Estate Planning & The ABC Trust

By Mark E. Charnet

If you are in your sixties or above, chances are you have given some thought to the subject of estate planning and or charitable giving. You worked hard all of your life; raised a family paid your taxes, managed to save some money, paid taxes on that amount too and in the end, you'll probably pay taxes on what you leave behind also. It's federal law and for those of us who live in NJ, it's the law here too.

For this year, 2007, the unified credit amount is $2,000,000 per individual, if used, and NJ is $675,000. Federal tax law phases out the estate tax where it will be zero in the year 2010. As a result of this, states like NJ have uncoupled themselves from the federal system that shared a portion of the revenue with the states. In addition, when the estate tax is phased out, capital gains tax at death are phased in. This is called the elimination of the step-up in basis, which is the current law. Our government's position to fight terrorism where ever it takes us across the world, tells this author that there will most probably be a tax at death with the same degree of certainty that there is an income tax. Add to this, the fact that capital gains tax revenue over the last ten years have been severely reduced due to a three year stock market slump in the early 2000's and you have more compelling evidence that estate taxes are here to stay. By the way, under the current estate tax law, in 2011, the unified credit or exemption is reduced back to $1,000,000 and the tax bracket increases to 55%.

One thing is certain; it is very expensive to die if you have assets. A couple worth $3,000,000, of which $1,000,000 is an IRA, has a lot to lose under current law. Due to a combination of the Federal Estate tax, Federal Income tax and the NJ estate tax and NJ income tax, a $1,000,000 IRA before death may be reduced to a paltry $250,000 after death! Did you realize that? 75% shrinkage!

Can something be done to eliminate or reduce the burden of these taxes? The answer - YES! Here is one solution. **It's called an ABC trust**. Most people have an "I love you honey will". That's a will that say's I love you honey, you get everything I own when I die or vice versa. Outside of no will at all, the I love you honey will is the most popular estate plan in our country. Unfortunately, if you have a will like this it utilizes the unlimited marital deduction and moves all jointly held and individually held assets to the surviving spouse's estate tax free! A fist look might conclude that this isn't such a bad deal. However, the decedent's $2,000,000 exemption died with him resulting in a loss of $780,800 in tax savings. This scenario can be prevented by using the unified credit at the death of the first spouse and having another exemption at the death of the second spouse. Using 2007 rules, this would allow $2,000,000 to pass estate tax free to the heirs resulting in a $780,800 savings. You should be asking, "how can I arrange this for myself" and if you are worth more than the $2,000,000, "what is the most cost effective way to pay estate and income taxes at death over and above our combined $2,000,000 exemption?"

The first step in establishing an ABC trust is to find a competent estate planning attorney. An estate planning attorney doesn't practice matrimonial, contract, real estate or trial law. All they do is estate and possibly elder law. The attorney will draft the proper language in your will that creates the A + B sections that come to life when either you or your spouse come to pass. If you live in a state where probate can be expensive, a living trust with an AB provision might be the better choice.

Section C is an irrevocable life insurance trust, known in financial circles as an ILIT. The ILIT is created upon underwriting approval from a life insurance company for a policy that you applied for, in the amount of the anticipated tax that needs to be paid in the future. If married, a JLS, joint and last survivor policy would be the best option due to its reduced mortality costs, since it pays the claim at the second death when taxes are due. (Important note - insurance applied for must not indicate any specific ownership or an estate inclusion problem could exist.) The lawyer should also provide you with a Power of Attorney document, a Durable POA or Health Care Proxy and a Living Will.

Your Financial Advisor or Planner will find the best insurance company and product to meet your needs and designate ownership to the trust upon its completion. You might not like the words "life insurance", but I'll tell you what, no other product or investment can guarantee a specific amount of money at a specific time in the future, free from both income and estate taxes, like a properly owned life insurance policy. More importantly, however, is the use of leverage. For example, if the total premium paid to the trust, which in turn pays for the policy, represents $200,000 paid in over 20 years at $10,000 per year and the death benefit is $1,000,000, your leverage was 5 to one! Not only did you pay a debt with discounted dollars, they were tax-free discounted dollars.

Getting back to our original example of a $3,000,000 net worth, what percent is the annual $10,000 premium of $3,000,000? Answer - under 4 tenths of 1 percent! In other words, if the portfolio is earning 8%, after the cost of the annual gift of $10,000 to the trust, the net return is 7.67%. Paying a debt for 20 cents on the dollar is the most cost effective way to satisfy this obligation. Don't worry if your health isn't 100%. Life insurance companies have come a long way over the years in underwriting specific medical histories such as cancer, diabetes and heart disease. All of these conditions are now insurable.

In conclusion, if you have no children or motivation to pay your estate taxes with discounted dollars, may I suggest using the same concept to benefit your favorite charity or to help find a cure for a dreaded disease? If structured properly, the premiums can be deducted as an added incentive. Lastly, if the government actually does permanently repeal the estate tax, either your children or a charity will receive a windfall. With a cost of a fraction of a percent of your portfolio's return annually, wouldn't that be wonderful alternative?

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Mark E. Charnet is President and Founder of American Prosperity Group. APG is the premier Retirement and Estate Planning Franchise in the United States. Mr. Charnet has over a quarter of a century of experience in the Retirement and Estate Planning fields. Interested in a career in financial planning? Check out our website: www.APGfranchise.com