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Introduction

This chapter provides an introduction to the concepts underlying estate practice in the United States. It provides definitions of key terms and describes what will be covered in the following chapters.

Definitions

Estate Planning

Q 1.1 What is legal and tax planning for private clients?

By "private clients," we are referring to individuals, rather than corporations, partnerships, limited liability companies or other entities. Legal and tax planning for private clients (which is often referred to as "estate planning") means planning for the present and future management of the individual's assets and personal affairs, both during that individual's lifetime, during any period of incapacity he or she may suffer, after the individual's death and, frequently, for many generations thereafter. Estate planning addresses the following issues for individuals:

- How can I manage my assets effectively and reduce income and other taxes payable on them?
- How will my assets be managed if I become incapacitated or if I need assistance from others to make investment, payment, and other decisions?
- How can I be sure that my spouse and family are properly cared for in the event of my incapacity?

- How can I protect assets from unwarranted and unreasonable claims of creditors, claims in divorce or other threats?
- How can I ensure that proper medical decisions are made for me if I am unable to make them?
- How can I transmit the ownership of my property to my family in a manner that is tax effective and that also protects them from financial threats?
- How can I provide for charity both during my life and after my death in a manner that will benefit the causes I favor and also taxes payable by my family members?
- How can I provide for the benefit, protection, and financial welfare of my current and future family members and current and future charitable organizations for years and generations after my death, taking into account the many contingencies that may arise?

Estate planning addresses these and a host of similar questions.

Assets

Q 1.2 What are assets?

A major goal of estate planning is to provide for the present and future disposition of an individual's "assets." By this term we mean all rights to property that the individual possesses. This includes:

- Financial assets such as stocks, bonds, brokerage and bank accounts.
- Interests in partnerships, corporations, limited liability companies and other entities.
- Interests in real property.
- Tangible personal property, such as furniture, jewelry, cars and boats, artwork, and pots and pans.
- Employment and retirement benefits such as pensions, deferred compensation, IRA and 401(k) accounts.

- Life insurance, both the cash value of a policy and the proceeds payable upon death of the insured.

It also includes patents, trademarks, and copyright. It includes all assets worldwide, not only those that are located in the United States. It includes assets that are held jointly, as tenants in common, as tenants by the entirety, as life tenant or remainderman, as beneficiary of a trust, as holder of a power of appointment over a trust, or any other way.

Transferring Assets

Q 1.3 How do individuals transfer assets?

There are many ways of transferring assets during one's lifetime and at death. During one's lifetime, cash and bank accounts can be transferred by checks or wire transfers. Stocks, bonds, and other securities are generally transferred by reregistering them in the name of the donee or recipient. Real estate is generally transferred by a deed, which must be notarized and which is filed with the county clerk of the county where the property is located and becomes a matter of public record. Retirement benefits and life insurance (and sometimes financial accounts as well) can be transferred effective on death by one or more beneficiaries on a written form that is on file with the insurance company or the plan administrator.

Assets that a decedent owns at death are disposed of by a will. The will must be prepared for the decedent and signed by him, generally in the presence of two witnesses, during his lifetime. It directs that all of his or her property passes effective at death. The will must be offered to a court for probate after the death of the person who signed it (the "testator") before the property may be passed to the intended recipient.

If a person dies without a will, his or her property passes pursuant to the laws of intestacy of the state. Such laws designate which close relatives will receive what proportion of the assets of a decedent. Contrary to widespread belief, assets do not go automatically to the state if there is no will. Nevertheless, a will is preferable to intestacy since it allows the testator to express his or her specific wishes rather than relying on the laws of the state.

Some people and entities may have claims against the property of the decedent's estate. Creditors of the decedent may generally pursue their claims against the estate. In addition, the taxing authorities can claim property of a decedent, and new taxes may arise as a result of the death ("estate taxes"). In addition, relatives sometimes have claims against the estate assets even if they are not mentioned in the will. Generally, the surviving spouse of a decedent has a claim against the estate and the decedent even if he or she does not receive benefits under a will.

The Role of a Trust in Estate Planning

Q 1.4 What is the trust and how does it figure in estate planning?

A trust is essentially a relationship between three parties: the "settlor" (or "grantor"), who creates the trust and gives assets to it; the "trustee" who is technically the legal owner of the assets and can administer them, by reinvesting or paying out funds, and the "beneficiary" who, although not the legal owner of the property, is entitled to benefit from the property. The rights and powers of the settlor, the trustee, and the beneficiary are set forth in a trust agreement, and also in the applicable laws governing the trust. The grantor generally has wide latitude in setting forth the terms and provisions of the trust agreement, but specific rules must be followed to ensure that the trust is valid under local law and also to assure that the desired tax treatment is achieved.

The trust is a great creation of Anglo-Saxon law that plays a central role in sophisticated estate planning. The settlor may provide in detail how property is to be managed and distributed, even though the settlor will no longer be the owner of the property, either because she has given it away for tax or other reasons, she is incapacitated or she is no longer living. The trust agreement sets forth the powers, duties, and restrictions of the trustee. Beneficiaries, who may receive distributions from the trust, are not the owners of the trust assets. Such trusts are generally created to achieve a variety of significant tax advantages or prevent availability of the trust assets to creditors, or because the beneficiary might spend or invest the funds unwisely.

Types of Trusts

Q 1.5 What are the different types of trusts?

Trusts can be divided into many different categories. Each one is different in terms of the tax treatment, the ability of creditors to reach trust assets, the degree of control exercised by the settlor, trustee, and beneficiaries over the assets, and the ability of the settlor and the beneficiaries to benefit from the trust. Among the different categories are:

- **Inter vivos versus testamentary:** An inter vivos trust is created by an agreement between the settlor and the beneficiary made during the settlor's lifetime. A testamentary trust is created by the testator's will and is only effective upon the testator's death.
- **Revocable versus irrevocable:** An inter vivos trust may be "revocable," meaning that the settlor may revoke or undo the trust and take back the trust assets; or it may be "irrevocable," meaning that the settlor gives up this power. All testamentary trusts are irrevocable.
- **Grantor versus non-grantor:** This is a tax concept. A grantor trust is considered to be owned by the settlor of the trust for income tax purposes, so that all income of the trust is taxed directly to the settlor even though the income remains in the trust or is paid to another beneficiary. If the trust is a non-grantor trust, the trust is taxed on the income, although distributions from the trust to beneficiaries may carry out income that is taxed to the beneficiaries instead.
- **U.S. trust versus foreign trust:** This is also a tax concept. A U.S. domestic trust is subject to U.S. income tax on its worldwide income (unless either the grantor or the beneficiary is taxed on that income). A foreign trust is subject to U.S. income tax only on its U.S. source income, although U.S. beneficiaries of a foreign trust may be taxed on distributions to them from the trust.

Transfer Taxes

Q 1.6 What are transfer taxes?

Transfer taxes is the term used for all taxes imposed by the government on the gratuitous transfer of property from one individual to another, either by gift or, in some cases, on the transfer of property via a trust after the death of the settlor of the trust. At present there are four different taxes imposed by the federal government on gratuitous transfers:

- Federal estate tax is imposed on the worldwide assets of every decedent. It is imposed at a current rate of 40% (after a threshold exemption).
- Gift tax is imposed on gratuitous lifetime transfers of any worldwide property. It is imposed at a rate of 40%, after the application of exclusions.
- Generation-skipping transfer tax is an additional tax, on top of the gift or estate tax, on transfers to grandchildren and more remote descendants. For an outright gift or bequest, it is imposed at the same time as the gift or estate tax. If a transfer to these younger beneficiaries is made by trust, the generation-skipping tax may be imposed years after the death of the settlor of the trust.
- Section 2801 of the Internal Revenue Code imposes a 40% tax on property that is received by a U.S. citizen or resident as a gratuitous transfer from a "covered expatriate." A covered expatriate is a former U.S. citizen or green card holder who gave up their citizenship or green card and meets certain other qualifications. Apart from this tax, recipients of gifts and bequests are not taxed by the United States. Instead, the donor or the estate of the decedent must pay the tax.
- The United States allows a "unified credit" against both gifts and bequests. For 2018, the amount of this credit is $11,180,000 per donor/decedent. Each U.S. person may make gifts in this amount during their lifetime. To the extent that it is not used

during his or her life, it is available to his or her estate at their death. There is an exemption in the same amount available against the generation-skipping transfer tax.

- In addition to these federal taxes, most estates have a state inheritance tax that is applicable to the assets of their residence and to real property located in that state. These state estate taxes are lower than the federal estate tax, and they may usually be claimed as a deduction against the federal estate tax. However, the exemptions for many states are lower than the $11,180,000 exemption available for federal purposes, so that estates that are too small to pay a federal estate tax may nonetheless have a state estate tax payable. One state (Connecticut) still has a state gift tax.

Techniques for Transfer Tax Reduction

Q 1.7 What are the most common techniques for reducing transfer taxes?

Most people do not wish to pay a 40% tax on their property at the time they give it away or leave it at their death. The following a brief overview of the many techniques to reduce these transfer taxes:

- **The marital deduction:** All property passing to a surviving spouse in qualified form is free of estate tax (though it is generally taxed on the death of the spouse).
- **The charitable deduction:** Assets passing to qualified charities, or to a foundation created for the benefit of charities, are not subject to U.S. estate tax.
- **Gifts:** Property that is gifted to another person or a qualifying trust will not be subject to estate tax at the death of the donor. Of course, there is a gift tax to the extent that gifts exceed the exemptions available. Ideally, gifts are made of property that currently has a low value in order to avoid current gift tax. If the property subsequently goes up in value after it has been given away by the donor, the appreciation will not be subject to estate tax at the donor's death.

- **Valuation:** If the value of property can be reduced, the gift or estate tax on transfer of that property will be reduced as well. A common technique for reducing the value of property is to make gifts of minority interests that qualify for a discount in value, often using a family limited partnership or similar entity.
- **Present value discounts:** If a donor give an asset to his or her child, but retains the use of that asset for ten years, the value of the gift is the present value of an asset that will not be received for ten years, which is much less than if the asset were given outright today. This is the concept behind several forms of gift being in trust, including the Grantor Retained Annuity Trust (GRAT) and the Qualified Personal Residence Trust (QPRT). Gifts of this type are subject to the stringent requirements of the Internal Revenue Code.

Incapacity

Q 1.8 What is planning for incapacity?

As human beings live longer, it becomes more likely that they will enter a period when they cannot manage their own assets. Most people would rather name a child or other trusted person to manage their assets for them when they are incapacitated rather than leaving this up to a court. The client can designate an attorney-in-fact to manage assets for him or her using a power of attorney. Alternatively, the client can create a revocable trust that holds all of his assets, with himself as trustee and a family member or other persons named as successor trustees when he can no longer act. If a person has not taken such precautions, then it he or she becomes mentally incapacitated, family members must to go to court and have a guardian or conservator appointed to handle the estate.

Q 1.9 How can assets be protected from creditors?

Clients are often concerned that their assets may be seized by a financial creditor, or by a spouse in a divorce action or at death. To some extent, this is governed by local law and legal obligations cannot be

avoided. However, some long-term structuring can be done to protect certain assets from future unanticipated claims that may arise.

In addition, leaving assets to a spouse, child or other beneficiary in a trust instead of outright will give a very high degree of protection against the creditors of that spouse, child or other beneficiary.

A prenuptial agreement is another technique that can be used to protect assets from claims of a spouse in the future, or at least to quantify and contain those claims.

Cross-Border Implications

Q 1.10 What estate planning issues arise for non-U.S. persons, non-U.S. assets and U.S. citizens residing abroad?

The following two rules apply in all cross-border situations:

1. All U.S. persons (both U.S. citizens and noncitizens who are U.S. residents) are subject to U.S. transfer taxes on gifts and bequests of their assets located anywhere in the world.
2. Non-U.S. persons (who are neither U.S. citizens nor U.S. residents) are subject to U.S. transfer taxes only on transfer of their assets that have a U.S. situs.

Similarly, with regard to income tax, U.S. citizens and residents are taxed by the U.S. on their worldwide income, whereas non-U.S. persons are taxed only on U.S. source income. There are also extensive reporting requirements for U.S. persons who own or control assets abroad, whether directly or through a trust or corporation. The marital deduction on gifts and bequests is limited where the recipient spouse is not a U.S. citizen, and special rules apply.