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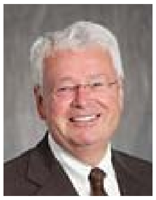
Estate Planning *Advisor*

Use of Irrevocable Life Insurance Trusts in Estate Planning



by R. Thomas Olson
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Irrevocable life insurance trusts are a frequently used tool for estate planners when the circumstances are appropriate. Generally, the proceeds of a life insurance policy are includible in the taxable estate of an insured decedent. The infusion of cash from the deceased's life insurance policy can be helpful to the survivors, but it can be considered a tax-inefficient method of providing liquidity.

A properly drafted and maintained irrevocable life insurance trust can provide the liquidity of life insurance proceeds without subjecting the proceeds to estate tax in the decedent's estate. Thus, a $1 million life insurance policy, which might generate an estate tax of up to $550,000, can avoid all estate taxes with an irrevocable life insurance trust.

How does this work? In its simplest form, an irrevocable life insurance trust is formed by the person to be insured. A trustee (who is often an adult child), other than the insured, is designated in the trust instrument to manage the trust and the trust designates beneficiaries such as spouse and children of the insured. The trust purchases the appropriate insurance policy to meet the objectives of the trust. The insured makes gifts of cash to the trust, which the trustee uses to pay the insurance premiums. Upon the insured's death, the trust has the cash proceeds of the life insurance policy, which can be

(continued on page 7)

Estate Tax Update!

by Ronald A. Shellan

As almost everyone is aware, at the end of last year Congress reformed the estate and gift tax laws for 2011 and 2012. The next presidential election cycle is left to hash out the rules following 2012.

For 2011 and 2012, the estate and gift tax exemptions have been increased to $5 million per person and $10 million for a married couple. The tax rates have been lowered to 35 percent. The rules have also been changed for the generation-skipping tax ("GST"). It is a tax that generally hits transfers from grandparents to grandchildren. The GST exemption for each grandparent has been increased to $5 million and the tax rate lowered to 35 percent.

Back in 2001, the estate tax exemption was $675,000. It increased over the years to $3.5 million in 2009. For 2010, the estate tax was eliminated and was scheduled to reappear this year at an exemption of only $1 million. This would have adversely affected many middle-class taxpayers.

The new law has an additional benefit for married couples. They can now transfer their unused portion of the $5 million estate tax exemption to their surviving spouse. In the past, if a spouse died and gave his assets to his spouse

(continued on page 7)

INSIDE THIS ISSUE

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What is the Number-One Technique Used by Wealthy Families to Transfer Assets to Children?

Defective Trusts Avoid Income, Estate, and Gift Taxes

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Defective grantor trusts are a surprisingly powerful tool that can be used to transfer valuable assets to children or anyone else without incurring income, estate, or gift taxes. And better yet, with low asset values today and low required interest rates on installment sales, there will probably never be a better time to make such gifts.

> "The use of an intentionally defective grantor trust is a very powerful way to transfer huge amounts of assets without any income, gift, or estate tax consequences."

Why use a trust with a defect? The key to structuring such transfers is to sell the assets to an intentionally defective grantor trust. If someone creates a trust for the kids, but retains the right to substitute assets after the trust is created, it is a defective grantor trust. Being defective means that property can be sold to the trust income-tax-free! Better yet, the trust need not be included in the taxpayer's estate for estate tax purposes.

There are a number of amazing results if the trust is treated as a defective grantor trust for income tax purposes. As mentioned, a sale to the trust is not a taxable event and does not create any taxable income. Any income earned by the trust is taxed to the grantor. Although the Internal Revenue Service does not like this result, when the grantor pays tax on the trust's income, it is not treated as a taxable gift. As long as the law does not change, paying taxes on the trust's income will increase the estate of the trust beneficiary and will decrease the assets of the grantor. Finally, the transfer is respected for federal estate tax purposes and is not treated as a gift.

An example may help. Let us assume that Mr. and Mrs. Joe Blow have a $90 million estate composed mostly of appreciated stock in Joe, Inc. Their only heir is their 19-year-old daughter, Julie Blow.

First, Joe must create a typical irrevocable trust, making Julie the beneficiary. The trust will terminate at Joe's death. Joe can even be trustee of the trust. Joe will sell $40 million in stock to the trust. Assuming that a 50 percent discount can be achieved because of the minority interest and lack of marketability, the stock will be sold to the trust for $20 million. It is generally assumed that the trust's purchase of the property will not be recognized as a real transaction unless the trust has some of its own assets. Many commentators indicate that the trust should have separate assets equal to 10 percent of the assets purchased. So Joe and his wife give the trust $2 million in cash to be used as a down payment to purchase the stock. Since neither Joe nor his wife has ever made previous taxable gifts, the entire amount of the gift is sheltered by Mr. and Mrs. Blow's $2 million gift-tax credit equivalent (this is a 2010 number).

When the stock is sold for $20 million, the Blows take back a promissory note for $18 million ($20 million less $2 million down payment). The note must bear interest at the applicable federal rate. The note could be paid over a long time, such as 30 years. Some commentators have indicated that the note should be made to come due before the grantor's actuarial date of death. The applicable federal rate for obligations due in more than nine years with monthly payments is currently only 3.47 percent. Either the note can amortize fully over its term or it can balloon. The note need not be secured. For tax purposes, there is no sale under the grantor trust rules, and thus the Blows do not need to pay any capital gains taxes.

As long as the value of the transferred Joe, Inc., stock appreciates more than 3.47 percent per year and produces sufficient cash flow to pay the interest on the note, life should be merry. Note that the trust will now have stock in Joe, Inc.—stock that represents $40 million in value. The underlying assets need to produce a cash return of only 1.74 percent annually in order to make interest-only payments on the note.

Assuming that Joe dies after the

(continued on page 7)

Electronic Newsletter

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Discretionary Trusts—Providing Guidance to Your Trustee

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A common way to provide for a surviving spouse is through a trust in which the income of the trust will be paid to the surviving spouse for his or her life, with the principal of the trust to be distributed to designated beneficiaries—typically the trustor's children—upon the death of the surviving spouse. Such trusts generally provide that the trustee can make discretionary distributions of the principal to the surviving spouse based on a standard that often includes language such as "to maintain the standard of living to which she has been accustomed during my lifetime." The standard may also identify specific expenses for which the trustee may use this discretionary power, such as medical expenses, or, in the case of a trust for a child, educational expenses.

Such clauses create an inherent tension between the lifetime beneficiary and the beneficiaries who will receive the balance of the trust principal on the death of the lifetime beneficiary—the "remainder beneficiaries"—because, to the extent that the trustee makes discretionary distributions of principal to the lifetime beneficiary, less money will be left for the remainder beneficiaries. The trustee has fiduciary duties to both the lifetime and remainder beneficiaries and must balance both of these interests. In the event of a conflict, the trustee—and the court, if litigation results—will look to the language of the trust instrument in an effort to determine the intent of the trustor (the person who created the trust).

Accordingly, when you create a discretionary trust, it is critical that you provide guidance to the trustee, particularly on two key issues. First, with respect to discretionary distributions of principal to your surviving spouse, how generous do you want the trustee to be in exercising this discretionary power? Is your focus on providing comfort and care to your surviving spouse, or preserving the principal of the trust for your children? If you want not only to provide basic support for your spouse, but also to allow for luxury items or permit your spouse to use trust principal for things unrelated to support, such as charitable giving, you should work with your estate planning counsel to craft language that reflects your intent. If you contemplate a very generous exercise of discretion by the trustee, for example, you might provide that the trustee can use the discretionary power to distribute principal, even if it results in the depletion of the entirety of the trust. On the other hand, you can express your intent that the trustee exercise this discretion narrowly, for specific categories of expenses. If you seek a balance between spousal support and preservation of principal for your children, your trust should provide some guidelines for achieving that goal.

> ". . . without some direction from the trustor in the language of the trust, conflicts can easily give rise to litigation that may result in a distribution at odds with the true intent of the trustor."

The second key issue is whether, in making a determination regarding a discretionary principal distribution, your trustee should take into account the other resources available to your surviving spouse. For example, if your surviving spouse has substantial assets of his or her own, should the trustee require your surviving spouse to use those assets first before making discretionary distributions of principal? This issue can arise in any discretionary trust, but often arises in a blended family, in which the surviving spouse may wish to preserve her separate assets to leave to her children; the children of the trustor, who will receive the balance of the trust, may find it unfair if the surviving spouse receives discretionary principal distributions that diminish the value of the trust while preserving her own assets. The case law on the "other resources" issue is widely divergent, so without some direction from the trustor in the language of the trust, conflicts can easily give rise to litigation that may result in a distribution at odds with the true intent of the trustor.

The terms of a discretionary trust will be dictated by a host of factors, including the magnitude and character of the assets to be left in trust, the age, needs, and financial wherewithal of the beneficiaries, family dynamics, and the wishes of the trustor. In creating a discretionary trust, you will not be able to anticipate all the circumstances that may arise in the future. By giving careful thought to the issues discussed above, however, you can provide guidance for your trustee that will minimize the potential for conflict in the administration of your trust, give the beneficiaries an understanding of their relative rights under the trust, and ensure that your assets will be distributed as you intended.

Where There's a Will . . . There's Relatives

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Where there's a will . . . there's relatives. This truth, proved time and again in probate proceedings and will contests, holds a clear lesson: Good estate planning is about more than taxes; it requires careful consideration of who should receive your assets, and how and when they should receive them, as well as a clear statement of your wishes and expectations. The following are some of the important nontax issues that may face a person planning his or her estate:

Should I have a revocable trust? Placing your assets in a trust during your lifetime can preserve your privacy and spare estate expense by avoiding a court-supervised probate proceeding. This step also allows you to name a successor trustee to serve in case you become incapacitated, thus avoiding a court-monitored guardianship or conservatorship proceeding.

Whom should I name to serve as my successor trustee or my personal representative? Naming of a trustee (or personal representative) to serve after your death is a key decision, particularly if you leave assets requiring investment or management expertise. Does your spouse, child, or trusted relative have the necessary skill? If a trust company or capable nonfamily trustee is named, should a family member serve as a cotrustee to help ensure that family members' needs and circumstances are given consideration?

Should I leave assets outright or in trust? Before leaving assets outright, consider problems that could arise in the event of divorce, remarriage, creditors, profligacy, and partners new to the scene. Leaving assets in trust can help ensure that they will be held and distributed according to your wishes and will not be wasted. In the case of children or grandchildren, provision can be made for distributions for special purposes, such as education or purchase of a home or business. Principal can be distributed in stages as the beneficiary reaches specified ages.

Should I treat my children equally? Should a child who has done well be treated the same as one who has chosen a less remunerative occupation? If children have produced varying numbers of grandchildren, should each child's family be treated equally, or should each grandchild be equally provided for?

How do I provide for the children of a prior marriage? Assets can be placed in trust for the life of a second spouse, with provision for children to share at the spouse's death. If the spouse is significantly younger, would this potentially postpone the children's benefit from at least some of their parent's wealth? In a blended family, should children of the spouse's first marriage eventually share as well?

How about IRAs, retirement accounts, and life insurance? These assets normally pass to beneficiaries you designate directly with the account or policy provider, and your will or trust does not override this designation. The assets can be placed in trust through a proper beneficiary designation. However beneficiaries are designated, it is important to be sure that these assets are integrated into your overall estate plan.

Who gets the fine china and the coin collection? A will or trust can include specific instructions about personal property items having real or sentimental value. Discussions with family members can help ensure that the distribution you make does not cause hurt feelings.

Because no two families share the same dynamic, every individual or couple planning how their wealth should eventually be distributed may have different answers to these and similar questions. The key point is to recognize that, while minimizing taxes is an important element of an estate plan, other elements must be kept in mind if your heirs are to receive the full benefit of your planning.

Control Your Business's Destiny: Plan to Leave It!

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The baby-boomer generation is rapidly approaching retirement age. Studies suggest that as many as two-thirds of small and midsized businesses are owned by baby boomers who plan to exit their companies within the next ten years; yet fewer than one in five have completed a written succession (or "exit") plan.

To give you an idea of where you stand in developing your own exit plan, take a moment to review the following questions. If you can answer "yes" to these questions, then you are on your way to developing your exit plan. If you are like the vast majority of business owners, however, these questions will highlight areas to start your planning.

- Do you know:
  - When you want to exit?
  - How much money you need to exit?
  - To whom you want to sell the business?
- How much is your business worth today (not just your best guess)?
- Do you have a strategy to increase the value of your business between now and your target exit date?
- Do you know how to structure a sale to a third party, or a transfer to a family member, co-owner, or key employee, to maximize your cash, minimize your tax liability, and reduce your risk?
- Have you taken steps to ensure that the business will continue if you don't and to provide for your family's security if you die or become incapacitated?

If you are like many business owners, you may be able to answer "yes" to only a few of these questions. In our experience, if you are going to successfully exit your business, you must be able to say "yes" to most of the questions listed above. Unless you can, you may be headed toward a short-time-frame, "seat-of-your-pants" exit that will not maximize net value or minimize your taxes or your risk that the transaction succeeds.

The techniques that produce business success (learning from mistakes, developing a business strategy based on experience, trial and error, and running the business efficiently and effectively) do not guarantee a successful exit. Unfortunately, the valuable experience that owners develop over the course of their business lives does little to equip them to exit successfully. Experience, learning, and "trial and error" all require time—a luxury that most business owners do not enjoy as they approach the end of their business ownership lives.

Our experience is that business owners can benefit substantially from engaging experienced advisers to develop an effective exit plan, starting not later than three to five years before they actually wish to leave the business. Owners should choose advisers who have seen and learned from the failures and successes of other owners exiting their businesses. These advisers should be able to help guide you through an established exit planning process so that you can avoid costly mistakes.

A successful exit plan should be in written form, contain specific recommendations, and include a checklist to assist with and monitor implementation. Typically, the checklist should describe each action to be taken, assign responsibility for each task to a specific

adviser (or advisers), and specify a date by which this action must be completed. Armed with a written exit plan and checklist, a team of skilled and experienced advisers, and (ideally) several years, you will be able to optimize your chances for leaving your business when you want—and on your terms.

Bill Manne chairs the firm's tax and business-owner exit practice teams and is also a certified public accountant. This article was previously published in the AGC Oregon-Columbia Chapter's Construction News Update.

The Generation-Skipping Transfer Tax

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The generation-skipping transfer tax (the "GST Tax") was first enacted in 1976; in 1986, it was substantially revised to its current form. The GST Tax is a separate tax on certain transfers of property that is imposed without regard for and often in addition to the federal estate and gift tax. The GST Tax rate is equal to the highest estate tax rate.

Before the enactment of the GST Tax, wealthy families could create trusts that lasted for generations without the imposition of estate tax. For instance, a grandfather could create a trust that would benefit his daughter for her life. The daughter's rights to the trust assets would be limited such that, although she would have use of the assets for her life, the trust assets would not be included in her taxable estate. At the daughter's death, the remaining trust assets would be held in the trust for her children under the same terms so that the assets would not be included in the children's estates. The trust would continue in this manner until state law required that it terminate. (Before 1986, states had statutes that limited the time a trust could exist. Now some states allow a trust to continue indefinitely.) By creating this type of trust, the assets would be subject to estate tax at the grandfather's death, but not again until the death of the members of the generation that received the assets when the trust terminated.

The purpose of the GST Tax is easily understood, but the GST Tax rules are some of the most complicated in the tax code. The GST Tax is intended to require the payment of a transfer tax on a family's assets at least once each generation, whether or not each generation actually has the direct or indirect use of those assets. Accordingly, the GST Tax is imposed on the transfer of assets to anyone who is considered to belong to a generation that is two or more generations below that of the transferor. Most typically, a GST Tax would be imposed on transfers to or for the benefit of the transferor's grandchildren.

The GST Tax is substantial and is imposed at a rate equal to the maximum federal estate tax rate. To ease the burden of this tax and to allow grandparents to give some assets to their grandchildren, the law contains an exemption from GST Tax that allows each person to transfer assets with a certain value free from GST Tax during that person's life or at death. For many years, the exemption was $1 million, as indexed for inflation. The GST Tax exemption was $3.5 million in 2009. In 2011 the law reduces the GST Tax exclusion to $1 million, indexed for inflation. If Congress increases the exclusion amount for estate tax purposes, Congress will likely also increase the GST Tax exemption.

For a client with a large estate, the GST Tax exemption can be used to create a trust that will hold assets for multiple generations without the imposition of either GST Tax or estate tax. Although this cannot be done in an unlimited amount, as was possible before 1976, with proper planning, it is possible to leverage the GST Tax exemption so that ultimately a substantial amount can be held in a GST trust. An example of how this might be done is to fund a GST Tax-exempt trust with life insurance or with assets valued with a minority or liquidity discount, such as an interest in a family business or family partnership.

The tax benefit of taking advantage of the GST Tax exemption is substantial and can allow the older generation to create financial security for their family for generations.

Announcements & Events

- Ronald Shellan was elected President and Valerie Sasaki was named Secretary of the Portland Tax Forum.
- Miller Nash was recently named one of Oregon's Healthiest Employers and one of Oregon's Most Admired Companies by the *Portland Business Journal*. The *Portland Business Journal* also recognized Miller Nash's Don Burns as CEO of the Year for professional service firms.
- Robert Walerius, partner and leader of Miller Nash's Healthcare practice team, has recently been named a member of the Northwest Kidney Centers board of trustees.
- Miller Nash had 32 attorneys named on the 2010 *Oregon Super Lawyers* and *Rising Stars* lists, making the firm one of only three law firms in the state to have four lawyers listed on the *Top 50 Super Lawyers* list.
- Michelle Barton and Jennifer Roof were recently elected as Miller Nash partners. Congratulations!
- Welcome, Ian M. Messerle (Seattle) and Meghan E. Williams (Vancouver), who recently joined Miller Nash as associates.

For details, visit www.millernash.com or e-mail clientservices@millernash.com

Use of Irrevocable Life Insurance Trusts in Estate Planning | Continued from page 1

used for purposes of liquidity, such as payment of death taxes, and ultimate distribution to the trust beneficiaries.

With each of the steps outlined above, there can be variations in the provisions of the trust, so long as the basic elements of trust agreement, independent trustee, and no economic benefit on the part of the insured are met. For instance, an existing insurance policy can be transferred into the trust. This can be helpful when there are issues about whether the insured can obtain a new policy. The transfer of the existing policy is, in itself, a gift to the trust and has the disadvantage of a three-year period after the gift is made during which time the life insurance proceeds will be considered part of the insured's estate.

If the insurance policy has annual premium requirements, the funds for these premiums are typically provided to the trust in the form of gifts from the insured. Most typically, the gifts would not exceed the annual exclusion amount, currently $13,000 per beneficiary of the trust. For example, assuming that the beneficiaries of the trust are the insured's two children, up to $26,000 could be contributed to the trust annually for the purpose of paying the premium, free of gift tax. There are technical requirements associated with those gifts that are beyond the scope of this brief introduction to irrevocable life insurance trusts.

Anyone who has a taxable estate, and particularly an estate that is not readily convertible to cash because of the nature of the assets in the estate, should consider the significant benefits of a life insurance trust — because paying up to $550,000 in estate taxes on $1 million of life insurance is just not necessary.

Estate Tax Update! | Continued from page 1

Calendar Year	Estate Tax Exemption	GST Tax Exemption	Gift Tax Exemption	Top Tax Rates
2009	$3.5 million	$3.5 million	$1 million	45%
2010	Repealed	Repealed	$1 million	35% (gift tax only)
2011	$5 million	$5 million	$5 million	35%
2012	$5 million	$5 million	$5 million	35%

(which qualified for an unlimited marital deduction), the exemption of the first spouse could be wasted. In the past, to avoid wasting the exemption, the unused estate tax exemption amount was often given to the surviving spouse in trust that met special requirements and thereafter distributed at the surviving spouse's death to the children. In the estate planning world, the trust for the surviving spouse is known as a Bypass Trust.

But the need for Bypass Trusts continues. Because of the generous exemptions, very few individuals dying in 2011 and 2012 will be subject to the federal estate tax. Yet the Oregon and Washington versions of the estate tax continue. In Oregon, there is only a $1 million exemption. The top inheritance tax rate is 16 percent. In Washington, the exemption is $2 million and the top rate is 19 percent. A Bypass Trust in Oregon could save as much as $160,000 in taxes ($1 million exemption × 16 percent rate) and in Washington a Bypass Trust could save as much as $380,000 in taxes ($2 million exemption × 19 percent). Note that neither Oregon nor Washington imposes a gift tax.

Many clients have wills or revocable living trusts that utilized a formula to determine the amount going into the Bypass Trust. The formula might say, "I give to the Bypass Trust the largest amount possible while still keeping my federal estate tax at zero." These old formula provisions may need to be rethought to ensure that provision is made to place the Oregon and Washington exemption amounts in a Bypass Trust.

What Is the Number-One Technique . . . | Continued from page 2

note is fully paid up, he will be able to exclude from his estate the entire $40 million in interests in the Joe, Inc., stock sold to the trust. If everything goes well, over that time, this property could appreciate to $100 million or more! Joe will have to include in his estate the principal payments plus interest on the note, but this amount could be substantially diminished over the years if Joe, instead of Julie, pays all the taxes on the income of the trust and Joe consumes a portion of the payments for monthly living expenses.

The use of an intentionally defective grantor trust is a very powerful way to transfer huge amounts of assets without any income, gift, or estate tax consequences. Intentionally defective grantor trust transactions are becoming increasingly popular, but they are complex transactions and should be undertaken only with the help of experienced tax counsel.

TRUSTS & ESTATES

The Miller Nash Trusts & Estates Practice Team assists our clients in achieving their goals for the disposition of their estates. In this process we consider first a client's goals and then examine a variety of strategies to achieve those goals, including the relative tax efficiencies of the various strategies.

Our team has assisted clients with appropriate and efficient estate plans for estates ranging in size from $100,000 to $100,000,000. We are well acquainted with bank trust departments and trust companies throughout our region.

Estate planning may include consideration of transitioning a family business to the next generation, the preservation of ownership of significant family property, and the achievement of philanthropic objectives.

Members of our team are available to help you with any questions you have.

Adrienne P. Jeffrey	Sarah MacLeod	R. Thomas Olson	Ronald A. Shellan
C. Marie Eckert (*Litigation*)	William S. Manne	Jack B. Schwartz	

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