Insight on **estate planning**

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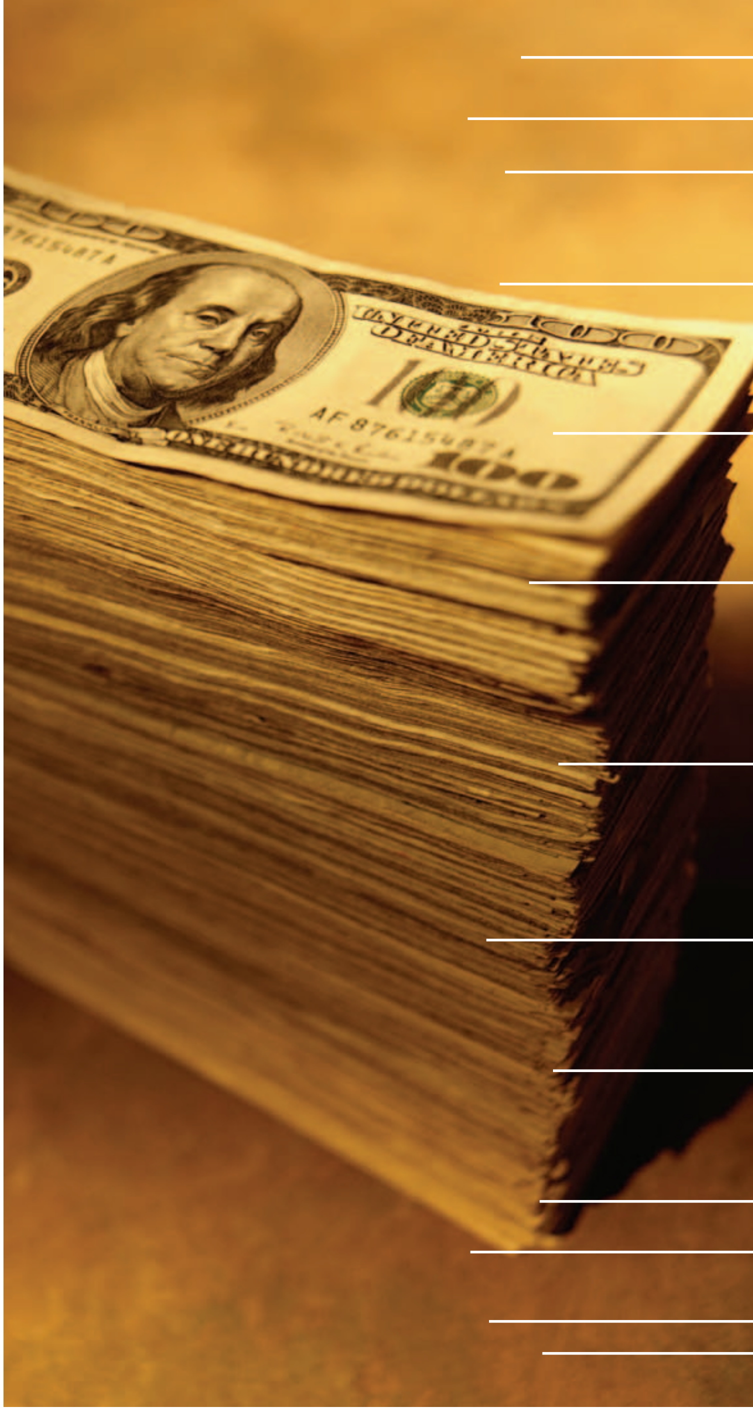

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Keeping up with the GST tax exemption

PLUS!
How to choose a trustee

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Are intrafamily loans hazardous to your financial health?

Lending money to loved ones may seem like a natural way to help out less fortunate family members. But intrafamily loans can cause some unpleasant tax surprises in the form of unexpected taxable income, gift tax or both.

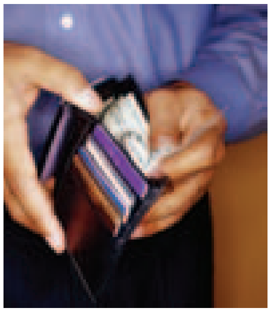
Loans can trigger income/gift taxes

If you lend money to family members at below-market interest rates, you're in particularly dangerous territory. If the loan is for more than $10,000, you may have to report taxable interest income at market rates, even though the borrower can't deduct the additional interest expense. The interest income will be "imputed" by the IRS.

Intrafamily loans — as well as any forgone interest or debt forgiveness in connection with such loans — may also trigger gift tax. And for federal tax purposes, forgone interest expense, the value of a loan guarantee and forgiven debt may be considered taxable income to the recipient.

How to avoid tax pitfalls

If you make intrafamily loans, you can avoid or minimize negative tax consequences by following these tips:



Charge interest. Under complicated rules that require the imputing of interest on below-market-rate loans, forgone interest will be treated as income to you and as a gift to the borrower. To avoid this result, charge at least the applicable federal interest rate — currently around 5% on long-term loans — on loans exceeding $10,000 to friends or relatives.

Beware loan guarantees

If you think you can skirt the rules by guaranteeing a loan rather than lending the money directly, think again. In the eyes of the IRS, loan guarantees are actually a transfer of economic value. In other words, a loan guarantee can be a gift subject to gift tax with its exact value determined case by case.

Make your intentions clear. Be sure to have the borrower make at least a few payments, even if you may forgive some or all of the payments in the future. By having at least some repayment history, you'll make it harder for the IRS to argue that the loan was really an outright gift. And if you think a would-be borrower would be unwilling or unable to repay a loan, don't make it. If you're audited, the IRS will probably treat such a loan as a gift.

Put it in writing. If you lend money to family or friends, create a solid paper trail. An informal loan may have unpleasant consequences if the lender dies. Suppose you lend $100,000 to your son, but you die before he repays the loan. Your daughter may be unhappy if that $100,000 is not deducted from your son's share of your estate. You can make your intentions clear — and help avoid misunderstandings — by documenting the loan and payments received.

Of course, other important advantages flow from good loan documentation. If you should later need to write off an intrafamily loan as a bad debt, you'll need to show that the loan was bona fide. In deciding whether a debt is bona fide, courts consider written evidence of the debt, interest charged, fixed repayment schedules, collateral, demands for repayment, the borrower's solvency at the time of the loan and payments made.

Make the most of the annual gift tax exclusion. Say you want to help your daughter and son-in-law buy a house, but you don't want to use any of your lifetime gift and estate tax exemptions. Consider making a loan and then forgiving some or all of the interest, principal or both. Under the annual gift tax exclusion, you can forgive up to $11,000 per year per person ($22,000 if your spouse joins in the gift) without paying gift taxes or using any of your $1 million lifetime gift tax exemption. But you'll still have interest income in the year of forgiveness.

Take action. If the borrower defaults, you need to move quickly to demonstrate that this was a legitimate loan gone bad. If you don't take appropriate legal steps toward collection, the IRS may argue that it was really a disguised gift. If you know you'll never collect and can't bring yourself to file suit, begin forgiving the loan using the $11,000 annual gift tax exclusion, if possible.

Develop a strategy

Before you make an intrafamily loan, understand the rules and develop a lending strategy that fits your particular circumstances. The best loan structure will depend on your financial situation and the amount. For example, on a loan of up to $100,000, imputed interest income is limited to the amount of the borrower's net investment income for the year, and nothing needs to be reported if that amount is less than $1,000.

By evaluating the income and gift tax consequences of intrafamily loans, you can provide the financial support your family needs at the lowest possible tax cost.

Protect your business with a buy-sell agreement

If you own a company, you know that business affairs and family affairs are closely intertwined. The company is likely the principal source of your wealth, so your family's financial future depends on its success. One of the most important factors in a business's long-term survival is a smooth transition from one generation to the next. A buy-sell agreement can facilitate this transition.

What is it?

A buy-sell agreement is a contract that provides for the disposition of your business interests when you die, become disabled, or leave the company for some other reason. By permitting or requiring the company or other shareholders to acquire your interest, a buy-sell agreement creates a market for your ownership shares, which thereby reduces or eliminates the estate liquidity problems that a block of closely held stock may cause your heirs at death. In addition, a buy-sell agreement may assist in resolving disputes among shareholders. Often, companies use life insurance on each shareholder to fund the agreement so that a deceased shareholder's family can receive faster payouts.

Factors such as the structure of your business and the degree to which you and others remain involved in it will dictate the buy-sell agreement's terms. But perhaps the two most important elements of any buy-sell agreement are the triggering events (what will cause your business interests to become available for sale) and how your company will be valued.

Triggering events may include 1) divorce, disability, retirement or death; 2) employment termination of a minority owner; or 3) bankruptcy or loss of a professional license. Ultimately, because buy-sell agreements plan for future uncertainties, yours needs to be flexible in the triggering events it names and how it interprets them.

What's the business worth?

It's critical for a buy-sell agreement to establish reliable procedures for determining the value of your business interest. Most agreements set the price in one of these ways:

Independent appraisal. Owners often use fair market value to set the purchase price, typically selecting one or more outside professional valuators to determine this value. If you choose this method, address how you'll select the valuator or valuators. If you're using more than one and they disagree, how will you reconcile the difference?

Valuation formula. Some buy-sell agreements include an objective valuation formula, such as a multiple of earnings, sales or book value. Although valuation formulas are straightforward and easy to apply, they fail to reflect the many subjective factors involved in arriving at a value — such as upcoming new products or services, or the power of your good reputation.

Agreement by shareholders. Another effective approach is for you and the other shareholders to meet periodically to review the company's value and update the buy-sell agreement accordingly. You can use either a formula or outside appraisal to determine the price.

How costly are valuation errors?

Designing a buy-sell agreement that accounts for every factor that affects your company's value is next to impossible. But if the IRS determines that an estate tax return improperly reflects business value, your heirs may pay the price.

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Suppose, for example, that your estate tax return reports your company's value as \$10 million. If the IRS later finds that your business was actually worth \$15 million at your death, your estate will face the tax burden on the \$5 million difference. At the 2004 top estate tax rate, 48%, your heirs would face \$2.4 million in additional tax liability. They might get hit with interest and penalties, too.

The IRS is suspicious of buy-sell agreements it believes are devices to pass your shares to family members for less than adequate and full consideration. Regardless of the valuation method, you can't use a buy-sell agreement to intentionally lower the value of your business interests to reduce estate taxes. So, as a last step of due diligence, make sure your buy-sell agreement is safe from IRS scrutiny before implementing it — particularly if a related party is a potential buyer.

Buy-sell provides many benefits

A buy-sell agreement helps sustain your business as it changes hands from one generation to the next. It can also provide other benefits, such as improving company morale by reassuring employees of your company's stability. And, perhaps most important, it protects your heirs from a potentially devastating future estate tax bill. As discussed above, thorough planning and solid valuation provisions are keys to achieving these objectives.

How to choose a trustee

Most estate plans today are centered around trusts, for a variety of tax and planning reasons. But a trust can achieve its objectives only with a competent trustee or trustees to oversee and administer the trust for the beneficiaries' best interests. Let's look at how you can find a reliable trustee.

Grantor as trustee?

If you've established a revocable trust, you can serve as trustee if you have the requisite skills and comfort level. You can always consult lawyers, accountants and financial advisors for advice. But if you don't feel up to the task, name a third-party trustee. Keep in mind that in the case of an irrevocable trust, a third-party trustee is usually required.

Individual or institution?

If a third-party trustee is necessary or desirable, you need to decide whether to appoint a person, an institution or both. Institutional trustees, such as bank trust departments or trust companies, offer several advantages. They specialize in managing estates and trusts and are generally free of conflicts of interest. They also have direct access to investment advisors, tax planners and other financial experts. Most institutional trustees charge fees based on a percentage of the trust's assets, so find out the fee schedule up front.

Individual trustees also have their advantages. A reliable person might be willing to manage a trust that's too small for an institution, charge lower administrative fees and be more sensitive to the beneficiaries' needs.

Be selective

Whether you choose an individual or institutional trustee, it's important to appoint highly competent people who possess sound judgment. Often a grantor will appoint as trustee a relative who is an attorney, accountant or stockbroker. But just because they are professionals doesn't mean they have the necessary estate or tax planning expertise or the patience to deal with beneficiaries who have special needs. If you foresee that conflicts over money might cause discord among family members, appoint a dispassionate third party rather than a relative.

Consider two trustees

In some cases, you can have the best of both worlds by appointing an individual and an institution as co-trustees. The institution offers the experience and skills needed to competently manage the trust assets, while the individual is someone you can trust to act in your family's best interests. Each plays an appropriate role and acts as a check against any conflicts of interest the other may have.

Above all, you need to feel confident that the trustees you select will support your overall estate planning goals — now and in the future.

Keeping up with the GST tax exemption

The federal tax on generation-skipping transfers (GSTs) is one of the harshest in the tax code. Transfers to a "skip person" — such as a grandchild or other person more than one generation below you — are subject to a flat tax at the highest marginal estate tax rate (48% in 2004). Fortunately, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) made it easier to avoid, or at least minimize, the GST tax. Even though EGTRRA is a few years old now, it's important to revisit its provisions periodically in light of your changing estate planning needs.

Plan to make the most of exemptions

Under EGTRRA, the estate tax rate — and, consequently, the GST tax rate — are gradually declining, and both taxes will vanish in 2010. Absent additional legislation, the estate and GST taxes will reappear in 2011 at their 2001 levels. The act also boosted the GST tax exemption to $1.5 million for 2004 and 2005, matching the estate tax exemption. Both exemptions jump to $2 million in 2006 and then to $3.5 million in 2009.

EGTRRA also provided for automatic allocation of the GST tax exemption and other relief to help you make the most of the exemption. (These changes generally apply to transfers made after Dec. 31, 2000.) You'll need to plan carefully, though, to use the GST tax exemption effectively and to ensure that the automatic allocation rules don't work against you.

Avoid automatic allocation traps

EGTRRA's automatic allocation rules are designed to help taxpayers avoid unintended tax consequences if they fail to allocate their GST tax exemptions. Before EGTRRA, the exemption was automatically allocated to direct skips, which are outright gifts to a grandchild or other skip person. Now, for transfers made after Dec. 31, 2000, a similar rule applies to lifetime transfers that are indirect skips — taxable transfers of property to a "GST trust." Although the statutory definition of a GST trust is complex, the term generally refers to an irrevocable trust intended to hold property beyond your child's generation.

Automatic allocation for indirect skips, like the existing rule for direct skips, is based on the assumption that a taxpayer would want to allocate the GST tax exemption to potential indirect skips.

In most cases, that assumption is accurate, but there are times when this won't be beneficial. For example, you may create a trust to benefit your children, with your grandchildren as contingent beneficiaries. If the trust is considered a GST trust, it will trigger the automatic allocation rules, but if your grandchildren are unlikely to benefit, you will waste your exemption. To avoid this result, EGTRRA establishes a procedure for opting out of automatic allocation.

Consider two trusts

You may find that your estate plan includes "blended" trusts — trusts that are only partially exempt from the GST tax. This can

Retroactive and late allocation rules also help you avoid unintended results

It's impossible to plan for every contingency, but the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) helps you ease the tax impact when something unexpected happens, such as an unnatural death order. Suppose, for example, that you establish a trust for the benefit of your child, with your grandchildren as contingent beneficiaries. You don't allocate any of your GST tax exemption to the trust because, if the trust works as intended, your grandchildren won't receive any of the assets and you won't waste your GST tax exemption. In the event that your child dies prematurely, EGTRRA allows you to avoid unexpected GST taxes by retroactively allocating the GST tax exemption to the trust.

Keep in mind, however, that this is a retroactive allocation rule — not a late allocation rule — so the assets are valued at the date of the gift. The provision applies to deaths of nonskip persons after Dec. 31, 2000.

Prior to EGTRRA, no statutory provision allowed you to correct an inadvertent failure to allocate your GST tax exemption on a timely filed gift tax return. Late allocation could be costly because you'd have to use the assets' value on the allocation date rather than on the transfer date. If the assets had appreciated in value, you'd have to use more of your exemption than you would have if you had made the allocation earlier.

EGTRRA allows you to request an extension to make an allocation of the GST tax exemption to a lifetime or at-death transfer. The new rule applies to requests for relief pending on or filed after Dec. 31, 2000. The Treasury is also directed to publish procedures for requesting comparable relief with respect to transfers made before EGTRRA's enactment. In determining whether to grant relief, the Treasury considers all relevant circumstances, including the evidence of intent contained in the trust instrument or other transfer instrument as well as other factors deemed relevant.

happen if the GST tax exemption isn't allocated to all the trust assets.

In most cases, it's preferable to have two trusts — one that's completely exempt from the GST tax and one that's completely subject to it. This allows you to more effectively make income and principal distributions to different generations. For example, distributing blended-trust assets to grandchildren would trigger the GST tax. But, if you have two trusts, the GST-tax-exempt trust may make distributions to grandchildren without incurring the GST tax. The different trusts can also pursue different investment strategies.

EGTRRA allows you to divide a blended trust into two trusts, something that wasn't possible before. You can divide a single trust and create (through trust provisions or under applicable state law) two or more separate trusts for GST tax purposes. But you must meet two requirements. First, the single trust must be divided on a fractional basis, not by asset allocation. Second, the new trusts' terms must, in the aggregate, provide for the same succession of beneficiaries' interests as provided in the original trust instrument.

Review your GST tax situation

EGTRRA's changes generally benefit taxpayers, but you need to examine your potential GST tax liability to take advantage of the changes and avoid unintended consequences.

The gift tax exemption ($1 million) allows you to fund long-term GST trusts more rapidly without incurring gift tax. The GST tax relief provisions help you avoid certain inadvertent impositions of the GST tax. (But, as discussed above, they can also cause unintended tax consequences.) Also, the ability to sever a blended trust is a valuable tool that may reduce any eventual GST tax.

If your estate plan involves multiple generations, review your plan and take steps to maximize your available GST tax exemption and minimize any estate, gift or GST tax.

Weinstock, Manion, Reisman, Shore & Neumann

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Comprehensive Estate Planning Services

Founded in 1960, Weinstock, Manion, Reisman, Shore & Neumann offers estate planning, probate and trust administration, general business and corporate law, taxation, real estate and litigation services. Because 10 of our 13 attorneys are actively involved in estate planning, we specialize in helping clients meet objectives like these:

- Dispose of assets in a tax-efficient manner by using revocable living trusts.
- Minimize estate taxes by using sophisticated lifetime giving techniques, such as Grantor Retained Interest Trusts and Charitable Remainder Trusts.
- Provide liquidity and save estate taxes by using life insurance and irrevocable life insurance trusts.
- Efficiently administer probate and trust estates.
- Transfer business interests to younger family members in a tax-efficient manner.
- Minimize generation-skipping transfer tax on transfers to grandchildren and great-grandchildren.
- Implement deferred compensation and qualified retirement plans, including pension and profit sharing plans.
- Reduce income and estate taxes on the receipt of benefits from retirement plans.
- Avoid court intervention if disability strikes.
- Maximize employee productivity through the use of stock options and other incentive programs.
- Dispose of business interests among co-owners.
- Save on income taxes, both now and in the future.
- Select and form business entities, such as corporations, limited liability companies and family limited partnerships.

The professionals at Weinstock, Manion Reisman, Shore and Neumann bring over 150 years of combined experience to the services we provide. The stability of our firm enables our lawyers to work closely together with business specialists to give clients outstanding individualized attention.

Many of our lawyers are instructors at UCLA Extension and highly sought after as speakers for professional organizations in the community. Because we are at the forefront of current developments in law, we excel in designing strategies which help clients balance their business and financial interests with their personal and professional objectives in order to preserve and transfer their wealth.

We welcome the opportunity to discuss your needs and help you meet your estate planning and wealth transfer objectives.

Please call us at 310-553-8844 to let us know how we can be of assistance.