EXCERPTS FROM 2005 Newsletter

REPEAL OF ESTATE TAX? STATUS, LEGISLATIVE PROSPECTS, FUTURE OF ESTATE TAX, GIFT TAX, GENERATION-SKIPPING TRANSFER TAX

Recent Developments. As all of you are aware, the Republicans in Congress and President Bush have been trying to repeal the estate tax, and that effort was scheduled for a Senate vote in September. But Hurricane Katrina and its $10 billion plus of damage to the federal budget took that off the legislative calendar. For how long? In the *Wall Street Journal* of November 9, 2005 Senator Grassley, Republican Chairman of the tax-writing Senate Finance Committee, was quoted as saying that repeal of the estate tax would not again be considered in this Congress. This would delay further consideration of repeal until 2007, when Congress may have more liberal and Democratic members than it does today, and prospects for repeal may be less likely.

It was generally believed even before Katrina that the votes were not there to repeal the estate tax, and key Republicans were considering a compromise to raise the exemption and lower the top tax rate, but they were split on which feature to emphasize.

Modestly wealthy constituents -- wealthy farmers and entrepreneurs and professionals -- would completely avoid the estate tax if the per person exemption could be raised permanently to $3.5 million - $5 million, and they did not care so much about the top bracket, because such large exemptions would have spared them (and 99% of Americans) from any estate tax, and their views influence many on the Hill. But super-wealthy constituents were more focused on materially reducing the top tax rate, say to the 15% capital gains rate. Each of these approaches has a substantial impact on federal tax revenues and exacerbates the burgeoning federal deficit. So predicting the ultimate resolution of the federal estate tax debate is impossible, and the most that may be said with confidence is that the results of the 2006 Congressional elections and the state of the federal deficit in early 2007 will have a large influence on the outcome. We believe the Republicans will try very hard to get some further permanent relief from federal estate tax before President Bush leaves office. But, of course, if a Democratic President is elected in 2008, he may try to roll back any expansion of the estate tax exemption or reduction of the top estate tax rate perceived to be too damaging to the federal deficit.

Expansion of the Estate Tax Exemption to $2 Million Per Person January 1, 2006.

For now all any of us may rely on is the existing law, which calls for the expansion of the estate tax exemption to $2 million per individual effective January 1, 2006. This is not controversial at all, and is, in fact, seen as little more than an inflation adjustment of the $600,000 exemption adopted in 1981. Obviously a father and mother have $4 million of exemption between them to pass assets tax-free to their children, so it is sometimes said that there is a $4 million Aper family@ estate tax exemption. The top estate tax rate drops on January 1, 2006 from 47% to 46%.

Scheduled Expansion of Estate Tax Exemption to $3.5 Million in 2009.

Under current law the estate tax exemption is scheduled to expand to $3.5 million per individual ($7 million per married couple) in 2009, and this may well happen as scheduled. Again, this is not considered controversial by the Democrats as long as the budget deficit can be brought under control by then.

What Will NOT Happen.

What will absolutely NOT happen is the scheduled one-year repeal of the estate tax in 2010, or the scheduled return of the estate tax after a one-year hiatus in 2011, with $1 million exemption. The 2010-2011 arrangements were placed in the law cynically with no expectation they would ever come to pass, but they were put in the law (1) to put

pressure on future Congresses to permanently repeal the estate tax, and (2) to meet budget guidelines, which did not permit permanent repeal in 2001 or even 2010.

Future Possibilities.

It is possible that in 2007-2008 Congress may expand the exemption beyond the scheduled $3.5 million limit for 2009 and/or reduce the top bracket below the scheduled top bracket of 45% (which will take effect under current law in 2007).

EXPANSION OF THE ANNUAL GIFT TAX EXCLUSION TO $12,000 (FROM $11,000) PER DONEE FOR GIFTS TO INDIVIDUALS OTHER THAN SPOUSES EFFECTIVE JANUARY 1, 2006

The annual per person gift tax exclusion is inflation adjusted, and the Treasury has announced that as of 2006 every individual donor will be able to give to as many individual donees as he or she likes $12,000 every calendar year, with no transfer tax consequences. Theoretically this includes the annual aggregate total of all birthday, Christmas, Hanukkah and other gifts, but payments directly to service providers for education expenses and/or medical expenses are not subject to this limit. It does not matter if the donee is a child or a grandchild or an unrelated party. Gifts to citizen spouses may be made without limit. Gifts to non-citizen spouses are subject to special limits.

EXAMPLE: a father and mother with four adult children and eight grandchildren may in 2006 give them $24,000 x 12 = $288,000 without transfer tax consequences. The donees receive the gifts tax-free: no income tax is due, and no tax reporting is required.

Gifts to minors may be made to custodial accounts at financial institutions established under each jurisdiction=s Uniform Transfers to Minors Act. The account documents should provide that the custodian may hold the funds until the child attains the age of 21 (rather than 18). Until the minor reaches age 21, the custodian may expend funds from the account for the minor=s benefit as the custodian deems appropriate. Income earned in these accounts is taxable to the minor beneficiary, and donors should not retain control as custodians.

Annual exclusion gifts also may be made to educational accounts established under Internal Revenue Code Section 529 ("' 529 Accounts@) directly with states sponsoring such programs or with financial institutions managing such funds. Only in the case of '529 Plans may the donors use the current year and the ensuing 4 years= exclusions up front, and make a $60,000 gift ($12,000 x 5) in 2006 ($120,000 from both spouses) for one child in a lump sum, using up the annual exclusions not only for 2006, but also for 2007-2010. 529 accounts, like IRAs, grow tax-free, and distributions to pay direct and indirect costs of higher education (college, post-graduate, professional) come out tax free. The donors may retain control over these accounts, may subsequently redirect them to other people and may even get the funds back at the cost of taxes and penalties.

Because UTMA accounts (must pass to the child=s control at age 21) and 529 Accounts (must be used for higher education expenses to avoid income tax) are restrictive, frequently parents or grandparents will ask us to draft a more flexible, customized irrevocable trust for a child or grandchild which may be used at the trustee=s discretion for any purpose and may be held to age 35 or even for life if the settlor and trustee decide that is appropriate.

Gifts to any of these vehicles remove the assets given from the parents= taxable estates and remove the income earned by the donated funds from the parents= income tax returns.

Gifts Above Annual Exclusion Amount. If gifts to any donee(s) in a calendar year exceed the annual exclusion, the gifts will still pass tax- free up to $1,000,000 in the aggregate over the donor=s lifetime, but gift tax reporting (on IRS Form 709) is required to inform the IRS of the use of some of the estate tax exemption that otherwise would have been available at the donor=s death. Such gifts over the annual exclusion would normally be made only in cases where the donor expects to obtain substantial leverage, i.e., where the donor expects the asset donated to appreciate very substantially over the donor=s life, so it is smart to give it away at the present low values. A number of sophisticated techniques are available to discount the present value of an asset being given for gift tax purposes.

Qualified Personal Residence Trusts (QPRTs)**.** For example, a Aheritage@ second home the donor hopes to keep in the family for generations may be donated to a Qualified Personal Residence Trust (QPRT) under which the donor retains the exclusive right to use the property for a fixed period of time, for instance 20 years. The 20-year retained interest discounts the current value of the gift by more than 50%, permitting the home to be given away tax-free now at a relatively low value. The house will not be included in the donor=s taxable estate if he outlives the reserved period.

ASSOCIATION W I T H EVAN J. KRAME, ESQ. IN MONTGOMERY COUNTY, MD

We have recently associated our practice on a reciprocal Aof counsel@ basis with Evan Krame and his firm. Evan and I got to know each other when both of us served on the Steering Committee of the D.C. Bar=s Wills, Trusts and Estates Section. Evan is located at 11300 Rockville Pike, Suite 603, Rockville, MD, website: www.kramelaw.com.

Evan is admitted in Maryland and can assist us with Maryland trust and estate matters and has a particular expertise in structured settlements and other arrangements for disabled parties.

EXCERPTS FROM 2004 NEWSLETTER

On Monday, November 24, 2003, six years after our firm started, we opened for business in new premises in a much-upgraded office environment. After 21 years in Tysons, we decided we wanted to try walking to lunch, and we thought the small town environment of downtown McLean would be a charming and stimulating change. We believe and hope our new location will be at least as convenient for you as our old one was. We have worked hard to develop a map and directions for our clients who are not familiar with downtown McLean. These are on our website.

We would like to add your e-mail address to our database and generally to update our information on your address, phone and fax numbers. One of our future goals is to be able to e-mail our newsletter and other announcements to you, bringing you up-to-date on pertinent changes in the estate and tax laws and keeping in touch. Please drop us a line or e-mail us with any pertinent information when you have a chance.

Our business model is to LISTEN to our clients attentively so we may provide the services you need and want, customized to suit your unique goals, family circumstances, assets and world view of financial, estate, business and tax planning. We hope to provide the most sophisticated tax, estate and trust, and business and financial planning available in the marketplace at reasonable rates, below those of large local firms, much below comparable services in New York City. We strive to be responsive and attentive, to return calls and e-mails on the day received if at all possible, and to be prompt and meet any time deadline we can possibly meet. We pledge to keep ourselves current on legal, tax and planning developments. We will always endeavor to welcome with humility and without defensiveness suggestions and criticism, so we may constantly improve our performance and be more useful to you.

Over the years we have seen greater demand for more holistic advice. We know our clients need good advice on life insurance, long-term care insurance, investments, retirement planning, income tax planning and tax return preparation, and general financial planning, and we know many of you will need to identify attorneys to help you in divorce and custody matters, commercial litigation, intellectual property, incapacity/guardianship/conservator-ship, employment law and real estate. We have developed working relationships with, and confidence in, professionals in all of these areas, and we will be pleased to try to identify appropriate professionals to meet the idiosyncratic needs of our clients.

To update you on what we are doing, the following is a not-quite comprehensive listing of our current practice areas:

$ Wills

$ Lifetime Revocable and Irrevocable Trusts, including

B Trusts for Children and Grandchildren

B Life Insurance Trusts for Single Life or Second-to-Die Policies

B Qualified Personal Residence Trusts

B Grantor Retained Interest Trusts

B ADefectiveAGrantor Trusts

$ Testamentary Trusts, including

- B Marital Trusts
- B Family Trusts for Surviving Spouse and Children
- B Children=s Trusts Until They Attain an Appropriate Age, With Staged Distributions
  - B Generation-Skipping Trusts for Children for Life, Then to Grandchildren
  - B Perpetual Trusts for Descendants Indefinitely Into the Future

$ Lifetime and Testamentary Charitable Planning, including Lead and Remainder Trusts, Private Family Foundations, Advised Funds

X Estate and Trust Administration, including disputes, advice to beneficiaries and fiduciaries

X Asset Protection Planning

X Tax Planning and Tax Disputes

X Pre-and Post-Marital Agreements

X Post Mortem Tax Planning and Probate Avoidance Planning

$ Planning for Incapacity

$ Closely-Held Business and Investment Entity Planning for
- S C Corporations
- S S Corporations
- S LLCs
- S LLPs
- S Family Limited Partnerships

$ International Estate Planning, including
- B Offshore Trusts for Resident and Non-Resident Aliens
- B Offshore Trusts for U.S. Citizens, Including Offshore Asset Protection Trusts
- B Qualified Domestic Trusts for Non-Citizen Spouses
- B Pre-Immigration Planning for Aliens
- B Expatriation Planning for U.S. Citizens and Residents
- B Income Tax Planning for Foreign Investors in U.S. Situs Assets
- B Gift Tax Planning for Families Across Borders

<u>Closely-Held Business Practice</u>. We routinely represent entrepreneurs, executives, professionals and investors and the closely-held business and investment entities with which they are associated with respect to --

$ Choice of entity, including tax and

asset protection planning
- $ Shareholder, partnership and
  operating agreements, funding of
  cross-purchase agreements with insurance
- $ Shareholder, partner, member
  disputes
- $ Ownership and management
  succession planning
- $ Governance issues
- $ Commercial agreements and
  disputes
- $ Purchases and sales of businesses by stock and asset transactions
- $ Tax -efficient exit strategies

If we may be of assistance to you or any of your colleagues or friends with business issues, please contact us.

Sophisticated Charitable Arrangements: Charitable Remainder and Lead Trusts, Private Family Foundations

Many of our clients decide to reduce their income taxes or estate taxes and simultaneously accomplish serious philanthropic objectives by making substantial lifetime or testamentary gifts to charity.

On our website are two relevant outlines, one presented to Georgetown University and Law School alumni at the last two reunions, and one presented to the D.C. Bar Association on Charitable Remainder Trusts.

Charitable Remainder Trusts (ACRTs@)

In a charitable remainder trust the donor or a relative will receive an annual income distribution from the funds contributed, normally at 5%-7%, for a term. At the end of the term, the remaining principal will pass to charity outright and irrevocably. The donor of a lifetime CRT will frequently reserve the income stream to himself for life, but it could be reserved for a fixed number of years, e.g., 10 or 20. He may reserve the income stream for the joint lives of himself and his spouse. A lifetime CRT gift will normally result in an income tax charitable deduction which reflects the difference in value between the income stream reserved by the donor and the residuary value. This is actuarially calculated on software based on current interest rates, the payout percentage reserved, and the term of the reserved interest, which may involve the life expectancy of the income beneficiary. The older the donor of a lifetime CRT gift which reserves a life interest, the greater the deductible gift. A particular advantage is found in such an arrangement if the donated property is highly appreciated, as the donor avoids the capital gains tax he would have paid had he sold the property, today normally 15%. The trustee of the CRT may sell the property tax free, and invest 100% of the proceeds to generate an income stream for the donor annuitant.

A testamentary CRT may be used to provide an income stream for a loved one, child or grandchild, before the remainder passes to the charitable beneficiary. An estate tax charitable deduction will be allowed for the actuarially calculated difference between the present value of the income stream (based on the annuitant=s age and life expectancy, payout rate and current interest rate) and the remainder expected to pass to charity.

In our office in 2003 a 66 year old single client made a charitable remainder gift to Harvard University of some $350,000 by a CRT which we drafted. He retained a life income stream of 6% distributed quarterly, adjusted annually based on the then-current value of the endowed gift. He gave appreciated securities. Based on his life expectancy, the then current interest rates and the 6% annual payout, our software told us he was entitled to a current charitable income tax deduction in 2003 of 43.56% of the $350,000, or $152,446. His income stream for 2004 at 6% will be $21,000.

Also in our office previously a testator left most of his very large estate via the revocable trust which we drafted in 5% annual payout remainder trusts for the lives of his two children. Twenty-eight percent of the total value of the assets passing to these CRTs qualified for the charitable deduction based on the current interest rate, the payout percentage and the life expectancies of the beneficiaries. (Both were about age 50). At the deaths of each child the remainder will pass to a private foundation that was created by the same revocable trust which we drafted and which his descendants (grandchildren) will eventually control.

Charitable Lead Trusts (ACLTs@)

In a charitable lead trust the donor sets aside a trust fund and provides from it that an income stream of a certain percentage (e.g., 5%-6%) will pass annually to one or more chosen charities (or even to a private foundation established by the donor) for a fixed period of time (e.g., 20-40 years). At the end of that period the remaining principal returns to designated descendants of the donor, children or grandchildren.

In a lifetime CLT gift, the income tax and gift tax deductible charitable gift is the actuarially calculated (on software) percentage value of the term income stream based on current interest rates and the designated payout rate. (CLTs must be structured in a particular way to be eligible for an income tax charitable deduction.) In a testamentary CLT, the estate tax deductible charitable bequest is calculated in the same manner.

In a transaction handled in our office, a donor contributed $2 million of appreciated securities to a CLT, providing 5% income to be distributed to his own private foundation each year for 35 years based on the annually recalculated value of the trust assets. At the end of that period the remaining principal will return to his children, all under 10 years old at the time of the gift, 40-50 years old when they receive the distribution. He received a deduction in 2003 of 82% of the value of the gift, or over $1.6 million, and yet at the conclusion of the trust term it is likely that more than $4 million, maybe considerably more than $4 million, will return to his children tax free, because notwithstanding the annual payout his investment advisors expect the principal to grow substantially over the 35 year term. He and his wife are considered to have made a gift to their children of less than $400,000, which uses up less than $200,000 of the applicable estate and gift tax exemption amount of each. The amount of the gift tax exemption available to each parent in 2004 was $1 million, so in effect, the father and mother reduced their respective gift tax exemptions to $.8 million each, and their estate tax exemptions to $1.3 million each, but as a result of this gift their children should receive in 35 years $4 million-plus tax free. This technique reflects remarkably effective leverage of their exemptions, converting $400,000 of exemption into $4 million-plus of tax-free gifts, more than 10-1 leverage.

By using a testamentary CLT even the largest estates -- billion dollar estates -- can pass almost tax free to heirs if the family is willing to be patient and trade off a 40-year income stream to charity in a CLT.

And the charitable distributions themselves can remain in family control if they are made, as they were in the case we handled last year, to a Family Foundation we established, so that parents and children will decide how to distribute Foundation income, to which charities.

Private Family Foundations

Families in a position to commit $1 million or more during life or at death to charitable objectives should consider establishing their own Private Family Foundation. This is a not-for-profit corporation created by us under state law and recognized as tax-exempt by the IRS in response to an application filed by us. Subject to some strict rules, family members and, if the donors like, trusted friends, may sit on the corporation=s board and select the charities to receive at least a 5% payout each year. This is a great way for parents to involve children and eventually grandchildren in their culture of philanthropy, teaching them why and how to do it.

Generally estates may take an unlimited charitable deduction for gifts to any charity, including a Family Foundation, and this is true of the charitable portion of such split-interest gifts as CRTs and CLTs. Income tax deductions for CRT and CLT gifts to public charities are limited annually to 50% of the donor=s adjusted gross income, but any surplus may be carried over and used in future years. Deductions for lifetime gifts to Private Family Foundations are limited to 30% of adjusted gross income, but again any surplus may be carried over and used in future years.

Last year we created several Private Family Foundations to receive lifetime gifts and one received the term payout of a CLT. We provided in testamentary documents for the creation of Private Family Foundations, CRTs and CLTs at death.

Please contact us if you would like to consider lifetime or testamentary gifts to CRTs, CLTs or a Private Family Foundation. We can help sort out and evaluate the appropriateness of various options and prepare all necessary documents and filings.

IS A FAMILY LIMITED PARTNERSHIP RIGHT FOR YOUR FAMILY?

Why is there so much talk about Family Limited Partnerships (FLPs)? The Wall Street Journal, The Washington Post Business Section, and all major business, tax, financial and estate planning oriented publications have published numerous articles on them. What is all the hubbub and controversy about?

Tax Advantages Despite Retention of Control. Normally the price of making a completed gift for tax purposes, giving away property so that it is out of your taxable estate and off of your income tax return so that the benefit of future appreciation and the burden of future income tax on the asset falls on someone else is loss of control. If you deed a principal residence or vacation home to your children but continue to use it rent free, you have not made a completed gift because you have kept control. If you put stock in trust for a beneficiary but retain the right to change beneficiaries in the future, you have not made a completed gift because you have not given up control.

But if you transfer real estate or stock to an FLP, retaining the right to be managing partner, when you give away limited partnership interests to children or trusts for them such gifts are completed gifts even though you retain complete control over the partnership (as managing general partner) and the children have no say.

A mother owning a closely-held business might be willing to give away 99% of the ownership if she could retain complete control over the business by retaining a 1% general partnership interest. This can be an attractive opportunity to parents willing to give away the value but not the control. While recent cases have created some uncertainty about the tax consequences when the donor retains control as general partner, it is our opinion that such control by the donor may still be accomplished under proper circumstances with careful planning.

Gift Tax and Estate Tax Discounts

If you have $330,000 of publicly-traded stock and you want to give it away to your three children within the gift tax annual exclusion, you may give away $12,000 worth of stock, valued at the public market price on the date of gift, each year to each child, so it would take 10 years to give it all away if it does not appreciate. If, in the alternative, you contributed the same stock to an FLP and gave the three children each year limited partnership interests worth $12,000, you could apply a discount to the value of the limited partnership interests off the pro rata value of the underlying asset, maybe conservatively 20%. Therefore you could give partnership interests to each representing some $13,750 of underlying assets to each child each year, or some $41,250 in the aggregate instead of $33,000. So you could give all the stock away in 8 years rather than 10. Much greater discounts, maybe conservatively 35%, could be taken if the partnership assets were investment real estate or closely-held stock. So if parents owned a $3 million small office building and wanted to give it away to their children immediately, they would each use up all of their respective $1 million gift tax exemption and would incur a 48% gift tax on the $1 million balance, or $480,000. But if, instead, they first gave it to an FLP and gave away instead 99% of the limited partnership units, they could do so at a value under $2 million, and owe no gift tax.

Moreover, fractional partnership interests held by the parents at death would be entitled to discounts, likely 20% if still a majority and controlling interest, likely 35% if minority and non-controlling at death.

So both gift and estate tax discounts are available, on the gifts going out and on the estate retained at death, substantially leveraging both the gift and estate tax exemptions.

Asset Protection

A single person owning a home and brokerage assets could lose them to a lawsuit in our litigious society, and this risk would be particularly higher if the person is a professional liable to suit for malpractice above insured limits or an entrepreneur at risk from a myriad of business-based claims. But if the home and brokerage assets were contributed to an FLP in which other family members (e.g., siblings, spouse, children or trusts for children) might have modest or even minuscule percentage interests from assets of their own which they contribute or from gifts of partnership interests from the relative creating the FLP, the assets in the FLP would be immune from claims of the creditors of any partner because under state law everywhere creditors of partners who have won judgments against them may not attach or force the liquidation of partnership interests or even become substituted partners. All they may obtain is a charging order, under which the General Partner is directed to pay partnership distributions coming to the debtor instead to the creditor with the charging order. But, of course, in the family context, no general partner will make a distribution to a partner upon whose interest there is a charging order, so the charging order may be worthless. Moreover, the IRS has ruled that a creditor with a charging order must pay tax on the pro rata share of partnership income represented by the interest against which he has the charging order. So the creditor must pay tax on income not distributed to him. For creditors, a partnership interest is an ugly asset. In contrast, a judgment creditor could seize, sell and liquidate the proceeds of real estate or brokerage assets owned by the debtor in his own name.

Principally for these three reasons FLPs have grown exponentially in popularity with clients and advisors for

the past decade. Naturally, too, planners and clients have sometimes stretched the envelope with this technique, and in circumstances of over-aggressive planning and/or highly controversial facts, courts have lowered the boom in some notorious cases, and denied the clients the tax advantages sought. If one can generalize, the anti-FLP cases, which have received a great deal of publicity, fall into two categories: (1) cases that should have been lost by the taxpayer because, by any reasonable analysis, well-known legal principles were violated; or (2) cases where the facts were so bad, so close to the line of propriety and law that the judge=s sensibilities were offended, cases that demonstrate the axiom that bad facts make bad law.

An important point to make is that the notorious anti-FLP cases are almost all tax cases, so that where FLPs are created principally for asset protection purposes and before any creditor problems exist or are threatened and where the tax planning is conservative, these cases are not negative precedents. In our experience and practice many FLPs are established principally for asset protection reasons without aggressive tax planning components, and this use of FLPs remains unaffected by recent anti-FLP cases.

With respect to tax planning oriented FLPs, over-aggressive planning in circumstances with suspicious facts have created bad precedents, but these precedents should not be read as eliminating less aggressive tax strategies with more favorable facts. So, for instance, the courts have refused favorable tax treatment of deathbed gifts made on behalf of a dying taxpayer in a coma by his attorney-in-fact under a general power of attorney which did not expressly authorize gifts, where assets of huge value constituting most of the coma victim=s net worth were transferred into an FLP, where most of the limited partnership interests were then given away to family members, and where the victim=s home in which he continued to live rent-free was included in the FLP. I think any of us can understand how a court might find such a scenario to fail the Asmell test.@

At the other extreme, if a retiring owner of a closely-held business contributed its stock to an FLP, and gave each of 4 sons working in the business a 15% interest as limited partner, and created an LLC to serve as General Partner in which LLC he and each of 4 sons owned 20%, we see no reason why substantial discounts on the partnership interests given, even in the range of 35%, could not be taken.

Fred was quoted in a Wall Street Journal article on tax developments in family limited partnerships in December 2003, and we can send you a copy of the article if you are interested.

A Word on Asset Protection

ERISA assets -- 401(k)s, pensions and profit-sharing plans, but not necessarily IRAs and Keoghs -- are exempt from claims of creditors. Tenants by the entirety assets held by husband and wife -- a home or liquid investment assets held in brokerage or mutual fund or investment management accounts -- are immune from claims of creditors of one spouse. But if the possible claim could come against both spouses, or if the owner of real estate or investment assets is single or if he is married but must keep the assets in his or her own name, an FLP may be a way to afford asset protection.

On our website are two very comprehensive outlines Fred has presented to lawyers all over the country, one on domestic asset protection strategies, one on offshore asset protection trusts.

Evaluation of Your Existing Estate Plan

The dramatic increase in the estate tax exemption -- it is $2 million per individual as of January 1, 2006, whereas it was $675,000 per individual in 2001 -- may distort many estate plans in unacceptable ways. For example, the tax planning may unnecessarily Aswallow@ the estate plan. For a decade or more wills and revocable trusts for upper middle class couples have had a Family Trust (sometimes the documents called this a AResiduary Trust@) and a Marital Share. The Family Trust has normally been defined in a formula based on the size of the exemption at death. Consider that for our clients with such documents -- and there are hundreds of you -- the Family Trust has grown from $675,000 in 2001 to $2 million in 2006.

That should not be a problem, in fact it is a great thing, for the very wealthy, with combined estates over $5

million. It also should not be a problem for husbands and wives whose assets in their own names or revocable trust names and payable to their estates and their revocable trusts (e.g., life insurance) do not exceed an amount they are comfortable putting into a tax planning Family or Residuary Trust. These trusts, intended to take advantage of the estate tax exemption of the first spouse to die, are normally drafted as discretionary trusts for the benefit of the spouse (as a first priority) and children, and maybe grandchildren (as a second priority). But if husband or wife have $1.5 million - $2 million of assets in their own name or own trust name, all will go into trust for the surviving spouse now, whereas only $675,000 would have through 2001. Is that a problem? It should not be, as our tax-planning trusts are generally drafted to permit any or all principal to be distributed to the surviving spouse outright at the independent Trustee=s discretion (and normally the spouse may discharge the independent Trustee). So if too much in the way of assets passes in trust for the surviving spouse (however and whatever the surviving spouse defines Atoo much@), that problem may be cured after the first spouse dies by retaining an appropriate amount in the trust and distributing the balance outright to the surviving spouse.

On the other hand, the expanding exemptions have given many of our clients the opportunity to simplify their estate plans and to set up trusts at the first spouse=s death only if needed and as needed to save taxes, with the determination being made by the surviving spouse at the first spouse=s death. This approach uses a so-called ADisclaimer Trust@ to create this stand-by tax planning. The Wall Street Journal published an article in July, 2004 citing the growing popularity of this approach. We can send you a copy of this article if you like.

The question of what estate plan is right for a married couple has gotten more complex and nuanced, and impossible to generalize about. We can help you rethink your plan if we have updated information on your family, goals and net worth (what is in each name, what is joint). Couples with net worth under $4 million, and particularly couples who have no children of prior marriages and expect to die with combined net worth of under $2 million (including life insurance and pensions), and who feel their estate plans are overly complicated, may be able to simplify them considerably. If you would like us to evaluate the efficacy of your estate plan under the current tax law, please call Sherry Burford at our office at (703) 288-0119 to make arrangements. We have a program with a modest fixed fee whereby we will evaluate your existing documents, updated family and financial information, meet with you to discuss the issues, and make a written recommendation. If you decide to have new documents prepared, we will apply the fee in full to the cost of the new documents.

EXCERPTS FROM 2001 NEWSLETTER

On November 1, 2000 we celebrated the Third Anniversary of the founding of our firm. But we have some 40 years of experience in estates and trusts, tax planning and closely-held business matters. We are committed to writing our clients and friends at least once a year to bring you up to date on any important changes in the law, and specific estate planning ideas we think might be of particular interest.

Gift Tax

The gift tax rate brackets are the same as the estate tax rate brackets, so the 2001 Act reduces the gift tax rate between 2002 and 2009. But the 2001 Act caps the gift tax exemption at $1 million, without the additional increases after 2003 scheduled for the estate tax (and generation-skipping tax -- see below). Interestingly, after 2010 a gift tax remains on lifetime transfers (other than to spouses or charity or within the $10,000 annual per donee gift tax exclusion) to discourage transfers to lower income beneficiaries in order to minimize capital gains taxes. As of 2010, if the estate tax is actually repealed, the top gift tax rate bracket will be adjusted to the same rate as the top individual income tax rate.

Complex New Rules on Income Tax Basis of Inherited Assets

Under the old law all inherited assets receive a complete step-up in income tax basis to date of death value. This will remain the law through 2009 at least. Under the new law, but only when the estate tax is fully phased out in 2010 (if it ever is -- see below), an estate generally will be permitted to have an asset base of $1.3 million that will be

stepped up to fair market value. (The $1.3 million may be increased by net operating loss and capital loss carryovers of the decedent unused at death.) Transfers to a surviving spouse will be entitled to the stepped-up basis to the extent of an additional $3 million ($4.3 million total).

NOTE. Such a new carryover basis regime would impose incredible record keeping obligations and tax complexity, but these issues will only arise if, as and when the estate tax is completely eliminated. It would obviously be ludicrous to impose this regime for a one-year window and then reimpose estate tax, a fact which strongly suggests that even Congress does not expect this scenario to come to pass.

State Death Tax Credit. Under present law estates generally are entitled to a dollar-for-dollar credit against the federal estate tax for any state death tax paid. The 2001 Act eliminates the state death tax credit with respect to estates of decedents dying after 2004, and reduces the allowable credit by 25% for estates of decedents dying in 2002, by 50% for estates of decedents dying in 2003, and by 75% for those dying in 2004. After 2004 an estate would be allowed a deduction for state death taxes rather than a credit. This will have the effect of increasing federal estate tax, but not materially.

Query. Today most states have an estate tax that is equal to the credit for state death taxes afforded for federal estate tax purposes. As this credit is phased out, estate tax revenue for these states is being phased out, and states will lose billions of dollars of tax revenues. Will not many states substitute new inheritance taxes as a replacement, which will, in effect, reimpose some of the estate tax the federal government has eliminated? Will not this development administratively complicate both estate planning and estate administration?

Generation-Skipping Transfer (AGST@) Tax Simplification. The 2001 Act for the first time ties the size of the GST tax exemption to the estate tax exemption. The GST exemption will remain at current amounts ($1,060,000 for 2001, subject to increases for inflation in 2002 and 2003) until 2004. The GST tax exemption will then increase with the estate tax exemption to $1.5 million in 2004, $2 million in 2006, and $3.5 million in 2009. The tax rate on GST transfers is the top federal estate tax rate and is reduced on the same schedule as the top estate tax rate diminishes. The 2001 Act makes it easier to allocate the GST tax exemption to certain transfers. This should reduce the complexity of reporting GST transfers on federal gift tax returns. This coordination of the estate and GST tax exemptions is a welcome simplification which will make estate planning documents and trust administration less complex for high net worth individuals, and it reflects a significant expansion of this important tax savings opportunity for such taxpayers.

WHAT DO THE ESTATE TAX CHANGES MEAN FOR YOUR ESTATE PLAN?

Issues That Cause Concern

X **The Expanded Exemption Will Distort Some Existing Estate Plans** -- Many married couples with a combined net worth of $1-4 million have two-share estate plans in their wills or revocable trusts. In such plans one share, often held in trust, is for the benefit of the children and frequently also for the surviving spouse for life, and takes advantage of the estate tax exemption, whatever it is. This share is referred to as the Family Trust, or as the Acredit shelter trust (or share)@ or Abypass trust (or share).@ And the other share, the AMarital Share,@ representing the balance of the estate above the exemption, is exclusively for the benefit of the surviving spouse, either outright or in trust. For many clients the formula language in their existing documents, in taking maximum advantage of the estate tax exemption as it expands to $3.5 million will eventually direct their entire estates into the Family Trust Share, with nothing left for the Marital Share. The Family Trust Share is often discretionary, with all distribution decisions made by an Independent Trustee. While this outcome is fine from a tax planning point of view, it may be impractical and unnecessary. Surviving spouses may be distressed to have no absolute right to income or principal from this share. This scenario may cause tension between surviving spouses and decedents= children and may make the Independent Trustee=s responsibilities to arbitrate between the needs of spouse and children burdensome and tense in some cases.

As a counterpoint it should be recalled that formula clauses in wills or revocable trusts do not control a couple=s joint property (such as homes, bank and brokerage and mutual fund accounts), which automatically passes outright to the surviving spouse. These formula clauses also do not control retirement plans and life insurance, which typically pass to the surviving spouse by virtue of beneficiary designation. So one way to control this problem of the expanding exemption sending too much property to the Family Trust is to hold more property in joint names and/or to pass more property to the surviving spouse by beneficiary designation.

X For Many People Tax Planning Will No Longer Be Necessary in Their Estate Plans -- To the extent that married couples may prefer to simplify their estate plans, this will be possible without adverse tax consequences for many people. As the exemption expands, one exemption may be sufficient to cover the combined estates of many couples, so that each may leave his or her entire estate outright to the surviving spouse, counting on the survivor=s exemption to shelter the entire combined estate from taxation at the surviving spouse=s death. Obviously in the Washington area few couples expect to have combined assets at death under $2 million or $3.5 million. But thoughtful reflection suggests that this simplistic approach may carry unacceptable risks and problems for many couples, for instance if your spouse is not the parent of all of your children, or has other children from a prior marriage, you might not want to rely on your spouse to dispose of your property as you would;

X moreover, your spouse could remarry and may want to leave your property to a subsequent spouse or afterborn children of another marriage.

A simple approach might be suitable for older couples in long-term, stable marriages with all children born of that marriage. But even in that case there is a risk of remarriage of the widow/widower in old age and an improvident disposition of the family=s assets influenced by the new spouse=s pressure on a physically, mentally or emotionally weak surviving spouse.

Elimination of estate tax considerations will not necessarily simplify estate plans.

Estate Planning Options May Become More Complex, Creative and Sophisticated, Not Simpler -- Under the old transfer tax system neither lawyers nor clients had much flexibility. To a great extent the tax law dictated strict parameters for the estate plan. There was limited room for creativity or innovation by clients or lawyers. With much larger estate tax exemptions and possible eventual elimination of the estate tax, clients and lawyers will now have much greater opportunity for creativity and customization.

The Elimination of Estate Tax Considerations Will Not Make Trusts Less Common in Estate Planning Documents

X The benefits of revocable trusts have never had anything to do with tax planning, and they will remain as desirable as they have been

- to avoid probate
- for confidentiality of the nature and extent of the client=s assets and the client=s dispositive plan
- to provide an efficient means of managing the client=s assets in the event of long-term disability.

- X Trusts will still be required for minor and disabled children, and for older children until they reach a suitable age or become responsible. The terms of the trust will continue to depend not on tax law but on the child=s character, capacity and maturity, the parents= values, the nature and worth of the assets in the trust, and concerns about potential claims against the child from future creditors or spouses.
- X Trusts will still be required for a surviving spouse

  - who is not the parent of all of the decedent=s children, to attempt to preserve trust assets for the decedent=s children at the surviving spouse=s death;

  - who has children of his or her own who are not children of the decedent, for the same reason;

  - who does not have the desire or ability to manage money for himself or herself;
  - if it is desirable to make assets available to the spouse but not susceptible to claims of the spouse=s current or prospective future creditors;

  - if there is concern the spouse could remarry and divert funds away from the decedent=s family at the surviving spouse=s death.

- X Trusts will still be required to provide for grandchildren and subsequent generations of descendants

  - whether there is a generation-skipping transfer tax or not, clients will want to make provision for their grandchildren (beyond UTMA custodial accounts or state tuition programs under Internal Revenue Code '529).

  - Such trusts may be structured to make funds available for the client=s spouse and/or children and/or grandchildren for as long as spouse and children live, before vesting in grandchildren.

    - All three local jurisdictions now authorize the establishment of trusts of unlimited duration, a new concept in American law which has evolved in the past 5 years. Many clients, particularly those of high net worth, are interested in creating a family safety net or Abank@ for unlimited future generations of descendants. Obviously such trusts must be drafted with great sensitivity, sophistication and forethought regarding claims of potential future creditors and spouses.

Life Insurance Will Continue to Be An Important Component of Many Estate Plans Even if Estate Tax Considerations Are Eliminated -- Recognizing that the reduction or elimination of estate tax will reduce liquidity requirements for many estates, and may result in a reduction in the need for life insurance to create liquidity, life insurance will continue to meet important needs for

- X parents with young children who face heavy financial obligations to raise and educate those children and who do not have current assets to provide for them in the event of untimely death;

- X parents of disabled children who have inadequate current resources to provide lifetime care and support;

- X spousal support if the spouse with high current and potential income dies prematurely and the surviving spouse would otherwise face an abrupt and unpleasant lifestyle adjustment;

- owners of illiquid assets which might be difficult for their family to sell promptly and advantageously in the event of untimely death in a difficult economic environment. Examples of illiquid assets: real estate, closely-held business and investment interests, concentrated stock positions;

- co-owners of closely-held business interests, to facilitate buy-out of deceased co-owner=s interest.

Given the uncertainty about the future of the estate tax and the economy, no one should be hasty about dropping existing life insurance. Future developments, for instance unexpected growth in the value of the estate and/or continuation of the estate tax with an exemption limited to an amount less than presently scheduled, may increase future liquidity demands. The client=s health could deteriorate, making insurance impossible to obtain or exorbitantly expensive. It may be wiser to borrow against an apparently unnecessary policy to decrease the coverage but keep it available as a means to free liquid assets for other investments.

SOME ESTATE PLANNING APPROACHES TO BE CONSIDERED

Leave Everything Outright to a Surviving Spouse, With a Power to Disclaim Any Portion of the Spousal Share into a Family Trust/Credit Shelter/Bypass Trust to Take Advantage of Some or All of Estate Tax Exemption of First Spouse to Die -- Since none of us knows when he or she is going to die or what the estate tax exemption will be at death, whether $2 million or $3.5 million or whether there will be no estate tax, it is difficult to know how much of our exemptions we would need or want to take advantage of. To address this uncertainty, one possibility is to leave the entire estate and the planning to the surviving spouse, who will be able to take a Asecond look@ and make a prudent decision based on his or her circumstances and the circumstances of children and grandchildren and the tax law as it exists when the first spouse dies. Under this plan the surviving spouse would consult with a sophisticated lawyer (and possibly an accountant or financial planner) immediately after the first spouse=s death and carefully consider (a) the size of the decedent=s estate, (b) the value of the survivor=s own assets, including survivorship joint property and retirement plans and life insurance received on account of the first spouse=s death, (c) the size of the estate tax exemption then in effect, if the estate tax still exists, and (d) the financial needs of the surviving spouse and of children and grandchildren. Based on an evaluation of the foregoing factors and with prompt, appropriate professional advice, the surviving spouse would have the opportunity to renounce or disclaim some or even all of the inheritance from the decedent by timely filing of a written disclaimer in probate court or with the custodian of any nonprobate assets. This will permit the disclaimed portion to pass in trust for the surviving spouse and descendants for the spouse=s life and, because it is sheltered from estate tax by the predeceasing spouse=s exemption, to subsequently pass tax-free to descendants at the death of the surviving spouse. It may even be possible to disclaim joint property, life insurance and retirement benefits, permitting such assets to pass in trust instead.

PROBLEM: This technique relies on the surviving spouse=s engaging sophisticated advisors and making a prompt and prudent decision shortly after the spouse dies, the very time at which the survivor may be least able to make a thoughtful, dispassionate decision. The surviving spouse could be old or incompetent, could fail to obtain suitable advisors, could remarry, have more children, fall out with her own children, and should any of those things happen, planning that seemed good on paper could go awry. In any event this outright-gift-to-spouse-with-disclaimer-trust approach is probably most appropriate in situations of long-term, one-marriage families where both spouses are diligent and sophisticated and the assets are not so large that more elaborate planning is justified, for instance where family assets do not exceed $1-2 million or so.

Limit the Size of the Family/Credit Shelter/Bypass Trust -- The size of the family=s assets and the goals of the spouses may dictate that the share segregated to take advantage of the first spouse=s exemption should not in any event exceed a certain dollar amount. For instance, even if the estate exemption at the death of the first spouse is $3.5 million, his will or trust might limit the family trust to Ano more than $2.5 million@ because the family=s total assets are only $4-5 million.

PROBLEM: The family=s assets might grow or shrink materially and the decedent=s estate planning documents

might not have been updated or modified to reflect any change in his or her economic status, in which case available and needed estate tax exemption of the first spouse to die might either be wasted or overused. This problem could be addressed by vigilant monitoring of the family=s assets and a commitment to modify and update the estate planning documents as circumstances change.

Alternate Estate Plan Depending on Whether There Is or Is Not An Estate Tax at Client=s Death -- Some clients may want to have different dispositive plans depending on whether there is or is not an estate tax when they die. For instance, generation-skipping planning involving a long-term trust for grandchildren may not be important to a client whose children are unlikely to be subjected to estate tax.

Free of estate tax considerations, clients will need to give careful consideration to their non-tax objectives.

Because alternative estate plans would make documents even more complex than under prior law, instead it may be appropriate to consider giving a trustee or Atrust advisor@ the right to modify or terminate a trust created to reduce estate and GST taxes if the taxes are repealed or substantially modified.

Ideally a client should attempt to establish an estate plan that will work whatever the level of the estate tax exemption and whether the estate tax is ultimately repealed or not, but we recognize that in some circumstances that may not be possible, and in those cases the client and attorney will have to commit themselves to periodic reevaluation of the estate plan in light of changing circumstances.

EXISTING ESTATE PLANS FOR HIGHER NET WORTH INDIVIDUALS MAY REQUIRE NO CHANGES, BUT THERE ARE SUBSTANTIAL NEW OPPORTUNITIES

High net worth individuals, with assets in excess of $5 million to $10 million, who have current estate plans which take maximum advantage of the estate tax exemption and the GST tax exemption, will be happy to see $2 million or $3.5 million sheltered from estate tax in each estate and to see the same amount eligible to be put in GST Trusts for their children and grandchildren, passing free of tax no matter how large such trusts grow to grandchildren at the death of their children. Such clients will not want to undo this sound planning for fear of dying before the estate tax and GST tax are abolished. Having said that, for estates of that size, a review of the estate plan in light of the new law is certainly advisable.

The expansion of the estate tax exemptions and GST tax exemption for such clients may be more important than it appears, because there are several techniques for leveraging these exemptions and multiplying their effect by 10 or 20 times, so a scheduled $1.3-2.8 million increase in the exemptions could translate to a $10-20 million estate tax savings opportunity and even greater savings through GST planning.

IMPACT ON CHARITABLE GIVING

Charitable remainder trusts will remain useful as a diversification strategy for concentrated positions, to create liquidity and cash flow and avoid capital gains tax. Creation and funding of private foundations will continue to be an attractive means of obtaining substantial income tax deductions, avoiding capital gains tax on highly appreciated assets, and retaining control of the assets for use in highly customized charitable endeavors.

We believe the elimination of the estate tax would impact on testamentary charitable giving, but because we believe the estate tax will never be eliminated, we believe gifts to charitable lead trusts to radically reduce or even eliminate the estate tax for high net worth

individuals will remain popular, because most or all of the principal donated will eventually return to the family tax free. We also believe that testamentary gifts to private foundations or advised funds with community foundations, outright or in charitable lead trust form, will continue to be popular with clients desiring to establish customized charitable legacies memorializing the client=s name.

DO NOT COUNT ON THE END OF ESTATE TAX FOREVER

As many commentators have noted, it is by no means certain that the estate tax will quietly phase out of existence in 2010. In fact, unless Congress acts, the estate tax is scheduled to return in 2011. Consider that if we have an unexpected severe recession or budget crisis between now and 2011, even the expansion of the exemption could be frozen by a future Congress before fully phased in.

X The estate tax has been abolished and reinstated several times in the past.
X There will be two Presidential elections between now and 2010.
X There will be five Congressional elections between now and 2010.

While there is broad political support in both parties for raising the exemption, there is fierce opposition, especially but not only in the Democratic party, to the elimination of the estate tax on the very wealthy, who in 2010 are likely to represent 1 in 500 voters but who will by then pay some $50 billion per year in estate tax if the tax is retained. Consider that in 2010 the first wave of baby boomers will be reaching age 65 and looking forward to receiving medicare, medicaid and social security and prescription drug benefits. Watching the Congressional proceedings one had the sense that both parties recognized that the total elimination of estate tax will confront at least one more battle to be fought another day. Future economic conditions and federal budget surpluses or deficits will impact the final resolution of that issue.

On May 21, 2003 The Washington Post made this point:

ASome lawmakers and experts say it is nonsensical for the 107th Congress to dictate tax changes so far in the future. >Do you really think the 110th Congress, when they sit down, looking at a $100 billion budget hole we are leaving them on the estate tax,= will follow this path, asked Rep. Charles w. Stenholm (D-Tex). >It=s ridiculous.=@

SUMMARY

We do not believe the federal estate tax will ever be eliminated, and we advise clients to plan their estates on the basis of that assumption. We believe clients may count on the expansion of the estate tax and GST tax exemption to $2 million, but even the expansion from $2 million to $3.5 million in 2009 should not be relied upon. It is noteworthy that this final expansion is not scheduled to occur until after the 2008 elections. For optimistic high net worth clients for whom it is appropriate we are happy to prepare estate planning documents with alternative contingency planning in case the estate tax does or does not eventually disappear.

Despite political promises of dramatic, immediate change and relief, the final form of the tax changes works a relative modest, subtle, incremental change in the system, not a radical one, at least through 2008. It is our view that the vagaries of future political forces and economic conditions make it perilous to project the tax law beyond 2008. Clients with estates under $2 million have somewhat more leeway to either simplify or complicate their estate plans, as they prefer, and their estate tax burden has been eliminated if they plan carefully. Couples with estates of $2-5 million, and clients whose estates may be expected to grow into that range before they die, will appreciate the scheduled reduction of estate tax, but will need to plan carefully, in a fashion quite similar to what was required under prior law, to be certain not to waste the estate tax

exemption of the first to die. Clients who expect to have estates in excess of $5 million would be well advised not to assume the estate tax will ever be eliminated, but should welcome the expanded exemptions and more generous tax savings opportunities which have been made available to them. The tax reduction strategies useful to such clients under prior law have continued utility and expanded vitality.

We believe that the only sensible way to plan a client=s estate is to be sure it is effective if the client dies unexpectedly tomorrow.

Circumstances will normally permit flexibility to be built into an estate plan so that it will still work if and when the estate tax exemption expands, assuming there are no material changes to the family situation or assets. But if there is a significant change in net worth or the circumstances of any family member, it will be necessary to reevaluate the plan in the future.

PROTECTING FAMILY ASSETS FROM CREDITORS AND OTHER PREDATORS IN A VOLATILE ECONOMY

Baltimore owners of a business Atransferred tens of millions in assets into offshore accounts (actually a Cook Island Asset Protection Trust) on the day they entered into arbitration with Bank of America over a defaulted $17 million promissory note.@ This arbitration followed a year-long court battle over a default in payment of the note that occurred in May, 2000.

What is wrong with this picture? What the debtor did appears to be a blatant fraudulent conveyance under applicable U.S. and Maryland law, i.e., a transfer undertaken with intent to hinder, delay or defraud an existing creditor. If the transfer had been made to a U.S. trust or other U. S. transferee, U. S. courts would have had the authority to set aside the transfer and order reconveyance to the creditor. As a U. S. court has no jurisdiction over a Cook Island trust, the court=s only remedy may be to hold the debtors in contempt of court, which other U. S. courts in similar circumstances have done. And the creditor would have no recourse but to employ local counsel in the Cook Islands and pursue a claim of fraudulent conveyance under that country=s trust laws, which would require a proof of fraud beyond a reasonable doubt, i.e., meeting the burdens of proof reserved for criminal cases in the U.S. While the debtor=s strategy has worked for the moment, frustrating the U. S. courts and the creditor, it is by no means clear that it will work in the long run. And the debtor certainly risks imprisonment for contempt of court.

Now let=s consider another scenario. An owner of a closely-held business agrees to sell the stock of his company to a larger, possibly publicly-traded company in exchange for cash and maybe some stock of the acquiring company. The seller is concerned for whatever reason that the new owner will not enjoy the financial results from the acquired company that it is expecting and will blame the seller. Perhaps the buyer does not fully understand the seller=s business, perhaps the seller anticipates adverse macro- or microeconomic factors which the buyer does not, perhaps the buyer is simply not as good a manager. The seller believes, human nature being what it is, the buyer will not blame itself; rather the buyer will seek a scapegoat - - the seller. The seller is worried that the buyer will instruct his attorneys to scrutinize the 20 pages of warranties and representations made by the seller in the contract in order to develop a theory that the seller breached one or more. The buyer will seek to recover the cash he paid the seller which it believes is undoubtedly sitting in the seller=s brokerage account.

How could the seller of the closely-held stock handle his planning more artfully than the Baltimore deadbeats? A cautious, prudent client advised by a lawyer experienced with asset protection strategies would have considered the following issues:

Χ We live in a litigious society. The average American will be sued 5 times.

- X Asset protection is best done early, before the debt is entered into (or act triggering the liability occurs) if possible, but certainly as long as possible before the debt is in default or the liability matures, in contemplation of the risk that something unexpectedly might happen to cause default or liability. Asset protection planning and frantic transfers after the liability is mature and apparent are clumsy at best, ineffective and fraudulent at worst. If stock has been sold subject to representations and warranties, protection for the proceeds received should be undertaken immediately, before there is a hint of a complaint.

- X Transfers made with an eye on potential future liability are best defended from claims of fraud if they may be justified by some Abusiness purpose@ that has nothing to do with asset protection planning. Examples of such a business purpose might be estate tax planning, income tax planning, financial planning, probate avoidance planning. The protection strategy should document this business purpose - - not asset protection -- as the principal motivating force of the transaction undertaken.

- X Certain assets may be retained by the nervous party, possibly with his or her spouse, without fear that they may be lost to potential future creditors. Examples are certain types of retirement plan assets and property held in a certain form of joint ownership by husband and wife when the potential claim is against only one spouse. It is frequently effective and more subtle to Auglify@ and retain an asset rather than to convey it.

- X Subtlety and artfulness are desirable and rewarded. Greed and overreaching will be punished. Hogs get fat, pigs get slaughtered. Do not be a pig.

- X Offshore trusts generally are not worth considering for sums less than $500,000. - 1 million. For larger sums a thoughtfully established offshore trust may be remarkably effective in frustrating creditor claims. The settlor of that trust may retain indirect control of the trust and be a beneficiary of his own trust, even while his creditors are denied access to the trust funds.

- X Bankruptcy exemptions are generally narrow, and pending changes to the law will make them even narrower. Bankruptcy trustees are authorized and encouraged to examine for fraud transfers by the debtor within one year of the filing for bankruptcy. Creditors on their own may challenge earlier transfers as fraudulent.

- X The selection of appropriate asset protection strategies, domestic and foreign, for a specific client will require a close examination of the details of the family situation and balance sheet and an evaluation of the client=s psychological comfort level with more aggressive approaches.

- X No strategy should be adopted which will be regretted if the potential creditor problem does not arise.

- X Family partnerships may have unique combined benefits of estate and gift tax savings, creditors protection and retention of control.

- X Good basic and umbrella liability insurance is frequently the best way to protect against unexpected liabilities.

- X Life insurance placed in an irrevocable trust may be an excellent vehicle within which to accumulate funds for the family free of creditor claims.

- X Beware of inheriting assets at a time when you have exposure to creditors. A potential debtor should work with parents and grandparents and their lawyers to finesse this scenario.

- X Sometimes the potential future creditor is a spouse in a possible future divorce property settlement, a matter which requires great delicacy and special planning.

- X Sometimes the potential future creditors about whom there is concern are those of a spouse or children the principal wants to benefit, and it is possible through special trusts to make assets available to family members but inaccessible to their creditors (including their spouses.)

- X Generally there is no strategy which will thwart the IRS as a creditor for taxes due. Pay your taxes.

- X We are posting on our website two comprehensive outlines on domestic and offshore strategies for asset protection.

EXCERPTS FROM 2000 NEWSLETTER

Charitable Giving Using a Community Foundation

Too few people understand the benefits and flexibility available for charitable gifts through a Community Foundation. I was initially attracted to involvement with the Community Foundation years ago when I understood how helpful it could be to my clients.

A community foundation is a public charity, so gifts to it receive the most favorable income, gift and estate tax benefits that are available. Gifts to private foundations are not entitled to equally favorable tax treatment. The Community Foundation is an umbrella charity funneling money to other charities in the community, as its constituency of donors wants and directs. We administer numerous funds established by individual and corporate donors, each of which has the unique charitable focus and objective selected by the donor. Donors have it their way. The donor can even recommend the investment manager for his or her fund.

Anything you can do with any other public charity -- gift of appreciated stock, charitable remainder trust, charitable lead trust -- you can do with a community foundation.

The Northern Virginia Community Foundation serves those who live and work in Northern Virginia, but it can distribute funds to charitable organizations throughout the Metro region and even outside of our area. If you want to discuss ways in which you could use the Northern Virginia Community Foundation to accomplish your philanthropic objectives, call or e-mail me or contact the Executive Director Eileen Ellsworth at NVCF at (703) 902-3159, or e-mail ellsworth_eileen@bah.com.

Charitable Gifts of Interests in Land

Often landowners wish to make a charitable contribution of real estate. While these gifts can be advantageous for both the donor and the charitable beneficiary, environmental laws, tax laws and the nature of real estate itself can make such gifts more complicated than either a donor or the beneficiary might, at first, suppose.

Gifts of real property interests can be considered in two broad categories. The first comprises gifts made to

beneficiaries that will use the land directly in the accomplishment of their charitable purposes. Examples include the gift of a conservation easement to a land trust, the gift by a developer to a city or county of land to be used as a park, or the gift to a church or school of land on which to build. The second category comprises gifts made to beneficiaries that will not use the real estate directly in support of their charitable purposes, but rather would be expected to sell it and use the proceeds in their work. Not surprisingly, the second category generally poses greater difficulties, and a donor contemplating such a gift should discuss the idea with the intended beneficiary at the earliest possible time, to determine whether the plan is viable.

Because real estate is often highly appreciated, a charitable gift of real estate allows the donor to avoid recognizing gain on the appreciation; for most donors, the amount of the income tax deduction is the fair market value, subject in any year to percentage limitations based on the donor=s income. Because land, particularly undeveloped land, often produces little or no income, a donor can perhaps make a more significant gift with less impact on his or her day-to-day finances than would be possible using cash or financial assets. Finally, when the real estate will be used by the charity in its work, the donor has an opportunity to establish a tangible and lasting legacy.

The Internal Revenue Code imposes two requirements on donors that complicate the process. First, in general a donor must part with his or her entire interest. With two exceptions, gifts of less than all of the donor=s interest are not deductible. The two exceptions are a remainder interest in a personal residence and a qualified conservation interest (that is, a conservation easement). (Of course, to the extent that local law permits a particular piece of land to be subdivided, a donor can subdivide and properly claim a deduction for a gift of all of one of the resulting parcels, while retaining the other.) Thus, while landowner can legally rent out real estate for a particular term, that same landowner cannot claim a charitable deduction for allowing a charity rent-free use of the property. The second requirement is that the value must be substantiated by a Aqualified appraisal@ as that term is defined in Treasury Regulations, with an appraisal summary on IRS Form 8283 attached to the donor=s return. A valuable and otherwise valid deduction can be lost by a failure to comply carefully with the substantiation requirements.

From the perspective of the charity, disadvantages and risks in some cases outweigh benefits. Federal and state environmental laws impose liability on owners of contaminated land, regardless of whether the owner contributed to the contamination. Charities that receive gifts of land are not protected from this liability. There are more than a few cases where unscrupulous donors have attempted to foist off on a charity property they knew to be contaminated, and more occasions where scrupulous donors have done so unwittingly. Charities have been forced to become increasingly sophisticated and increasingly wary about accepting gifts of real estate. So-called Aphase 1" environmental audits that review public records and visually inspect the land have become as standard with charitable gifts of land as they are in commercial real estate transactions; if the Aphase 1" study uncovers evidence of potential contamination, a considerably more expensive Aphase 2" examination analyzes soil and water samples to determine the existence, nature and probable quantity of contamination. While some charitable beneficiaries that routinely deal in land -- for example, federal or state agencies such as the United States Fish and Wildlife Service, the United States Forest Service or the National Park Service -- have the expertise and systems to perform Aphase 1" audits in house, most charities must contract for such services, and a donor may be expected to bear some or all of the cost.

The nature of real estate itself poses problems to a donee. Real estate is illiquid and the market for it is local--unlike securities that trade on a national market or portable tangible personal property that can be transported--and a booming market in one locale is cold comfort to a charity trying to sell land in the face of slack demand where the real estate is located. Transaction costs in selling real estate are relatively high. Land can be expensive to maintain. Buildings must be insured against casualty loss and some minimal utilities must be provided simply to protect, market or use the building. Vandalism is always a risk; standing timber or growing crops must be guarded against theft, and vacant land invites dumping that can range from the unsightly to hazardous and toxic wastes. Landowners may be liable to persons who are injured on their land, even if the person is a trespasser. Real estate owned by charities and used for the charitable purpose is typically exempt from local ad valorem taxation, but many states do not exempt land owned by a charity but held for investment or resale.

Obviously, given enough value in the gift, and enough time, all of the stumbling blocks that a charity may perceive can be overcome, but a donor should not be surprised when an art museum is less than enthusiastic about a gift of the old factory site.

Several strategies, however, remain exceptionally valuable in the right circumstances. Conservation easements to protect land that has natural, scenic or open space value achieve important conservation objectives, provide significant income tax and estate planning benefits and allow the landowner to continue to use the land in ways that are consistent with the conservation objectives. Charitable remainder trusts funded with contributions of land offer an avenue for giving that may permit the donor to convert an appreciated but low-yielding asset into a higher income stream, without recognizing capital gains, and substantially benefit a charity without the problems that the outright gift may entail. A recent favorable ruling by the IRS on a proposal by a company that markets real estate investment trusts (REITs) also offers promise for donors wishing to use real estate to make a gift to a charity that otherwise would find it difficult or impossible to accept such a gift.

Because of the complexity surrounding gifts of real property, professional counsel is essential. We will be happy to discuss possibilities with you.

Succession Planning for Family-Owned and Closely-Held Corporations

Eighty-seven percent of family-owned businesses do not survive the second generation. Closely-held businesses often fail as a consequence of the death of one of the founding owners or the changes in the relationships among owners that inevitably occur over time. There are many reasons, of course, why these businesses fail. Structural changes in the economy or changes in the market may make the business obsolete or uncompetitive. There may simply be no interest among the survivors in continuing the business. Sometimes the business must be sold, perhaps at a Afire sale@ price, to provide liquidity to pay estate taxes when a shareholder dies. On occasion the relationships among owners becomes so acrimonious that effective management is impossible. Enthusiastic and capable younger family members or non-family members may be excluded from ownership; uninterested or unprepared family members may find themselves with control. Sound legal planning increases the probability that your business will survive.

The starting point for succession and management planning is establishment of clearly defined, easy to administer procedures to deal with changes in ownership, coupled, where necessary, with insurance or other sources of liquidity. Because partnership law has traditionally provided that a partnership terminates on the death or resignation of a partner and a partner=s capital account provides at least some mechanism for valuing the interest of a deceased or resigning partner, some of these mechanisms or protections are, or can easily be, be written into a partnership agreement. As multiple-party limited liability companies (LLCs) are treated for tax and many other purposes as partnerships, the same approaches normally apply. The equivalent to a partnership agreement for an LLC is an operating agreement. In contrast, for corporations the general rules are that shares of stock are freely transferable and the existence of the corporation is independent of the identity of the shareholders. Thus, the best practice for businesses that are organized as corporations is for the shareholders to enter into a separate agreement, to which the corporation itself is often a party, that provides solutions to the ownership contingencies that family-owned or closely-held businesses face.

Variously called shareholders= agreements, buy-sell agreements or cross-purchase agreements, when properly drafted these agreements anticipate the Aunexpected@ ownership and management succession events that may destroy or damage an otherwise viable business and provide straightforward procedures and objective principles to resolve the problems.

Typically, shareholders= agreements address five situations: i) the death of a shareholder; ii) the long term disability of a shareholder; iii) the desire of a shareholder to transfer his or her interest to third parties by gift, sale or exchange; iv) the voluntary withdrawal from employment by a shareholder; and v) the involuntary termination of a shareholder=s employment. The latter three situations can be further divided--for example, an agreement may distinguish between transfers to children or other family members and transfers to Aoutsiders@ or between situations in which the shareholder is fired for cause and situations in which he or she is terminated without cause. The provisions for death and disability are often funded with insurance policies that provide the liquidity with which to purchase the shares owned by the deceased or disabled shareholder. Installment buy-outs are also frequently used to

address liquidity concerns.

Properly drafted shareholder agreements provide critical benefits to all of the parties. They provide each shareholder with some control over transfers by other shareholders, to reduce the risk that stock will be owned by persons who are unqualified or otherwise inappropriate. They help to provide liquidity to the business itself or to shareholders or their families at critical junctures to reduce the risk of forced sales, the diversion of business capital or financial hardship. They can help to establish the value of otherwise difficult to value business interests in the estate of a deceased shareholder and reduce the risk of controversy with the Internal Revenue Service. By establishing clear rules in advance, disputes among shareholders are reduced and the costs of litigation or other Aafter the fact@ dispute resolution methods are avoided. Finally, because the parties can work out the solutions in advance--before anyone knows in which role he or she will be cast when the provisions actually come into play: whether a deceased or surviving shareholder, a shareholder who wishes to sell or retire or one wishing to buy who will remain in the business, a shareholder being forced out or one who is doing the forcing, and in an atmosphere free from time pressure and crisis--there is greater opportunity for creative, cooperative problem-solving, and increased likelihood that, when all is said and done, the outcome will be regarded by all parties as fair.

The choices made in the shareholders= agreement can have significant income and estate tax consequences. In addition, the shareholders= agreement should be considered in the context of the larger estate plan, so that the agreement complements other strategies such as gifting programs, estate equalization between spouses or a plan to defer the payment of estate tax for qualifying closely held business interests over 15 years. For these reasons, it is critical that corporations and shareholders seek legal counsel to ensure that the choices made are appropriate.

Depending upon the circumstances, we may appropriately represent individual shareholders and/or corporations. If you wish to discuss these ideas in relation to your business, please call to schedule an appointment.

Grantor Retained Annuity Trust (GRAT)

A Grantor Retained Annuity Trust (GRAT) is an irrevocable trust in which the Grantor retains the right to an annuity payment for a term of years. The initial transfer of assets to the GRAT is a taxable gift, valued by subtracting the value of the Grantor=s annuity interest (determined using the IRC Section 7520 interest rate) from the full value of the assets transferred to the trust. If the Grantor dies within the trust term, the trust assets are included in his gross estate for federal estate tax purposes, but if he survives the term, the trust assets pass to the remainder beneficiaries (typically his children) without further transfer tax consequences. If the trust assets appreciate more quickly than the 7520 rate, the GRAT produces gift tax savings because the excess appreciation passes to the remainder beneficiaries free of transfer tax. A GRAT can be structured in such a way that only a nominal taxable gift will occur upon the transfer of assets to it. The annuity payouts received by the Grantor each year may be transferred to additional GRATs, which are also structured to produce only nominal gifts upon the transfer of assets. (This technique is sometimes referred to as Arolling GRATs@ or Acascading GRATs.@) A GRAT can be an excellent vehicle for transferring quickly appreciating assets to family members at a reduced gift tax cost.

Intentionally Defective Grantor Trust (IDGT)

An Intentionally Defective Grantor Trust (AIDGT@) is an irrevocable trust structured in such a way that the Grantor is treated as the trust=s Aowner@ for income tax purposes (that is, she is responsible for paying income tax on the income generated by the trust) but not for estate tax purposes. A sale by the Grantor to an IDGT can be used to produce gift tax savings similar to those produced by a GRAT. After establishing the IDGT, the Grantor sells an asset to it in exchange for a small down payment and a promissory note. The note typically pays interest only during its term, with a balloon payment of principal at the end. If the interest rate on the note is at least the applicable federal rate (AFR) under IRC Section 1274, no taxable gift occurs at the time of the sale. No capital gain is recognized on the sale because the Grantor and the IDGT are deemed to be the same Aperson@ for income tax purposes. If the trust assets appreciate faster than the interest rate on the note, the IDGT will produce gift tax savings.

Of course, IDGTs also can be used independently of this sale technique. A Grantor may establish an IDGT for the benefit of her children and/or grandchildren and then make gifts to the IDGT. The key tax benefit of an IDGT is that while the Grantor is responsible for paying taxes on the income generated by the IDGT, and these tax payments are essentially gifts to the trust, the payment of taxes is not treated as a gift for gift tax purposes. Because the trust does not pay its own income taxes, more assets accumulate faster in the trust outside of the grantor=s taxable estate.

GRATs vs. IDGTs

Since GRATs and installment sales to IDGTs are used to achieve the same objective -- gift tax savings -- the question naturally arises as to which is the superior technique. In general, a GRAT is a safe strategy, governed by specific statutory and regulatory guidelines. If the assets transferred to the GRAT appreciate more slowly than expected, the Grantor is not much worse off than if he had not created the GRAT since the GRAT probably was structured to produce only a nominal taxable gift. In a Afailed@ GRAT, little of the grantor=s unified estate and gift tax credit will be used up and wasted.

There is no specific statutory or regulatory authority governing installment sales to IDGTs, and some commentators are concerned that the IRS could take the position that such a sale is really a completed gift of the full value of the transferred property. But the majority of commentators believe this technique is safe and conservative, and it is becoming widely recommended and used. The IDGT technique does have several advantages over a GRAT. Probably the most important of these advantages is that the minimum interest rate on the IDGT note is generally lower than the 7520 rate used in valuing the gift to a GRAT, meaning that assets transferred to an IDGT can appreciate more slowly than assets transferred to a GRAT and still produce gift tax savings. Another advantage of an installment sale to an IDGT over a gift to a GRAT is that the grantor does not have to outlive the terms of the note for sale to the IDGT to be effective, whereas a grantor must outlive the term of the GRAT or the GRAT is wasted.

EXCERPTS FROM FIRST ANNUAL NEWSLETTER – 1998

GST Planning and Dynasty Trusts

The generation-skipping transfer tax (AGST@) is a supplemental transfer tax imposed in addition to the estate or gift tax on transfers to individuals deemed to be two or more generations younger than the transferor (for example, grandchildren and grandnieces or grandnephews). Each individual has a $1 million exemption from the GST tax which can be used to shelter lifetime gifts or transfers occurring at death. The GST tax rate is equal to the highest transfer tax rate in effect at the time of the transfer (currently 55%).

Because of the high rate of the GST tax and the fact that it is imposed in addition to the estate or gift tax, it is rarely advisable to make generation-skipping transfers in excess of the exempt amount. However, it is often advisable for high net worth individuals to take advantage of their $1 million GST exemptions ($2 million per couple) by transferring up to the exempt amount to a lifetime or testamentary trust for the benefit of their children for as long as they live, and at the children=s deaths tax-free to grandchildren. Such a trust is structured so that the trust assets are not included in the estates of any trust beneficiaries until they are actually distributed to the beneficiaries. If the GST exemption is properly allocated to all transfers to the trust on a gift or estate tax return, no distributions from the trust will ever be subject to GST tax no matter how large the trust grows. The longer such a trust continues, the greater the tax benefits obtained. Lifetime generation-skipping trusts are typically funded with life insurance (because applying exemption only to the premium payments will shelter the full face value of the policy from tax) or with other assets likely to increase in value.

A dynasty trust is a generation-skipping trust designed to continue for the maximum period

allowed by law. The Internal Revenue Code itself does not limit the duration of GST-exempt trusts; instead, this issue is governed by state law.

Until recently, the duration of trusts was limited in all American jurisdictions by the common law Rule Against Perpetuities (which provides that trusts must terminate within twenty-one years after the death of persons who are living at the time the trust is created) or by some statutory approximation thereof (for example, that no trust may continue for more than one hundred years). Even when limited in duration by the Rule Against Perpetuities, dynasty trusts are a very effective tax planning technique. A trust which continues for the maximum period could in many instances last for the lifetimes of the transferor=s children and grandchildren and perhaps even great-grandchildren, escaping taxation at the deaths of each intervening generation until it ultimately terminated and was distributed, perhaps to the transferor=s great-great-grandchildren.

In recent years, a few American jurisdictions, including Delaware, Alaska, and more recently Maryland and Virginia, have abolished the Rule Against Perpetuities at least for some types of trusts. It is now possible to set up a GST-exempt trust in one of those jurisdictions which could, in theory, continue forever without being subject to GST tax or estate tax at the death of any of the future trust beneficiaries. There has been speculation that Congress may someday act to limit the tax benefits of perpetual trusts, but no such legislation is currently pending. If such legislation is enacted, it is possible (although not certain) that existing perpetual trusts would be Agrandfathered.@

Qualified Personal Residence Trusts

The qualified personal residence trust (AQPRT@) is an irrevocable trust that serves to pass the grantor=s primary personal residence or secondary vacation home as a gift at less than the current fair market value to one or more beneficiaries whom he wishes to eventually own the residence.

The structure of a QPRT is actually quite straightforward, although the rather technical provisions of the trust instrument are driven by the requirements articulated by both the Internal Revenue Code and the Treasury Regulations. In a QPRT, the grantor transfers his residence to the trust for a specified period of time, during which the grantor may continue to reside in the home. The grantor treats the transfer as a gift (it is normally sheltered from gift tax by estate/gift tax exemption). Tax savings are achieved because only the current fair market value of the remainder interest of the property is valued for gift tax purposes. The calculation of the value of the remainder interest, as compared to the interest retained by the grantor takes into consideration the age of the grantor, the term of the trust, the current interest rate (for present value calculation purposes) and the fair market value of the property at the time it is transferred to the trust. Generally, the longer the trust term, the larger the value of the interest retained by the grantor and the smaller the gift tax value of the interest passed to the remainder beneficiary. For example, if the grantor is age 55 and is donating property with a fair market value of $500,000 to a QPRT that is to be terminated and the property passed to the remainder beneficiary in 10 years, the taxable gift from the grantor to the beneficiary is approximately $226,000. If the term of a QPRT established by the same 55 year old is 15 years, the gift from the grantor to the beneficiary drops to approximately $144,000. Obviously, the QPRT is a very worthwhile tool for passing property at a significantly reduced gift tax value to a beneficiary whom you wish to ultimately receive the property. It is particularly useful for an heirloom-type property that the donor hopes to keep in the family for generations. A QPRT provides even greater value for property which is expected to appreciate, as the appreciation will pass to the remainder beneficiary at the end of the trust term free of additional gift tax or use of exemption. At the end of the QPRT term there is nothing to prohibit the new owners from renting the property back to the old owners at fair rental value, but this may not be agreed before the QPRT is established.

It should be noted that if the grantor does not survive the term of the trust, the property will be brought back into the grantor=s estate for estate tax purposes. So it is important to select a term for the QPRT which the donor comfortably expects to outlive. Any gift tax paid or unified credit applied at the time

of the transfer of the property to the trust will be taken into account or reinstated in the event of a failed QPRT. Thus, the downside risk to the grantor is limited to the cost of creating the QPRT. The property still passes to the remainder beneficiary as designated in the trust instrument if the donor dies before the trust term expires.

As with any estate planning tool, each client=s situation should be considered and evaluated to insure that a QPRT is truly an appropriate plan for his or her individual needs.

If you have any questions about any of these issues, please call the author for clarification or elaboration. If you hear or read about a tax development or planning opportunity or will or trust or incapacity or other related issue that you would like to know more about, please do not hesitate to call us. We undoubtedly will have an outline or article on point in our files which we can share with you. We welcome suggestions from you as to matters you would like to have us explain and evaluate.