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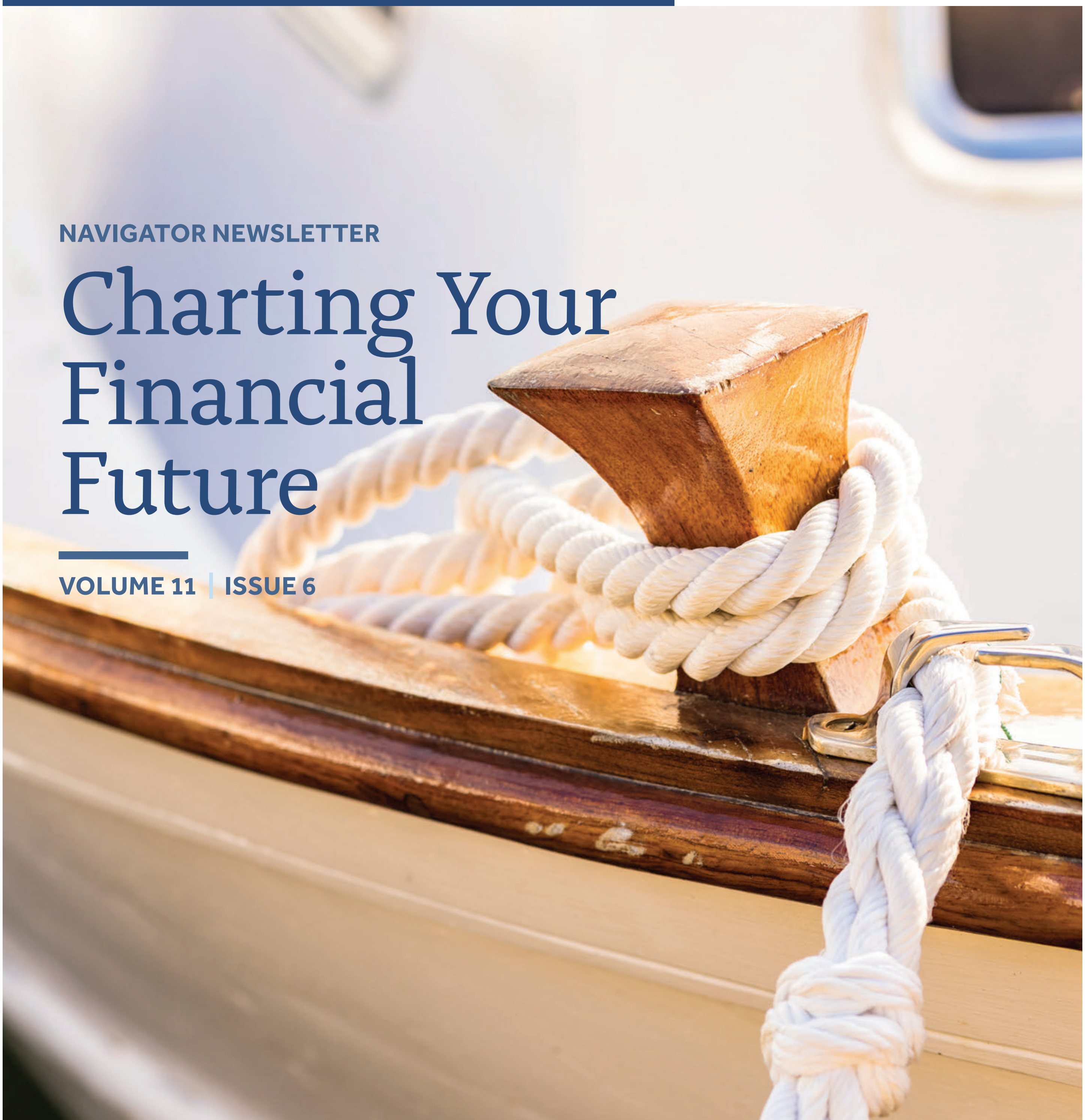

NAVIGATOR NEWSLETTER

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Estate Planning

The basics of "tax-wise" estate planning for married couples.

By Eva Stark, JD, LL.M.

Married, high net worth clients may not be aware of the potential need to incorporate "tax-wise" planning into their estate planning documents. The goal of tax-wise planning is generally to:

- Eliminate estate tax at the first spouse's death; and,
- Minimize overall transfer taxes at the surviving spouse's death.

Generally, there are three strategies for tax-wise estate planning:

1. Reliance on portability,
2. Bypass trust funding, or
3. A hybrid approach utilizing a combination of the two.

The strategy that may be optimal will depend on a client's specific circumstances. These strategies are described in more detail, below, following a brief overview of the current federal estate tax planning environment.

Background

While there is a federal estate tax regime, not all property owned at death is subject to estate tax. Federal tax law currently allows for a lifetime exemption amount. Generally, this is the combined amount that an individual may gift away either during lifetime or at death to persons other than his or her spouse without triggering federal gift or estate tax.

Currently, the federal lifetime exemption amount is $10 million, adjusted for inflation ($11,700,000 per individual in 2021).[1] Bequests to a spouse (or to certain trusts that qualify for the marital deduction) qualify for an unlimited marital deduction and thus, generally do not trigger estate tax or utilize the decedent's lifetime exemption.[2] Bequests to persons other than a spouse that exceed the decedent's lifetime exemption amount are generally subject to estate tax at a rate of 40%.

Three strategies to tax-wise planning

Reliance on portability

Federal tax law makes a deceased spouse's unused exemption "portable," meaning such unused exemption may be "transferred" to his or her surviving spouse provided that a portability election is made on the predeceased spouse's estate tax return.

With this strategy, a decedent leaves all his or her assets to the surviving spouse either outright or in a trust that qualifies for the marital deduction. Estate taxes are thus eliminated at the first death. A portability election is made, availing the survivor of the decedent's unused exemption amount in addition to his or her own exemption amount.

Assets that are left to the survivor or in a trust that qualifies for the

1 Absent legislative change, this amount is scheduled to revert to $5 million in 2026, adjusted for inflation (for an estimated exemption amount of approximately $6.4 million in 2026).

2 Special rules apply to non-U.S. citizens.

marital deduction are includible in the survivor's taxable estate.

KEY ADVANTAGES OF RELIANCE ON PORTABILITY:

- Simplicity.
- Assets generally receive a second basis adjustment upon the survivor's death.

KEY DISADVANTAGES OF RELIANCE ON PORTABILITY:

- Any appreciation that occurs between the first death and the survivor's death will be included in the survivor's estate.
- Even where a portability election is successfully made, the deceased spouse's unused exemption may be lost in some circumstances where the survivor remarries.
- The generation-skipping transfer tax exemption is not portable, which may be a concern any time an asset is left to persons other than a spouse or child.

Fully funded bypass trust

The second tax-wise planning strategy is to utilize the decedent's exemption by funding a "bypass trust" (also known as credit shelter trust) at the first death.

This strategy channels an amount equal to the decedent's remaining federal exemption amount to the bypass trust. The bypass trust generally benefits the surviving spouse and/or descendants and does not qualify for the marital deduction.

If the decedent's estate exceeds his or her remaining lifetime exemption amount, the balance of the estate is channeled to the surviving spouse or to a trust that qualifies for the marital deduction, thus deferring estate tax on amounts above the exemption amount at the first death.

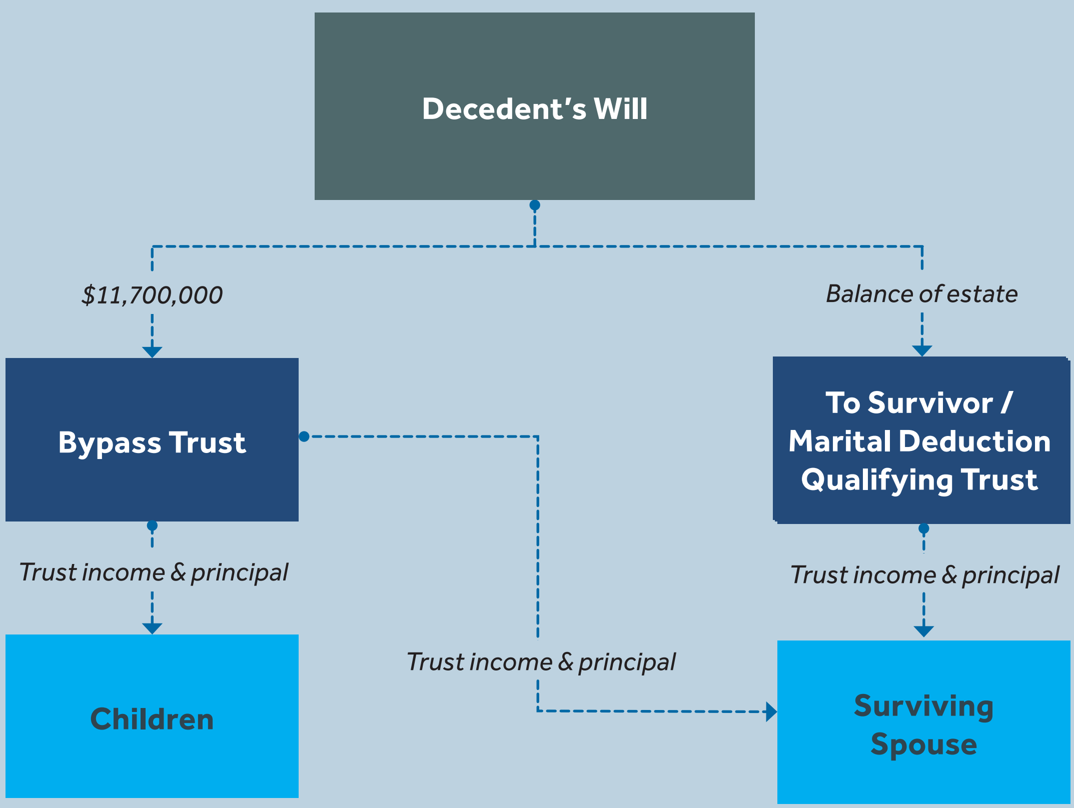
KEY ADVANTAGES OF A BYPASS TRUST

- Assets in the bypass trust, including any appreciation that occurred between the first and second deaths, are generally not includible in the survivor's taxable estate.
- The bypass trust can also utilize the decedent's remaining generation-skipping transfer tax exemption, if any.

KEY DISADVANTAGES OF A BYPASS TRUST

- Assets in a bypass trust generally do not receive a second basis adjustment at the survivor's death. This could increase the capital gains exposure for beneficiaries when bypass trust assets are subsequently sold.
- Added complexity.

Illustration of fully funded bypass trust strategy.



A NOTE ON STATE-LEVEL ESTATE TAX

Many states impose a state-level estate tax in addition to the federal estate tax regime.

Exemption amounts, tax rates, and whether or not a decedent's state-level exemption amount is portable, will all depend on the laws of the state.

Where state-level estate tax is a concern, the estate plan should address state-level estate planning strategies as well, the techniques for which are beyond the scope of this discussion.

Hybrid approach

The third, and increasingly popular, strategy is to incorporate flexibility into estate planning documents to allow for reliance on portability, funding of a bypass trust, or a combination of the two. Under this approach, bypass trust funding decisions can be made after the first death, when the tax picture is likely to be somewhat clearer.

For example, a hybrid approach might utilize a "Clayton QTIP," where funding of a marital deduction eligible trust and/or bypass trust depends on elections made by the executor. A hybrid approach could utilize "disclaimer" provisions, which permit the survivor to channel assets between the bypass trust and a marital deduction eligible trust.

These, as well as several other possible techniques, all have advantages and limitations that clients should discuss with their estate planning attorney.

The upshot is that the added flexibility generally allows for the focus of the estate plan to be shifted to minimizing estate taxes, minimizing capital gains exposure of beneficiaries, or to other objectives as circumstances or tax laws change.

Looking forward

Clients who are establishing or revising their estate plans may wish to discuss tax-wise planning strategies with their attorneys.

They also may wish to explore strategies for incorporating flexibility into their estate plans with their professional advisors to allow the focus of the plan to shift with changing circumstances and tax conditions.

Eva Stark, JD, LL.M., joined The Nautilus Group in 2014 to assist with the development of estate and business plans. She also performs advanced tax research. Eva graduated summa cum laude with a BS in economics and finance from The University of Texas at Dallas. She earned her JD, with honors, from Southern Methodist University, where she served as a student attorney and chief counsel at the SMU Federal Taxpayers Clinic. She received her LL.M. in taxation from Georgetown University Law Center. Prior to joining Nautilus, Eva worked in private practice in tax controversy, business law, and litigation.

Estate planning for 2022: Questions to ask your clients.

By Marvin E. Blum, JD, CPA

It's a whole new world of estate planning. From an all-time high estate tax exemption that soon sunsets in half, to the prospect of higher taxes, larger inheritances, complicated family dynamics, rising rates of divorce and litigation, electronic data, the list goes on and on.

Against this backdrop of uncertainty, below is a list of ten questions that every client should be asked to identify areas that need attention. The answers almost always lead to a serious estate planning update.

1 Do you own anything in your name (other than retirement accounts)?

Besides retirement accounts, are any assets directly owned by the client? If assets are titled in the client's name, it generally reveals two things: the assets likely are exposed to claims of creditors, and if the estate is above the exemption, the assets likely will be exposed to a 40% estate tax.

Once these assets have been identified, the first step should be to examine each asset to determine if it is "safe" or "risky." Risky assets (such as real estate or oil and gas) can give rise to claims. Address this exposure by putting an entity wrapper—a limited partnership or limited liability company—around each risky asset, so creditors can only reach the one risky asset and can't reach other assets outside the entity.

The second step is to protect all assets from being exposed to the owner's personal creditors (such as a tort creditor) by transferring both safe assets and risky asset entities to a family limited partnership (FLP). Finally, the third step is to transfer the FLP units to an irrevocable trust to add another layer of asset protection and to remove assets from the taxable estate.

2 After you're gone, will your retirement assets be protected?

Who are the beneficiaries of the client's retirement accounts? Naming children as outright beneficiaries puts the assets at risk. Instead, naming a trust as beneficiary places the funds outside the reach of creditors or divorce. Also, any funds remaining in the trust when the beneficiary dies may avoid estate taxes.

Normally, when a trust is named as beneficiary, the payout is subject to a five-year rule requiring the individual retirement account be distributed (and taxed) to the trust beneficiaries within five years of the death of the IRA owner. However, a special trust called an accumulation trust achieves the asset protection qualities inherent to trusts while also "stretching out" the payout period. With an accumulation trust, IRA amounts must be paid out to the trust within 10 years. The funds can then be held in the trust and dribbled out to the beneficiary as needed.

3 If you died right now, would your children's inheritance become divisible upon a divorce?

Remind clients that any asset owned by either spouse may be "marital property." Moreover, marital property may be presumed to be community property, and the burden of proof is on the party claiming an asset is separate property. Income from separate property may also be community property, depending on state law.

On the other hand, none of the assets owned by a properly structured irrevocable trust is marital property. Therefore, assets held in such a trust cannot be community property, do not generate community property income, and are not divisible upon divorce. Accordingly, planners should strongly urge clients to leave the inheritance to dynasty trusts for the benefit of heirs.

4 Have you taken advantage of the doubled estate tax exemption?

We have a limited "use it or lose it" opportunity to utilize the doubled estate tax exemption before it sunsets in half on December 31, 2025 (or sooner). To lock in the benefit of the doubled exemption, a couple has to transfer $23.4 million out of their estate. The most popular way for married couples to use each spouse's exemption is for each spouse to create a spousal lifetime access trust (SLAT) for the benefit of the other. When appropriately structured, SLATs allow clients to take full advantage of the increased exemption yet retain access to the assets.

5 Can you have your cake and eat it too?

If clients desire to transfer appreciating assets out of their estate but retain access to trust assets and control of trust investments, consider a Section 678 trust. Essentially, a §678 trust allows a beneficiary to be treated as the owner of the trust for income tax purposes but not for estate tax purposes.

With a §678 trust, a client can retain access to the trust's funds for health, education, maintenance, and support and also can serve as trustee of the trust.

Moreover, upon the client's death, the trust assets will not be subject to estate taxes. In addition, assets owned by the trust are generally not subject to the claims of creditors. State laws vary regarding creditor protection.

6 Do you have any low basis assets?

It is important to identify any assets that have appreciated significantly. If the client has low-basis assets, consider "upstream" planning.

If the client's parent has unneeded exemptions, the client could gift the asset to a parent outright or, even better, to a trust for the parent and give the parent a general power of appointment (GPOA) over the assets. The GPOA would cause the assets to be included in the parent's estate.

In the parent's will, the GPOA could be exercised to leave the assets to a trust for the client, thereby acquiring a stepped-up basis for the assets when the parent dies.

7 Do you love your grandkids equally?

Most people love their grandchildren equally. With a traditional per stirpes inheritance, grandchildren with more siblings receive less than grandchildren with fewer siblings. For instance, assume Generation 1 (G-1) has a son with two children, a daughter with four children, and a $12 million estate. After G-1 dies, the son and daughter (G-2) each receive $6 million. However, after G-2 dies, the son's children each receive $3 million while the daughter's children each receive $1.5 million.

To lessen this blow on the cousins, the client could take out a life insurance policy that goes to all the grandchildren (G-3) per capita. The rest of the estate plan remains intact. This creates new assets to use for gifting to G-3 without disrupting G-2's inheritance.

8 Do you have a "red file?"

People in seemingly excellent health can pass unexpectedly. If the client dies suddenly or becomes incapacitated, do loved ones have all the information they will need? Encourage clients to create a "red file" for what estate planning documents don't cover:

- Section 1 – Centralized file of personal information: passwords, contacts, listing of assets, location of documents.
- Section 2 – Business continuity plan: A will directs who will own the business, but not who will manage it. Clients should provide management succession guidance to facilitate the transition when they're gone.
- Section 3 – Plan for incapacity: preferred care providers, caregiver compensation, living preferences, general preferences

(favorite TV shows, movies, colors, foods).

- Section 4 – Legacy plan: document the "heart" side of an estate plan—information on ancestors, meaningful memories, lessons learned, values, and goals for the family.

9 Do you have a business succession plan in place?

As baby boomers age, many seem to think they're going to live forever and accordingly have done no business succession planning. To start, form a planning team (CPA, attorney, financial advisors) and bring all the key stakeholders to the table to develop a plan and implement the succession process.

When thinking about succession planning, searching for a solution involves evaluating a toolbox of planning options to find what works best. There are three primary choices in the toolbox:

1. Transfer the business to family;
2. Sell the business to people within the business; or
3. Sell the business to an outside party.

Every family is different—there's no single succession plan that works for all families.

10 Are you worried an inheritance will ruin your children?

We have all witnessed the disaster when an inheritance passes into unprepared hands. Families who succeed engage in best practices like family meetings and family education, all aimed at preparing heirs to be responsible inheritors.

A family advancement sustainability trust (FAST) equips your family to remain strong and connected through the generations.

In a nutshell, a FAST is an add-on to a traditional estate plan, often funded with life insurance, that does two things. First, it provides funds to pay for family enrichment and education activities such as family retreats, travel, and preserving the family's heritage, as well as maintaining legacy real estate assets passing down to future generations. Second, it appoints trustees/committees who are paid to do the legwork in planning these activities and making sure they happen. The end result is a gift to your family of a meaningful and lasting legacy.

In conclusion, asking effective questions is the gateway to creating an effective estate plan. With these ten questions as a guide, planners can navigate the current climate to identify their clients' most pressing needs.

Marvin E. Blum, attorney and CPA, established The Blum Firm more than 40 years ago, specializing in the areas of estate planning and probate, asset protection planning, planning for closely held businesses, tax planning, tax controversy, and charitable planning. The company is now the largest group of estate planning attorneys in the state of Texas. He is board certified in estate planning & probate law and is a Fellow of the American College of Trust and Estate Counsel. Blum was chosen as one of the "Nation's Top 100 Attorneys" by New York's *Worth* magazine and selected by his peers for inclusion in *The Best Lawyers of America – Trusts & Estates.*

Business succession: Working forever? Or just planning like it?

By David R. Toups, JD, MBA, CFA®, CFP®, CTFA

As businesses continue to recover from the effects of the COVID-19 response, a realization has occurred among business owners across the country: a heightened priority in preparing for probable or inevitable business events or setbacks.

Business succession planning addresses these concerns by creating contingency plans in the event of an owner's death, disability, incapacity, divorce, bankruptcy, retirement, or adverse legal developments. Absent such planning, when adverse events occur, it can be devastating to both the business and the families, employees, customers, and vendors reliant upon it.

On the other hand, a well-planned and funded transition, prompted by a possible or inevitable event, optimizes the business's value for the owners or their families and increases the probability that the firm will continue to operate and benefit its employees, customers, and community well into the future.

Three critical elements to creating a successful succession plan are described below.

Exit strategy

A clear picture of the owner's vision or ultimate destination for the business is necessary for succession planning.

- Does the owner want a legacy family business that his or her children eventually acquire and run?
- Does the owner want to eventually retire and sell the business to a partner, a group of employees, or an outside third party?
- Or does the owner work until the day he or she drops?

Each of these scenarios requires different structure parameters to bring the proposed succession to fruition.

An unhurried, anticipated timeline for an eventual exit permits a coordinated structure to be shaped and formed with an eye directed toward minimizing taxation, acquisition default risks, managerial transitional disruptions, and key employee flight.

Time

The key fundamental element is time. Does sufficient time exist to accomplish the stated goals or objectives of the owner given the business's profitability and prospects? What may be known and anticipated is profitability; what is unknown and uncertain is the amount of time the owner has left to accomplish and direct it.

Profitable businesses may be worth only a few cents on the valuation dollar after the owner's death, disability, or incapacity because the person who knew how to multiply or leverage the business's assets and motivate personnel is gone or unavailable. Often the successor is unprepared, inexperienced, or lacks the ability, available funds, or knowledge to maintain, maximize, and market the business until a suitable buyer can be found.

Succession plans can be established to blunt or minimize the adverse effects of such events; however, it must be done while the foremost expert on running that particular business can provide the direction and guidance in creating the strategies most likely to succeed in those scenarios.

In other words, the business owner must invest the time and expense to contemplate, create, and fund such plans; however, the eventual return will be many times more than that invested and most often at a time of turmoil for the owner or business.

Operating cash flow

Many operating agreements and corporate governance documents for small to medium sized businesses include generic, boilerplate language indicating that the adversely affected owner's stock or interest will be acquired with a promissory note of varying lengths. Although the succession planning has been done and a document addressing contingent event transfers has been adopted, without a funding mechanism to provide the capital necessary at such a critical time, the likelihood that the operating cash flow from the business will be sufficient to meet both the business's need and the increased debt service for the acquired interest is unlikely. Often the business will default on the obligation out of necessity during an economic downturn, and the owner's surviving spouse or family will lack the funds or the emotional strength (most likely both) to enforce the note; or, if successfully enforced, the obtained judgment may be pointless since the business likely will have defaulted due to poor economic performance in the first place, making any recovery remote.

> Having contingencies in place to address the loss of key personnel is a necessary component for a well-run business.

Another, equally distasteful, remedy may be the reacquisition or foreclosure upon the formerly held business interest, which often is found to be an empty and gutted corporate shell with limited or no remaining assets, value, or prospects.

In contrast, effective succession plans are nurtured and funded based upon realistic knowledge of the business and the forces that act upon it during an entire economic cycle. If some tragedy befalls the owner, funds and binding agreements are established and in place to address the development and respond to it. Conversely, if all goes smoothly during the owner's tenure, the business has available assets that may be paid out as a down payment, used as collateral for loans at a discounted secured rate, or used to structure a secured and protected buyout of the owner at a time of his or her choosing.

Conclusion

Successful companies do not run themselves without at least one or more owners or key personnel who can exercise great business judgment in making day-to-day decisions on actions to take, those to avoid, strategies to implement, and the best way to decompress volatile situations. Having contingencies in place to address the loss of such people — temporarily or permanently — as well as the operation of the business during or after their departure is a necessary component for a well-run, long-term business.

Discussing your future plans and thoughts on succession with a trusted advisor familiar with business succession planning is an essential first step in implementing and eventually funding such a plan, because planning to work forever is rarely a viable option.

David R. Toups, JD, MBA, CFA®, CFP®, CTFA, joined The Nautilus Group in 2016 after more than 14 years in the private practice of law focused in estate, trust, guardianship, and business planning and litigation. Prior to practicing law, he managed money professionally as an investment portfolio manager for several national corporate fiduciaries. He earned his BBA in marketing from Texas A&M; his MBA, with a finance emphasis, from Sam Houston State; and his JD, with honors, from South Texas College of Law. David is a former U.S. Marine Corps artillery and infantry officer.