ROCKAWAY TOWNSHIP PARENTS NIGHT

ESTATE PLANNING FOR SPECIAL NEEDS

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PRESENTED BY:
JONATHAN BRESSMAN, ESQ,
LAW OFFICES OF JONATHAN BRESSMAN LLC
(973) 533-1905
www.estatelawnj.com

Jonathan Bressman, Esq. is the principal member of The Law Offices of Jonathan Bressman LLC, providing high quality, professional and caring legal services.

Jonathan Bressman is a member of the Real Property, Probate & Trust Law and the Taxation sections of the American Bar Association and the Real Property, Probate & Trust Law and Taxation section of the New Jersey State Bar Association. He is a graduate of Lehigh University with a B.A. in English and was an officer in the Sigma Tau Delta English Honorary Society. He earned his law degree from Temple University School of Law. Mr. Bressman has been a member in good standing of the New Jersey Bar since 1988.

Mr. Bressman's practice is primarily focused on estate planning and estate administration, Medicaid eligibility planning, business planning and tax matters.

Jonathan Bressman, Esq. has lectured for the New Jersey State Bar Foundation, various local organizations, schools and brokerage firms.

CAVEAT

This is an outline and explanation of some of the options available in planning your estate. The material may not apply to you, or may apply to you with important modifications. In addition, there may be areas that you need to address that this outline does not cover. The material assumes that spouses are both United States citizens. If either you or your spouse is not a United States citizen there are additional issues that need to be addressed since there are different gift tax rules and there is no federal estate tax marital deduction.

Without knowing the size of your estate, the types of assets you own, and your family situation nobody can give you proper estate planning advice.

INTRODUCTION

There is a popular book called *Everything I Needed to Know I Learned in Kindergarten*. One of the "lessons" was, if you make a mess, clean it up. You are leaving a mess for your family to clean up if you do not properly plan your estate. If you die without a Will, New Jersey statutes decide who gets your property -- you don't. There are fees that your family can avoid by having a properly prepared Will. For example, surety bond fees for your estate's administrator can be $400 or more per year. The same is true for whomever the court appoints as trustee of any assets passing to minors (under 18 years old) and whomever the court appoints as guardian for a minor.

Parents with children who have special needs have even more reason to plan their estates. The child may have greater financial needs or dependence. He or she may be less able to financially handle their inheritance, even after they are adults. The impact an inheritance may have on the child's eligibility for government and charitable programs also has to be considered. While many of the concerns are the same as with any parent planning for their child's future inheritance, each child is unique.

The "one size fits all" Will done by many attorneys may be adequate for some, but not for a family with a special needs child. The solution proposed by some attorneys is to disinherit the child, i.e. leave them nothing. This emotionally unsatisfying alternative has significant legal pitfalls and can lead to disaster.

Fortunately, there are alternatives. Nothing can replace a parent's care, love, understanding and knowledge of their child. However, with proper planning, much can be done to take care of your child, and without unduly burdening or slighting his or her siblings.

Understanding the basics of estate planning is the first step. Estate planning is getting your assets where you want after you die as efficiently as possible and with as little tax as possible. Therefore, the place to start is with taxes.

Federal Estate Tax

The federal estate tax is based on the size of your estate. The federal estate tax rates are:

Column A Taxable amount over	Column B Taxable amount not over	Column C Tax on amount in Column A	Column D Rate of tax on excess over amount in Column A (Percent)
$ 0	$ 10,000	$ 0	18
10,000	20,000	1,800	20
20,000	40,000	3,800	22
40,000	60,000	8,200	24
60,000	80,000	13,000	26
80,000	100,000	18,200	28
100,000	150,000	23,800	30
150,000	250,000	38,800	32
250,000	500,000	70,800	34
500,000	750,000	155,800	37
750,000	1,000,000	248,300	39
1,000,000	1,250,000	345,800	41
1,250,000	1,500,000	448,300	43
1,500,000	2,000,000	555,800	45
2,000,000	--------	780,800	48

The top tax rate decreases 1% each year until it is 45% in 2007.

There are three main exemptions from the federal estate tax:

(1) the marital deduction;

(2) the charitable deduction; and

(3) the federal estate tax credit.

Marital Deduction

United States estate tax law treats a husband and wife as a single economic unit. Therefore, transfers between spouses, whether during life or on death, are not taxed. There is no limit on the amount. It is, however, limited to situations where both spouses are United States citizens.

Charitable Deduction

Any property included in your estate that is required by your Will or a trust agreement to be paid to a recognized charity is deducted from your estate and therefore not subject to the federal estate tax.

Federal Estate Tax Credit

Each person has a credit against the federal estate tax of $555,800. This is referred to as the "federal estate tax credit." This credit allows you to transfer $1,500,000 worth of assets without tax, at death. The $1,500,000 is referred to as the "exemption equivalent." The exemption equivalent will increase until it is $3,500,000 in 2009. The estate tax then disappears in 2010 (replaced by a different system) and then the entire tax system is restored to what it was in 2001, and the exemption equivalent will be adjusted to $1,000,000. For 2005 through 2009, the exemption equivalent in each year will be:

Year	Exemption Equivalent
2005	$ 1,500,000
2006	2,000,000
2007	2,000,000
2008	2,000,000
2009	3,500,000

The $1,500,000 exemption amount is applied after calculating the tax on the entire estate. So if you leave $1,500,001 to people other than your spouse, of the last $1, $.45 would be paid in tax ($555,800.45 estate tax on $1,500,001 minus $555,800 estate tax credit).

For example, a married couple has $2,000,000 in assets. There Wills leave everything to each other and on the second death to their children. There is no federal estate tax on the first death because of the marital deduction. On the second death, the tax on $2,000,000 is $780,800, less the estate tax credit of $555,800, for a federal estate tax of $225,000 and leaving their children with $1,775,000. Proper planning could have reduced the taxes to zero, leaving their children the full $2,000,000. In fact, with proper planning a husband and wife can leave their heirs $3,000,000 or more without a federal estate tax in 2004.

Federal Gift Tax

There is a federal tax on all gifts taxed at the same rate as the estate tax. However, there are four major exemptions. Two are identical to estate tax exemptions: the marital and charitable deductions. Therefore, there is no gift tax on transfers between spouses and gifts to charities. One is similar to the estate tax credit. Each person has a $345,800 lifetime credit against gift taxes that allows you to give $1,000,000 in gifts over the annual exclusion before you have to pay a gift tax. However, using the credit reduces your available estate tax credit.

There is also an annual gift tax exclusion that is currently $11,000. [1] You may make a gift of cash or property up to $11,000 to each of as many individuals as you want each and every year of your life without a gift tax. This "annual gift tax" exclusion can be used to reduce estate taxes by transferring assets out of your estate prior to death. Lifetime gifts in excess of the annual gift tax exclusion will reduce the amount of the $1,000,000 gift tax credit.

[1] This amount is adjusted annually for inflation. However, the amount is rounded down to the nearest thousand so that there will be no increase until the annual inflation adjustments total 9.09% and increase the annual gift tax exclusion to $12,000.

Once the gift tax credit is used up, gift tax is paid by the person making the gift based on the estate tax rates. For example, assume you make a gift to a child in 2004 of $1,111,000. First, you apply the annual exclusion, leaving a balance of $1,100,000. Then you calculate the tax on $1,100,000, which is $386,800. Then you apply your gift tax credit of $345,800 (the gift tax on $1,000,000), leaving a federal gift tax due of $41,000. All future gifts over the annual exclusion will require you to pay a gift tax since your lifetime credit will have been used up.

Federal Generation Skipping Transfer Tax

The generation skipping transfer tax is imposed at the highest estate tax rate (currently 48%) on transfers that "skip" a generation. This tax is in addition to any estate or gift tax on the transfer. This tax is imposed if you leave assets to grandchildren (or people who are deemed to be two or more generations younger than you) when their parents are still alive.

The tax does not apply to gifts that are within the annual gift tax exclusion ($11,000 or less). Each person has an exemption from the generation skipping transfer tax. The exemption allows each individual to transfer $1,500,000 of assets, either during life or at death, without a generation skipping transfer tax.[2]

New Jersey Estate Tax

Before the tax law changes in 2001, New Jersey's estate tax was equal to the maximum allowable state death tax credit under federal law (reduced by any New Jersey Inheritance Taxes, discussed below). The credit against federal estate taxes was for any state death taxes that were paid by a decedent's estate or heirs up to a maximum amount. For example, if you had a $1,000,000 estate, the federal estate tax would have been $125,250, and the maximum state death tax credit was $33,200. Therefore, instead of writing a check to the Internal Revenue Service for

[2] The amount of the generation skipping transfer tax exemption is equal to the estate tax exemption.

$125,250, you would pay $92,050 to the IRS and $33,200 to New Jersey.

The federal tax law changes removed the state death tax credit, therefore, under New Jersey's (and almost every other state) formula, the New Jersey estate tax was reduced to zero. Faced with this loss of revenue, New Jersey (and almost every other state) changed the estate tax.

New Jersey now imposes an estate tax equal to the federal state death tax credit under the law in 2001, when the federal estate tax exemption was $675,000. In rough terms, this means that there is a New Jersey estate tax of approximately 10% on all estates over $675,000 (after applying the marital and charitable deductions).

New Jersey Inheritance Tax

The New Jersey Inheritance Tax is based on the relationship of the person receiving the inheritance to the decedent.

Class A beneficiaries: There is no tax on spouses, domestic partners, issue (children, grandchildren, great grandchildren, etc.), and lineal ancestors (parents, grandparents, great grandparents). There is also no tax on property passing to charities.

Class C beneficiaries: Siblings, daughters-in-law and sons-in-law have a $25,000 exemption. Above that amount, the tax rate starts at 11% and goes up to 17%.

Class D beneficiaries: Everyone else is a Class D beneficiary. If a Class D beneficiary is left less than $500 there is no tax. If a Class D beneficiary is left more than $500 the entire amount is taxed at rates starting at 15% and going up to 16%. For example, a Class D beneficiary inheriting $499 receives $499 (no tax). A Class D beneficiary inheriting $500 receives $425 ($500 times 15% equals $75 tax).

THE FIDUCIARIES

The next step in planning your estate is understanding who does what.

Executors

The Executor is the person who carries out the directions in the Will for distributing your assets. The Executor is responsible for finding all your assets, making sure that any necessary tax returns are filed and making decisions that will affect the taxes paid, and, in some cases, who among your beneficiaries pays those taxes. Lawyers and accountants often call these decisions "tax elections." Executors can hire accountants, lawyers, investment advisors, etc. to assist them in doing this. Once the assets of the estate have been distributed as specified in your Will, your Executor's job will end. You should choose the person or people (or corporate trust department) who you think will do the best job as Executor or Co-Executors.[3]

Trustees

A Trustee is a person or corporation that holds money and other property on behalf of one or more other people. The Trustee follows specific written directions as to what the Trustee is to do with the property. Those directions are given in a Will or trust agreement. You may name whomever you trust to carry out your wishes regarding the property put into the trust.[4] The Trustee's job may last many years. It involves making investment decisions, record keeping, filing annual tax returns, and giving the beneficiaries an annual accounting of her actions. The Trustee may also be required to make decisions as to when to give or withhold the trust's money from the trust's beneficiaries.

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3 If there is no Will the person who does this is appointed by the Court and is called the administrator or administratrix.

4 You can one or more people, a person and a corporation, or a corporation (some brokerage houses and many banks have corporate trust departments).

Guardians

Perhaps the most difficult question that you may face in preparing your Will is deciding who will raise your children if something were to happen to you. Factors to consider include the age of your children, the age of the potential guardians, whether their ideas on child rearing are compatible with yours, religion, geographic location, continued accessibility of your children's relatives and friends, and educational and cultural opportunities or limitations.

Successor Fiduciaries

Executors, Trustees and Guardians are often referred to as fiduciaries. The naming of successor fiduciaries is optional, but I strongly recommend that you name at least one successor, if not two. You can allow the last Trustee, Executor and Guardian to name his or her own successors. The advantages of naming the successors is that you will pick people that you trust rather than relying on the judgment of the fiduciaries to pick people they trust and the possibility that they may fail to name any successor (in which case a Court decides who the successor trustee will be). The disadvantage of naming the successors rather than relying on the fiduciaries to name their successors is that circumstances can change and their selection is made at a time closer to when the successor will be called on to serve.

SELECTED ESTATE PLANNING TECHNIQUES

Using the Estate Tax Exemption

You can leave the exemption equivalent amount to people other than your spouse to take full advantage of the estate tax credit available to a husband and wife. Each spouse must have assets equal to or exceeding the exemption equivalent amount in their individual names and not designate each other as the recipient on death (i.e., joint tenants with right of survivorship or as a named beneficiary) in order to do this. An example of the potential tax savings is attached.

The advantage is that the money left in trust is not taxed in the surviving spouse's estate. By using this trust, you can effectively double your estate tax exemption. While the federal estate tax exemption is now $1,500,000, New Jersey's exemption is only $675,000. If you leave $1,500,000 to your children, there will be no federal estate tax, but your heirs will lose $64,400 for New Jersey estate taxes. If you leave $675,000 to your children, then some of your federal estate tax exemption will be wasted.

If your Will refers to an estate tax exemption amount, you must have an estate planning attorney review it to see whether your Will refers to the federal or New Jersey exemption. A careful consideration of your assets and family situation is needed to determine which exemption makes sense for you in your particular circumstances. Of course, without a Will, you cannot plan to save your family taxes.

Credit Shelter Trust

You may want the tax benefit of using the estate tax exemption in both estates but be concerned that giving some of your wealth to other people will not leave enough assets for your spouse. Placing the property in a Credit Shelter Trust can solve this problem. This type of trust is also called a By-Pass Trust (since it "by-passes" the surviving spouse's estate), or an Exemption Equivalent Trust. By whichever name it is referred to, it is a trust that may give your spouse some access to the net income and principal of the trust during his or her life.

Your spouse's rights can be very liberal, such as providing (1) that all of the income or a specified portion of the trust must be paid to him or her annually, (2) allowing your spouse to demand the greater of $5,000 or 5% of the trust each year, (3) requiring the trustees to provide money for health, support and maintenance, and (4) giving the trustees discretion to give additional trust funds for any reason. Alternatively, your spouse may be one of several permitted recipients of trust income and principal.[5]

The trust also provides for what happens to the trust property on your spouse's death. The trust can be set up in your Will so that the trust does not come into existence until you pass away. That way you have full use of the property while both of you are alive.

Properly drafted, a Credit Shelter Trust can give your spouse some rights and access to the trust property without having the trust taxed in your spouse's estate.

Disclaimer Trust

Instead of, or in addition to, creating a Credit Shelter Trust in your Wills, we can include a Disclaimer Trust. This trust would have similar provisions to the Credit Shelter Trust, but would allow the surviving spouse to decide how much should be put in the trust. This decision would be made at the time of the first death.

For example, your Wills could provide for a Credit Shelter Trust equal to the $675,000 New Jersey estate tax exemption, and the balance left outright to your surviving spouse. By adding a Disclaimer Trust, the surviving spouse, at the time of the first spouse's death, can decide whether to include additional property in the estate of the first of you to die, to avoid or reduce an estate tax in the survivor's estate. This is done by the surviving spouse disclaiming that additional property which will then go into the disclaimer trust.

5 This type of trust, which allows the trustees to make uneven distributions among two or more beneficiaries, is

Qualified Terminable Interest Property Trust

You can create a trust in your Will for your spouse that will be treated as passing to your spouse so that no estate tax will be due on the trust assets until your spouse's death. This marital deduction trust is known as a Qualified Terminable Interest Property Trust or a Q-TIP Trust, for short.

The Q-TIP trust must give your spouse the right to all of the trust income. The trust cannot allow any other person to receive any of the trust principal during your spouse's life. You decide in the Will whether your spouse can have virtually unlimited access to the trust principal (subject to trustee discretion), no access whatsoever to the trust principal or something in between. The final requirement is that the Executor of your estate must make an election on your estate tax return to qualify the trust as a Q-Tip trust. Once this election is made it is irrevocable. The value of the Q-TIP trust on your spouse's death will be included in their estate.

The Q-TIP trust's primary advantage is that the surviving spouse has no control over who receives the balance of the trust on their death (alternatively, the surviving spouse can be given a limited power to decide who receives the trust property on their death). The spouse who died and whose Will set up the trust makes that decision. This type of trust is often used in second marriages where there are children from a prior marriage since the Q-TIP trust allows you to provide for your spouse's needs during their lifetime and then at their death, passes the property to beneficiaries of your choosing.

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called a "spray" or "sprinkle" trust.

Special Needs Trusts

The purpose of a Special Needs Trust is to keep the disabled person eligible for benefits while supplementing and improving their lifestyle with their inheritance. To be eligible for governmental programs that can be essential for a disabled person, they can have very little income and very few assets. This is true for Social Security Disability Income, Supplemental Disability Income, Medicaid and other governmental and charitable programs. Therefore, leaving assets to a disabled person may make them ineligible for these programs.

Common, but unsatisfactory, alternatives to the Special Needs Trust are:

(1) Disinheriting the disabled person does not allow the parents to provide anything for their child. However, if there are few assets and other children, this may make sense.

(2) Leaving the assets to the disabled child will make them ineligible for governmental and charitable programs. However, if the disabled child qualifies for relatively little governmental and charitable aid and the inheritance is large enough, then a Special Needs Trust may be unnecessary. If the disabled person can handle their own affairs, then an outright bequest makes sense. If the disabled person cannot handle their own affairs, then a trust other than a Special Needs Trust may make sense.

(3) Giving the disabled child's inheritance to his or her siblings (or other relative) with the understanding that they will use the money for the disabled child's benefit is almost never a good choice. The assets are subject to the claims of the siblings' creditors, can be given to the sibling's spouse as part of equitable distribution in a divorce, and may be used by the sibling for their own needs. When the sibling does use the money for the disabled person's benefit, the sibling makes a gift and if over $11,000 in any year, has gift and estate tax consequences to the sibling. The gift itself, if not done properly, can make the disabled child ineligible for governmental benefits.

The purpose of a Special Needs Trust is to keep the disabled person eligible for benefits while supplementing and improving their lifestyle with their inheritance. It also allows for a qualified trustee, acting in a fiduciary capacity, to make investment and distribution decisions. It protects the assets in the trust from claims of creditors. It maintains the beneficiary's eligibility for governmental programs.

There are important limits on the trust terms. Distributions are in the discretion of the trustee. The trustee is prohibited from making distributions that would reduce government or charitable benefits. The disabled child (nor anyone acting on his or her behalf) cannot make the trustee distribute trust income or assets.

There is a lot of flexibility and tax planning that can be done with a Special Needs Trust.

The trust can be created by the parents during the parents' lifetimes (an Inter Vivos trust). The advantage of an Inter Vivos trust is it allows other family members to make gifts or inheritances for the disabled child to the trust.

If the trust is revocable it can be changed or ended by the parents while they are alive, and if ended, the parents would get the trust assets. The advantages are that there is greater flexibility in changing trust terms later on, the trust income is taxed to the parents and no separate tax return is required, and the parents can be the initial trustees. Disadvantages include that the trust is subject to claims of the parents' creditors, family members are less likely to leave assets to this type of trust, and the trust is included in the parents' estates. Gifts or inheritances left to the trust are treated as if they were made directly to the parents.

If the trust is irrevocable its terms cannot be changed or modified in any way. The advantages include that the trust is not subject to claims of creditors, family members are more likely to leave assets to this type of trust, and the trust is not included in the parents' estates. Disadvantages include there is no flexibility in changing trust terms later on, the trust income is taxed to the trust at the trust's less favorable income tax brackets, and a separate income tax return is required, and no one who contributes to the trust can be a trustee.

Gifts to the trust are not eligible for the annual gift tax exclusion unless one or more people (that cannot include the disabled person) have a "Crummey" power. A Crummey power is a right to withdraw the contributions to the trust for a limited period of time, usually 30 to 60 days. The trustees must give the person or people who have the Crummey power written notice each time a contribution is made to the trust of their right to make a withdrawal and when that right lapses. This is, in many ways, similar to a life insurance trust, discussed below. In fact, a Special Needs Trust can be funded with a life insurance policy.

Incentive Trusts

Incentive trusts are not really a separate type of trust. It can be Inter Vivos (created during your life) or Testamentary (created in your Will and not coming into existence until your death). If it is Inter Vivos, it can be either revocable (you retain the right to alter, amend and revoke the trust) or irrevocable (you do not have any rights to alter, amend or revoke the trust).

An incentive trust has a special feature or provisions. Simply, you provide that if the beneficiary does certain things, the trust will make certain distributions to him or her.

For example, the trust could provide that as long as the beneficiary is taking prescribed medications and meeting at least once a week with a psychiatrist (or psychologist, social worker, occupational therapist, et cetera), then the trust will distribute X dollars per month to the beneficiary. The trust could require periodic drug testing before distributions are made or forfeited. The trust could require that the beneficiary obtain a high school diploma or equivalency degree by a certain date or age or all or a portion of his or her interests in the trust will be forfeited. The incentives and bonuses or penalties that can be used are almost limitless. Certain “incentives” or “disincentives” are void as a matter of public policy, such as marrying or not marrying someone of a certain religion, requiring the beneficiary to engage in an illegal act, requiring the beneficiary to divorce their spouse, and similar requirements.

Life Insurance Trust

Life insurance proceeds are included in your estate if you owned the policy, the policy proceeds are paid to your estate or the executor of your estate, or if you possessed, at the time of your death, any "incidents of ownership" exercisable either alone or in conjunction with any other person. Incidents of ownership include the power to change the beneficiary, surrender or cancel the policy, assign the policy, revoke a prior assignment of the policy, borrow against the policy, pledge the policy for a loan, or retain a reversionary interest in excess of 5% of the value of the policy immediately prior to death (i.e., if there is a greater than 5% chance that the insurance policy or any incident of ownership could be possessed by you). For example, if you gave the policy to a parent and kept the right to get back ownership of the policy on their death, the likelihood that the parent would die before you, and therefore that you would receive the ownership of the policy is greater than 5%. Therefore the life insurance proceeds would still be included in your estate.

One way to avoid these prohibited incidents of ownership is to contribute the life insurance policy to an irrevocable life insurance trust. The transfer of the policy into trust may trigger a gift tax to you. In that case, a portion of your estate and gift tax credit can be used so that no gift tax will be currently paid. However, the gift could qualify for the annual gift tax exclusion if the beneficiaries of the trust have a "present interest" (a current right to immediate use, possession or enjoyment of the income or principal). Insurance proceeds from all insurance policies in which you had any incidents of ownership within three years of your death are included in your estate. The insurance proceeds will not be in your estate if you transfer the policies and live for more than three years after the transfer. The trust can provide that if any policy proceeds are included in your estate those proceeds will be held in a trust share that will qualify for the marital deduction as a Q-Tip Trust or paid outright to your spouse.

You may give sufficient funds to the trust directly in order to give the trustees sufficient money to pay the insurance premium. The beneficiaries must have the ability to take the money out of the trust if the gift to the trust is to qualify for the annual gift tax exclusion. This power is given for a period that usually begins immediately after the contribution to the trust and lasts for thirty days, after which it lapses. This is called a "Crummey Power."

An irrevocable life insurance trust's main benefits are (1) it keeps the insurance proceeds out of your estate; (2) it can keep the insurance proceeds out of your spouse's estate; and (3) provides a way for the insurance proceeds to be distributed as you direct. In addition, the life insurance proceeds can still be used to provide cash to your estate to pay death taxes by giving the trustees the power to use the policy proceeds to purchase non-liquid assets (such as real estate or closely held business interests) from your estate.

Second to Die Life Insurance Trust

An estate with a lot of non-liquid assets may have not have enough cash to pay bills, estate taxes, and other expenses. A Second to Die Life Insurance Trust can give your estate the cash it needs. This type of trust is funded with life insurance that is paid on the death of the surviving spouse. The premiums on these policies are generally less expensive than policies insuring one life since the insurance is not payable until the second death of two individuals.

On the death of the second insured, the trust collects the insurance proceeds and holds them under the terms and conditions of the trust. The trustee is given the power to use the insurance money to buy assets from the estate. The estate gets the necessary cash to pay bills, estate taxes, and other items and the trust retains the assets that it purchased and manages and pays out the assets in accordance with the trust terms. The trust terms can follow the provisions of your Will or provide have terms that are different from your Will.

The life insurance proceeds will not be included in your estate if the trust meets certain conditions. Therefore, you can provide your estate with liquidity and at the same time, not increase its value for estate tax purposes.

Conclusion

This is not intended to be an exhaustive discussion of all the estate planning issues, techniques and options. However, I hope you find it a helpful overview to some of the more common issues and options. Please feel free to call me if I can be of assistance to you or with any questions you may have. I hope to hear from you soon.