Insight on **estate planning**

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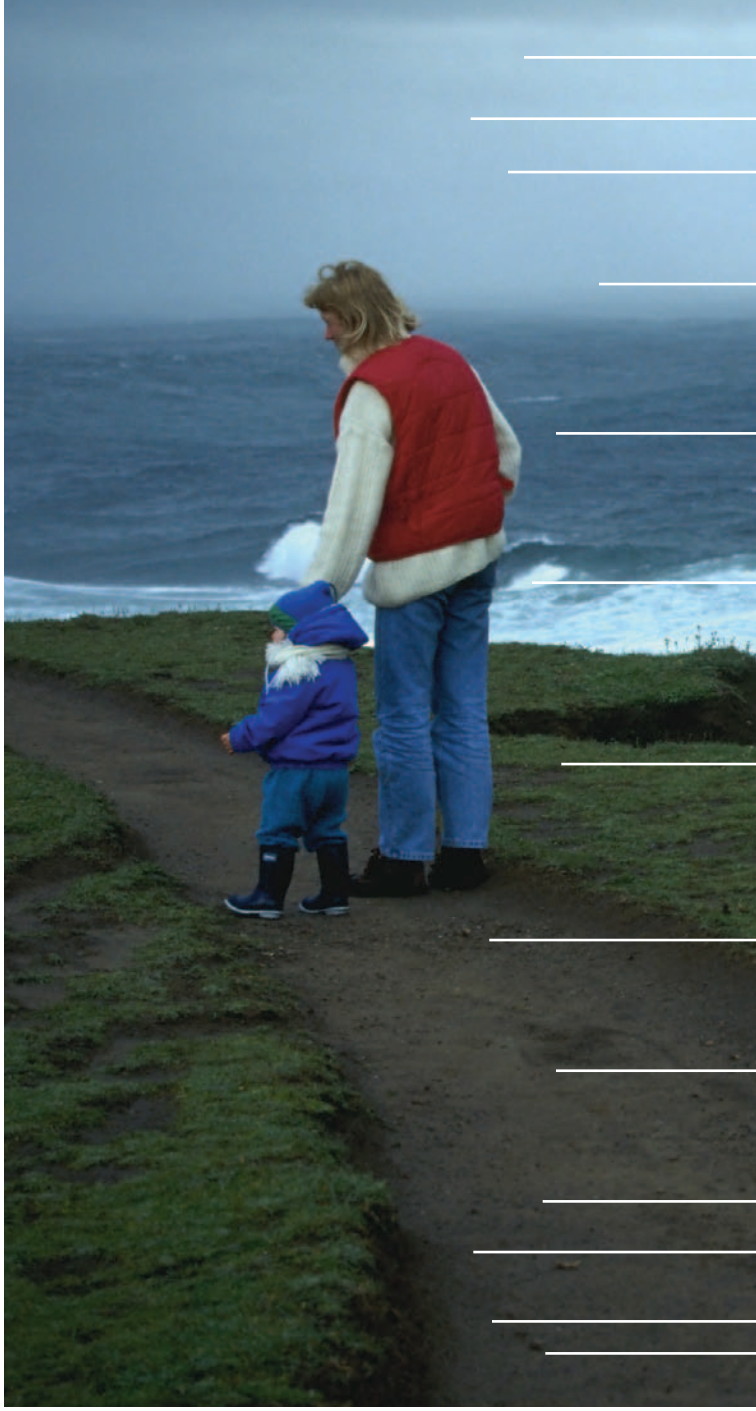

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Plus!

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Is a conservation easement right for your parcel of land?

Suppose you have a parcel of land you'd like your heirs to enjoy after your death. If you're worried that your family might be forced to sell the property to pay the associated estate tax, consider a conservation easement.

When doing so, first determine whether you qualify and then decide if you're willing to be bound by the restrictions.

Limiting use, reducing value

A conservation easement, in essence, is a restriction placed on a piece of property that limits its use and, in so doing, reduces the land's value. For a piece of land to be subject to a qualified conservation easement, as defined in Internal Revenue Code (IRC) Section 2031, the property must be located in the United States and have been owned either by you or a member of your family for at least three years before your death. In addition, you must file a proper election with your estate tax return.

A conservation easement, in essence, is a restriction placed on a piece of property that limits its use and, in so doing, reduces the land's value.

You must grant the easement to a qualified organization and exclusively for conservation purposes.

The IRC's definition of "conservation purpose" is somewhat broad, but there is specific language with regard to farmland and forestland that allows such property to qualify if the easement is for the preservation of open space for the general public's scenic enjoyment.

Calculating the exclusion

The amount of the exclusion is based on a formula that takes into account the percentage by which the conservation easement reduces the value of the property. The value of the easement is determined by calculating the difference between the value of the property with and without the easement.

If the value of the easement is at least 30% of the pre-easement property value, then 40% of the easement amount can avoid estate tax under the conservation easement exclusion. This amount, though, is subject to a cap, which for 2005 and beyond is $500,000.

If, however, the value of the conservation easement is less than 30% of the pre-easement property value, the exclusion will be reduced by 2% for each 1% or portion thereof that the conservation easement is below the 30% value threshold. This reduced amount is subject to the same $500,000 cap.

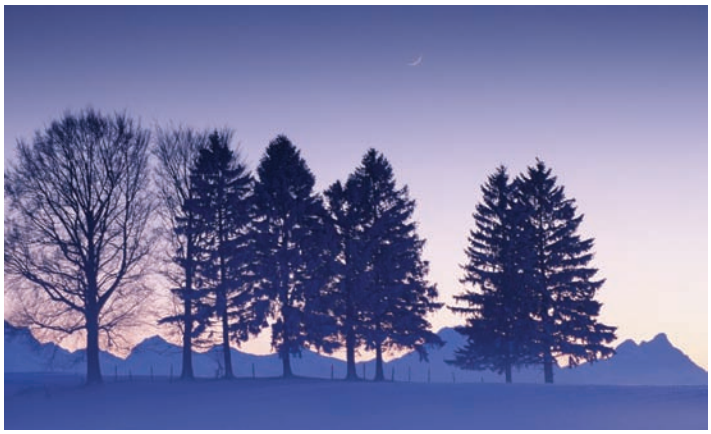
Also, the rules prohibit a step-up in basis for the portion of the property that has been reduced by the conservation easement exclusion.

Easement in action

Let's say Tina has a farm that has been in her family for generations. It's valued at approximately $3 million, and Tina's only other asset is $500,000 in cash and marketable securities, making her total estate worth $3.5 million. She hasn't made any prior taxable gifts, so her entire lifetime exemption amount is available. For 2005,

the amount is $1.5 million, and is increasing in 2006 to $2 million.

After obtaining a qualified appraisal, Tina's property, subject to the easement, is valued at just $1.75 million. To calculate the easement exclusion amount, Tina first determines whether the easement value is at least 30% of the property's value. The $1.25 million difference in the property value with and without the easement is more than a 41% reduction of the pre-easement value of the property, so there is no phaseout of the allowable amount.



So Tina is allowed an exclusion of 40% of the value of the easement, or $500,000. This leaves her, if she dies in 2005, with a taxable estate of $3 million — of the $3 million estate, half will be sheltered by the $1.5 million estate tax exemption. The federal estate tax on the $1.5 million excess will be $705,000. The $500,000 of cash that Tina has would be insufficient to pay the estate tax that will be due at her death.

If she were to die in 2006, however, the cash would be sufficient to pay the estate tax liability. Why? Because in 2006, the estate tax exemption increases to $2 million and the top marginal estate tax rate decreases to 46%. Thus, the estate tax due at Tina's death would be $460,000. Note that, if the difference in the property's pre- and posteasement value exceeded the $1.25 million figure, there would be no additional estate tax benefit because the exclusion amount would have been limited to the $500,000 maximum.

A win-win situation

The conservation easement exclusion may be worthwhile for you. You may find it to be the best way for you to keep your property in the family and reduce your estate tax burden at the same time.

Planning with your retirement account money

After years of hard work, you've managed to accumulate a large balance in your retirement plan accounts. Now you're concerned about how to best plan for the disposition of the assets, both during your life and after your death. The good news is that you have options available to you with respect to your IRA, 401(k) and other retirement funds.

Distributions

Starting at age 59½, and even sooner in certain circumstances, you may withdraw funds from your retirement plans without being subject to the penalty for early distributions. Once you reach age 70½, you're required to start taking annual distributions from your traditional IRA and employer-sponsored "qualified" plans such as 401(k)s. You aren't, however, required to take distributions from your Roth IRA.

In limited circumstances, you won't be required to withdraw funds from your 401(k) account. If you continue to work after age 70½, and you own less than 5% of your company, you aren't required to

take any distributions until after you retire. And, you're still eligible to contribute to your 401(k) for as long as you continue to meet this exception.

This can be a tremendous benefit; you may be able to accumulate significant additional funds tax-deferred. The more you accumulate, the more opportunities you'll have for planning with the funds. And, the Roth 401(k) debuts in 2006. As with the Roth IRA, there is no deduction for contributions to the Roth 401(k) but neither are there any distribution requirements.

Planning concerns

You have a few options for the funds in your retirement accounts:

Spend now. Generally, this is the least palatable option because you lose the benefit of tax-deferred growth on whatever you withdraw, paying tax sooner than necessary. Depending on your circumstances, though, it might actually be better for you to take a larger distribution and draw down your qualified plan balance. If, for instance, you're in a low marginal income tax bracket and can pull out your money at a lower tax rate, you might prefer to do so now rather than waiting until you're in a higher tax bracket. But again, if you do so you're forgoing your ability to defer tax on the funds.

Take only the minimum. If you don't have a need for the funds, this is the typical course of action. After all, the longer you can defer distribution, the more you'll have in your account. Plus, you won't have to pay any more tax than necessary. The issue is then what to do with the funds that remain at your death.

Postdeath. Any funds remaining in your traditional IRA and other retirement plans will be includible in your taxable estate and will be subject to estate taxes if your estate exceeds the estate tax exemption. But if your surviving U.S. citizen spouse receives the funds, the transfer will qualify for the unlimited marital estate tax deduction and, thus, only what remains at your spouse's death could be subject to estate tax. But estate tax isn't the only concern. When the funds are distributed, they are subject to income tax — regardless of beneficiary.

The combined estate and income tax rate can be rather high, especially if the beneficiary immediately withdraws the funds. With the highest marginal income tax rate at 35% and the highest marginal estate tax rate at 47% for 2005 (46% for 2006), and after considering the income tax deduction available for estate tax paid, the funds are potentially subject to a tax rate of 65% or more.

Designate a charity as beneficiary

Another popular use for qualified plan money, particularly in light of the potentially burdensome combined estate and income tax rate, is charitable bequests. Let's say, for instance, that you wish to make a substantial gift at your death to your favorite charity. All you need to do is change your IRA's beneficiary designation. Plus, it's just as simple to make a change if you decide to allocate a different amount to your charity.

If you're concerned that the charity might get a bigger percentage of your estate than you want, you may be able to put other restrictions on the beneficiary designation form, such as limiting the dollar amount that goes to the charity.

If, however, your beneficiary can defer distributions, the effect of the income tax bite is dramatically reduced. And, rather than allowing the funds to be treated as a "throwaway" asset subject to an oppressive tax rate, you may actually be helping your beneficiary to build his or her own retirement nest egg, especially if your beneficiary is young — such as a grandchild or great-grandchild.

You may even wish to discuss with your heirs their needs. You might decide to allocate all of your IRA to your child who doesn't have an immediate need for funds, for instance, and other assets to another child who has an immediate need. That way the bulk of the assets can continue to grow tax-deferred.

If you've started taking your required minimum distributions, your beneficiary will be required to continue to take distributions on the schedule you've been using. If you've not taken any distributions because you haven't reached your required beginning date, your beneficiary will be able to take distributions during his or her life expectancy. If you have a Roth IRA (and beginning in 2006, a Roth 401(k)), distributions will be based on your beneficiary's life expectancy. The Roth distributions are income-tax free.

Regardless, it's vital that your wishes be clear with respect to your beneficiary designations — naming your estate as beneficiary can be disastrous because it could force your heirs to distribute the funds more quickly than they'd prefer.

You also are permitted to name a trust as beneficiary. But before doing so, be sure to consult an expert because there are numerous rules to which you must adhere, and, thus, there are multiple traps into which you could fall.

Consider your options

The bottom line is that you have many choices with respect to your IRA and other retirement plan money. Knowing your options can help you find the best solution for your estate plan.

HEET shield

Hot new trust can insulate your estate against GST tax

Health and education exclusion trusts (HEETs) are becoming an indispensable estate planning tool for affluent families. By taking advantage of the exclusion for direct payments of medical and education expenses, a HEET enables you to provide valuable benefits for your grandchildren and future generations at a minimal tax cost.

For a HEET to work it must have a significant charitable beneficiary. But if philanthropy is one of your estate planning goals, you can use a HEET to shield large amounts of wealth against generation-skipping transfer (GST) taxes without burning up any of your GST tax exemption.

HEET elements

A HEET is a dynasty trust that allows you to transfer assets for the benefit of your children, grandchildren and future generations. Contributions to the trust are taxable gifts, but you can avoid gift tax by taking advantage of your annual gift tax exclusion (currently $11,000 per recipient or $22,000 per recipient for split gifts by married couples) or $1 million lifetime gift tax exemption.

Unlike a traditional dynasty trust, a properly drafted and administered HEET escapes GST tax without using up any of your GST tax exemption.

Unlike a traditional dynasty trust, a properly drafted and administered HEET escapes GST tax without using up any of your GST tax exemption. That's where the charitable beneficiary comes into play. By granting a "significant" interest in the trust (usually 10% or more) to a charity, you prevent a taxable termination by ensuring that the trust always has at least one non-skip beneficiary. The threshold for a significant interest may vary depending on which state law governs the trust. Be sure you meet the requirements of your state's law or you may risk losing the HEET's benefits. The charitable beneficiary also can be a charitable trust or family foundation.

Distributions on behalf of your descendants are tax free, provided the funds are used to pay for qualified educational and medical expenses. A HEET can be used to pay for tuition — but not for books, supplies, or room and board — at qualifying educational institutions at every level (from nursery school to college and graduate school). It also can be used to pay for most unreimbursed medical expenses (other than elective cosmetic surgery), including health insurance premiums, long-term care expenses and medical-related travel expenses.

Bear in mind that, to avoid taxes, the HEET must pay the educational institution or health care provider directly. The funds cannot be used to reimburse beneficiaries for these expenses.

Applying HEET

HEETs provide several estate planning benefits. Besides the aforementioned protection from GST tax, a HEET can help mitigate the skyrocketing costs of education and health care by providing your descendants with significant tax-free benefits.

A HEET also can be a critical component of a lifetime giving plan, especially if your plan includes grantor retained annuity trusts (GRATs). A GRAT is an irrevocable trust that pays you an annuity for a specified term and then transfers the remaining assets to your children or other beneficiaries.

When you establish a GRAT, you're subject to gift tax on the present value of the beneficiaries' remainder interest in the trust's assets, calculated using an IRS-published interest rate — the Section 7520 rate. By adjusting the annuity amount, you can minimize or even eliminate the gift tax. And if the trust assets outperform the Sec. 7520 rate, any appreciation beyond the IRS's assumed rate of return passes to your beneficiaries tax-free.

A GRAT can be an effective tool for making tax-free gifts, but it has a big disadvantage if you want to use it to benefit your grandchildren or other skip persons. With other types of trusts, you can allocate enough of your GST tax exemption to cover your initial contribution, and any future appreciation in value is shielded from GST tax. But with a GRAT, you can't determine your GST tax exposure until the end of the annuity term, and by that time the assets may have grown beyond your unused GST tax exemption, triggering GST tax.

One solution to this problem is to provide for the GRAT assets to be transferred to a HEET at the end of the annuity term.

Alternatively, the assets could be transferred to a specially designed dynasty trust that gives the trustee the ability to split the trust into two subtrusts — one funded with the amount of your unused GST tax exemption and the other set up as a HEET. Either way, the GRAT assets are shielded against both estate and GST taxes.

Don't get burned

A HEET can be a powerful estate planning tool, particularly if you're charitably inclined and have already exhausted your GST tax exemption or expect to do so. But to work properly, a HEET must be carefully prepared and executed.

Improve your well-being with an HSA

Health Savings Accounts (HSAs) allow tax-deductible contributions to a savings account you can use to pay current and future medical expenses. The earnings in the account grow tax-deferred — tax-free if you use them to pay qualified medical expenses.

To be eligible for an HSA, you:

- Must be covered by a "high deductible health plan," and,
- Must not also be covered by a plan that isn't a high deductible health plan or by a plan that provides coverage for any benefit that is covered under the high deductible health plan.

A high deductible health plan has a minimum deductible of $1,000 for individual coverage and $2,000 for family coverage. Further, for 2005, the plan maximum out-of-pocket amount cannot exceed $5,100 for individuals and $10,200 for families.

No matter how much you earn, you're permitted to deduct your contributions. Your contributions, however, are limited to the lesser of your annual deductible or a statutory maximum — in 2005 the maximum contribution for individual coverage is $2,650 and $5,250 for family coverage.

Individuals age 55 or older can make a catch-up contribution — the 2005 amount is $600. The annual contribution limits are indexed for inflation, while the catch-up amount is scheduled to increase in $100 increments through 2009.

Qualified medical costs include expenses that would otherwise be permitted as a medical expenses deduction on your income tax return. But any amounts paid from HSA funds may not be deducted. Any withdrawals you use for nonmedical expenses are treated as taxable income. Such withdrawals made before age 65 also are subject to a 10% penalty.

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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 12 of our 14 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.