trust, the surviving spouse is still able to live in the same manner as during the decedent's lifetime.

The surviving spouse is restricted is by a duty to preserve the bypass trust assets for the eventual heirs, the children. The standard of care in which the surviving spouse, as trustee, must operate under is that of a reasonably prudent business person. This should preclude the surviving spouse from spending or gifting the decedent's property in an indiscriminate manner or from making extremely imprudent investment decisions.

The surviving spouse controls and receives the benefits of the assets in the bypass trust. However, they are not subject to estate taxes in survivor's estate, regardless of how much they grow in value. In addition, the bypass trust assets receive protection from the survivor's creditors. Because the assets were left in trust for the surviving spouse by the deceased spouse, they can be protected from creditors by a "spendthrift clause" in the trust. This means that a creditor cannot seize assets within the bypass trust. The creditor can only seize distributions from the trust to the survivor. This puts creditors at a tremendous disadvantage.

<u>Expanding Creditor Protection Through Use of a QTIP Trust</u>. When the deceased spouse's share of the assets exceeds the estate tax credit amount, you have a choice to either add the excess assets to the survivor's trust, or to create a second irrevocable trust, which is usually referred to as a "QTIP" or "marital" trust. Both actions avoid estate taxes by qualifying for the marital estate tax deduction. You don't need to remember that QTIP stands for Qualified Terminable Interest Property. You do want to know that a QTIP trust qualifies for the marital deduction by requiring all income to be paid to the surviving spouse and by prohibiting any of its assets from being paid to anyone other than the surviving spouse.

If the decedent's excess assets are added to the survivor's trust, then they are subject to seizure by the survivor's creditors, just as any other assets owned by the survivor. However, if they are kept in a QTIP trust, then they can be protected from seizure by creditors by the spendthrift clause, just like the bypass trust assets. The survivor still controls and receives the benefit of the QTIP trust assets, but they are protected from creditors. The costs are the same as for the bypass trust: 1) the surviving spouse must file a separate income tax return for the QTIP trust, and 2) the surviving spouse must not imprudently dissipate the QTIP trust assets. You may conclude that the assets protection benefits outweigh these costs. If so, then your trust should include QTIP trust provisions.

Dynasty Trust Provisions to Provide Asset Protection for and Estate Tax Protection for Heirs. You also have a choice to distribute assets directly to your heirs, or to allow your heirs to control those assets in an irrevocable trust, similar to the bypass or QTIP trusts. In another words, rather than having the funds distributed to the children outright upon the surviving spouse's death, they can be retained in trust for the children during their lifetimes. They can act as trustees of their own trusts and control the assets. They can receive all of the income from the assets, as well as additional distributions for maintenance, health, support, and education.

<u>Asset Protection</u>. The assets in the trust will receive protection from creditors through the spendthrift clause. These assets will also receive some protection from an ex-spouse in the event of a child's divorce.

<u>Costs</u>. The primary cost to the child is the filing of the additional tax return. The child probably also loses some flexibility in his or her ability to give the assets away to charity or others. However, the child can give all the income away and still have tremendous discretion on using trust assets to benefit themselves.

Estate Tax Savings for Children by Preserving Your Generation-Skipping Tax Exemption. You can also protect some or all of the assets you leave in trust for your children from being taxed in your children's estate. You can shelter the same amount in trust that you can exempt from estate taxes in your own estate (currently $1,500,000). Consequently, between the two of you, you can leave up to $3,000,000 in trust for your children, and those assets will not be subject to estate taxes in your children's estate. This is true, even though the assets grow in value to a much larger amount. Therefore, just as we use the bypass trust to prevent assets from being taxed in the surviving spouse's estate, we recommend using similar trusts to keep the maximum amount outside your children's estates. The children may in-turn, choose to leave those assets in trust for their children, and avoid estate taxes again.

For Assets in Excess of Tax Exemption, You Can Give Directly to Children or Keep in Trust for Asset Protection. Assets in excess of the exempt amount must be included in your children's taxable estate, or be subject to a "Generation-Skipping Transfer" ("GST") tax at the maximum estate tax rate (approximately 50%). We avoid that by making sure the excess assets are included in the children's taxable estate. Consequently, you have the same choice about excess assets for you child that you have for the assets in excess of the estate tax credit that one spouse leaves to the other. You can either give the child full control of the assets or keep them in an irrevocable trust for the child's benefit to protect them against creditors.

Yours very truly,

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