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Estate Planning

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Estate Planning: An Introduction

By definition, estate planning is a process designed to help you manage and preserve your assets while you are alive, and to conserve and control their distribution after your death according to your goals and objectives. But what estate planning means to you specifically depends on who you are. Your age, health, wealth, lifestyle, life stage, goals, and many other factors determine your particular estate planning needs. For example, you may have a small estate and may be concerned only that certain people receive particular things. A simple will is probably all you'll need. Or, you may have a large estate, and minimizing any potential estate tax impact is your foremost goal. Here, you'll need to use more sophisticated techniques in your estate plan, such as a trust.

To help you understand what estate planning means to you, the following sections address some estate planning needs that are common among some very broad groups of individuals. Think of these suggestions as simply a point in the right direction, and then seek professional advice to implement the right plan for you.

Over 18

Since incapacity can strike anyone at anytime, all adults over 18 should consider having:

- A durable power of attorney: This document lets you name someone to manage your property for you in case you become incapacitated and cannot do so.
- An advanced medical directive: The three main types of advanced medical directives are (1) a living will, (2) a durable power of attorney for health care (also known as a health-care proxy), and (3) a Do Not Resuscitate order. Be aware that not all states allow each kind of medical directive, so make sure you execute one that will be effective for you.

Young and single

If you're young and single, you may not need much estate planning. But if you have some material possessions, you should at least write a will. If you don't, the wealth you leave behind if you die will likely go to your parents, and that might not be what you would want. A will lets you leave your possessions to anyone you choose (e.g., your significant other, siblings, other relatives, or favorite charity).

Unmarried couples

You've committed to a life partner but aren't legally married. For you, a will is essential if you want your property to pass to your partner at your death. Without a will, state law directs that only your closest relatives will inherit your property, and your partner may get nothing. If you share certain property, such as a house or car, you should consider owning the property as joint tenants with rights of survivorship. That way, when one of you dies, the jointly held property will pass to the surviving partner automatically.

Married couples

Married couples have unique estate planning challenges and opportunities. On the one hand, you can transfer your entire estate to your spouse gift and estate tax free under the unlimited marital deduction. This will postpone taxation until the death of the surviving spouse. While this may be a good outcome for couples with smaller estates, couples with combined assets in excess of the estate tax exemption amount (scheduled to be \$1 million per person in 2011) may wind up paying more in estate taxes than is necessary because they've wasted the exemption of the first spouse to die. Couples in this situation need to plan in advance to avoid this result (perhaps by using a "credit shelter" or "bypass" trust, or some combination of marital trusts, often referred as an "A/B or A/B/C trust arrangement").

Note: The federal estate tax is repealed for 2010, although that is likely to change. It is scheduled to be reinstated

in 2011. The federal gift tax, however, remains in effect through 2010.

Note: Funding a bypass trust with funds from a retirement plan could have adverse income tax consequences.

Note: In the states that have "decoupled" their death tax systems from the federal system, using a formula provision to fund a bypass trust may increase the chance of having to pay state death taxes.

Married couples where one spouse is not a U.S. citizen have special planning concerns. The marital deduction is not allowed if the recipient spouse is a non-citizen spouse (although a \$134,000 annual exclusion, for 2010, is allowed). If certain requirements are met, however, a transfer to a qualified domestic trust (QDOT) will qualify for the marital deduction.

Married with children

If you're married and have children, you and your spouse should each have your own will. For you, wills are vital because they can name a guardian for your minor children in case both of you die simultaneously. If you fail to name a guardian in your will, a court may appoint someone you might not have chosen. Furthermore, without a will, some states dictate that at your death some of your property goes to your children and not to your spouse. If minor children inherit directly, the surviving parent will need court permission to manage the money for them.

You may also want to consult an attorney about establishing a trust to manage your children's assets in the event that both you and your spouse die at the same time.

Certainly, you will also need life insurance. Your surviving spouse may not be able to support the family on his or her own and may need to replace your earnings to maintain the family.

Comfortable and looking forward to retirement

If you're in your 30s, you're probably feeling comfortable. You've accumulated some wealth and you're thinking about retirement. Here's where estate planning overlaps with retirement planning. It's just as important to plan to care for yourself during your retirement as it is to plan to provide for your beneficiaries after your death. You should keep in mind that even though Social Security may be around when you retire, those benefits alone may not provide enough income for your retirement years. Consider saving some of your accumulated wealth using other retirement and deferred vehicles, such as an individual retirement account (IRA).

Wealthy and worried

Depending on the size of your estate when you die, you may need to be concerned about estate taxes.

Current law repeals the estate tax for 2010 only, then reinstates it in 2011, with an exemption amount of \$1 million and a top tax rate of 55 percent.

There is uncertainty about the exact form the federal estate tax system will take in future years. However, it appears that individuals with estates valued at under \$1 million need not worry too much about federal estate taxes, those with estates between \$1 million and \$3.5 million should have some flexibility built into their plans, and those with over \$3.5 million need to implement plans now to avoid having to pay federal estate tax.

Whether your estate will be subject to state death taxes depends on the size of your estate and the tax laws in effect in the state in which you are domiciled.

Elderly or ill

If you're elderly or ill, you'll want to write a will or update your existing one, consider a revocable living trust, and make sure you have a durable power of attorney and a health-care directive. Talk with your family about your wishes, and make sure they have copies of your important papers or know where to locate them.

Gift and Estate Taxes

If you give away money or property during your life, those transfers may be subject to federal gift tax and perhaps state gift tax. The money and property you own when you die (i.e., your estate) may also be subject to federal estate taxes and some form of state death tax. You should understand these taxes and when they do and do not apply, especially since the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 Tax Act). This law contains several changes that are complicated and uncertain, making estate planning all the more difficult.

Federal gift tax and federal estate tax--background

Under pre-2001 Tax Act law, no gift tax or estate taxes were imposed on the first \$675,000 of combined transfers (those made during life and those made at death). The tax rate tables were unified into one--that is, the same rates applied to gifts made and property owned by persons who died in 2001. Like income tax rates, gift and estate tax rates were graduated. Under this unified system, the recipient of a lifetime gift received a carryover basis in the property received, while the recipient of a bequest, or gift made at death, got a step-up in basis (usually fair market value on the date of death of the person who made the bequest or gift).

The law substantially changed this tax regime.

Federal gift tax

The 2001 Tax Act increased the applicable exclusion amount for gift tax purposes to \$1 million. The top gift tax rate is 35 percent in 2010 (the top marginal income tax rate in 2010 under the 2001 Tax Act). In 2011, the gift tax rates are scheduled to revert to pre-2001 Tax Act levels. The carryover basis rules remain in effect.

However, many gifts can still be made tax free, including:

- Gifts to your U.S. citizen spouse (you may give up to \$134,000 in 2010 tax free to your noncitizen spouse)

- Gifts to qualified charities
- Gifts totaling up to \$13,000 (this figure is indexed for inflation so it may change in future years) to any one person or entity during the tax year, or \$26,000 if the gift is made by both you and your spouse (and you are both U.S. citizens)
- Amounts paid on behalf of any individual as tuition to an educational organization or to any person who provides medical care for an individual

State gift tax may also be owed if you are a resident of Connecticut, Louisiana, North Carolina, Tennessee, or Puerto Rico.

Federal estate tax

Under the 2001 Tax Act, the federal estate tax is repealed for 2010, although that is likely to change. The estate tax is scheduled to be reinstated in 2011, with an applicable exclusion amount of \$1 million. The top estate tax rate is scheduled to be 55 percent. The federal gift tax, however, remains in effect through 2010.

Federal generation-skipping transfer tax

The federal generation-skipping transfer tax (GSTT) taxes transfers of property you make, either during life or at

death, to someone who is two or more generations below you, such as a grandchild. The GSTT is imposed in addition to, not instead of, federal gift tax or federal estate tax. You need to be aware of the GSTT if you make cumulative generation-skipping transfers in excess of the GSTT exemption, which is scheduled to be \$1 million in 2011. A flat tax equal to the highest estate tax bracket in effect in the year you make the transfer is imposed on every transfer you make after your exemption has been exhausted.

Some states also impose their own GSTT.

Note: Like the federal estate tax, the federal GSTT is repealed for 2010 and is scheduled to be reinstated in 2011.

Note: The GSTT exemption is the same amount as the applicable exclusion amount for estate tax purposes.

State death taxes

The three types of state death taxes are estate tax, inheritance tax, and credit estate tax, which is also known as a sponge tax or pickup tax.

Wills: The Cornerstone of Your Estate Plan

If you care about what happens to your money, home, and other property after you die, you need to do some estate planning. There are many tools you can use to achieve your estate planning goals, but a will is probably the most vital. Even if you're young or your estate is modest, you should always have a legally valid and up-to-date will. This is especially important if you have minor children because, in many states, your will is the only legal way you can name a guardian for them. Although a will doesn't have to be drafted by an attorney to be valid, seeking an attorney's help can ensure that your will accomplishes what you intend.

Wills avoid intestacy

Probably the greatest advantage of a will is that it allows you to avoid intestacy. That is, with a will you get to choose who will get your property, rather than leave it up to state law. State intestate succession laws, in effect, provide a will for you if you die without one. This "intestate's will" distributes your property, in general terms, to your closest blood relatives in proportions dictated by law. However, the state's distribution may not be what you would have wanted. Intestacy also has other disadvantages, which include the possibility that your estate will owe more taxes than it would if you had created a valid will.

Wills distribute property according to your wishes

Wills allow you to leave bequests (gifts) to anyone you want. You can leave your property to a surviving spouse, a child, other relatives, friends, a trust, a charity, or anyone you choose. There are some limits, however, on how you can distribute property using a will. For instance, your spouse may have certain rights with respect to your property, regardless of the provisions of your will.

Gifts through your will take the form of specific bequests (e.g., an heirloom, jewelry, furniture, or cash), general bequests (e.g., a percentage of your property), or a residuary bequest of what's left after your other gifts.

Wills allow you to nominate a guardian for your minor children

In many states, a will is your only means of stating who you want to act as legal guardian for your minor children if you die. You can name a personal guardian, who takes personal custody of the children, and a property guardian, who manages the children's assets. This can be the same person or different people. The probate court has final approval, but courts will usually approve your choice of guardian unless there are compelling reasons not to.

Wills allow you to nominate an executor

A will allows you to designate a person as your executor to act as your legal representative after your death. An executor carries out many estate settlement tasks, including locating your will, collecting your assets, paying legitimate creditor claims, paying any taxes owed by your estate, and distributing any remaining assets to your beneficiaries. Like naming a guardian, the probate court has final approval but will usually approve whomever you nominate.

Wills specify how to pay estate taxes and other expenses

The way in which estate taxes and other expenses are divided among your heirs is generally determined by state law unless you direct otherwise in your will. To ensure that the specific bequests you make to your beneficiaries are not reduced by taxes and other expenses, you can provide in your will that these costs be paid from your residuary estate. Or, you can specify which assets should be used or sold to pay these costs.

Wills can create a testamentary trust

You can create a trust in your will, known as a testamentary trust, that comes into being when your will is probated. Your will sets out the terms of the trust, such as who the trustee is, who the beneficiaries are, how the trust is funded, how the distributions should be made, and when the trust terminates. This can be especially important if you have a spouse or minor children who are unable to manage assets or property themselves.

Wills can fund a living trust

A living trust is a trust that you create during your lifetime. If you have a living trust, your will can transfer any assets that were not transferred to the trust while you were alive. This is known as a pourover will because the will "pours over" your estate to your living trust.

Wills can help minimize taxes

Your will gives you the chance to minimize taxes and other costs. For instance, if you draft a will that leaves your entire estate to your U.S. citizen spouse, none of your property will be taxable when you die (if your spouse survives you) because it is fully deductible under the unlimited marital deduction. However, if your estate is distributed according to intestacy rules, a portion of the property may be subject to estate taxes if it is distributed to heirs other than your U.S. citizen spouse.

Assets disposed of through a will are subject to probate

Probate is the court-supervised process of administering and proving a will. Probate can be expensive and time consuming, and probate records are available to the public. Several factors can affect the length of probate, including the size and complexity of the estate, challenges to the will or its provisions, creditor claims against the estate, state probate laws, the state court system, and tax issues. Owning property in more than one state can result in multiple probate proceedings. This is known as ancillary probate. Generally, real estate is probated in the state in which it is located, and personal property is probated in the state in which you are domiciled (i.e., reside) at the time of your death.

Will provisions can be challenged in court

Although it doesn't happen often, the validity of your will can be challenged, usually by an unhappy beneficiary or a disinherited heir. Some common claims include:

- You lacked testamentary capacity when you signed the will
- You were unduly influenced by another individual when you drew up the will
- The will was forged or was otherwise improperly executed
- The will was revoked

Estate Planning and 529 Plans

When you contribute to a 529 plan, you'll not only help your child, grandchild, or other loved one pay for college, but you'll also remove money from your taxable estate. This will help you minimize your tax liability and preserve more of your estate for your loved ones after you die. So, if you're thinking about contributing money to a 529 plan, it pays to understand the gift and estate tax rules.

Overview of gift and estate tax rules

If you give away money or property during your life, you may be subject to federal gift tax (and, in certain states, state gift tax). The money and property you own when you die may also be subject to federal estate tax and some form of state death tax.

Federal gift tax generally applies if you give someone more than the annual gift tax exclusion amount, currently \$13,000, during the tax year. (There are several exceptions, though, including gifts you make to your spouse.) That means you can give up to \$13,000 each year, to as many individuals as you like, gift tax free. In addition, you're allowed a gift tax credit, which effectively exempts from gift tax up to \$1 million in gifts that you make during your lifetime which would otherwise be subject to tax.

When you die, your estate will be entitled to a tax credit for federal estate tax purposes. In 2009, this credit effectively exempted up to \$3.5 million from federal estate tax, and in 2011, it is tentatively set at \$1 million (the federal estate tax is currently repealed for 2010). However, the estate tax credit will be reduced by the amount of any gift tax credit used during your lifetime. Because the credit works this way, it is often referred to as the "unified credit," but the amount excluded from tax is more properly known as the "applicable exclusion amount."

Note: Since state tax treatment may differ from federal tax treatment, look to the laws of your state to find out how your state will treat a 529 plan gift.

Contributions to a 529 plan are treated as (federal) gifts to the beneficiary

A contribution to a 529 plan is treated under the federal gift tax rules as a completed gift from the donor to the designated beneficiary of the account. Such contributions are considered present interest gifts (as opposed to future or conditional gifts) and qualify for the annual federal gift tax exclusion. This means that you can contribute up to \$13,000 per year to the 529 account of any beneficiary without incurring federal gift tax.

So, if you contribute \$15,000 to your daughter's 529 plan in a given year, for example, you'd ordinarily apply this gift against your \$13,000 annual gift tax exclusion. This means that although you'd need to report the entire \$15,000 gift on a federal gift tax return, you'd show that only \$2,000 is taxable. Bear in mind, though, that you must use up your applicable exclusion amount of \$1 million before you'd actually have to write a check for the gift tax.

Special rule if you contribute over \$13,000 in a year

Section 529 plans offer a special gifting feature. Specifically, you can make a lump-sum contribution to a 529 plan of up to \$65,000, elect to spread the gift evenly over five years, and completely avoid federal gift tax, provided no other gifts are made to the same beneficiary during the five-year period. A married couple can gift up to \$130,000.

For example, if you contribute \$65,000 to your son's 529 account in one year and make the election, your contribution will be treated as if you'd made a \$13,000 gift for each year of a five-year period. That way, your \$65,000 gift would be nontaxable (assuming you didn't make any additional gifts to your son in any of those five years). A married couple can make a joint gift of up to \$130,000.

If you contribute more than \$65,000 (\$130,000 for joint gifts) to a particular beneficiary's 529 plan in one year, the

averaging election applies only to the first \$65,000 (\$130,000 for joint gifts); the remainder is treated as a gift in the year the contribution is made.

What about gifts from a grandparent?

Grandparents need to keep the federal generation-skipping transfer tax (GSTT) in mind when contributing to a grandchild's 529 account. The GSTT is a tax on transfers made during your life and at your death to someone who is more than one generation below you, such as a grandchild. The GSTT is imposed in addition to (not instead of) federal gift and estate taxes. Like the applicable exclusion amount, though, there is a GSTT exemption (this exemption was \$3.5 million in 2009 and is tentatively set at \$1 million for 2011; the federal generation-skipping transfer tax is currently repealed for 2010). No GSTT will be due until you've used up your GSTT exemption, and no gift tax will be due until you've used up your applicable exclusion amount.

If you contribute no more than \$13,000 to your grandchild's 529 account during the tax year (and have made no other gifts to your grandchild that year), there will be no federal tax consequences--your gift qualifies for the annual federal gift tax exclusion, and it is also excluded for purposes of the GSTT.

If you contribute more than \$13,000, you can elect to treat your contribution as if made evenly over a five-year period (as discussed previously). Only the portion that causes a federal gift tax will also result in a GSTT.

Note: Contributions to a 529 account may affect your eligibility for Medicaid. Contact an experienced elder law attorney for more information.

What if the owner of a 529 account dies?

If the owner of a 529 account dies, the value of the 529 account will not usually be included in his or her estate. Instead, the value of the account will be included in the estate of the designated beneficiary of the 529 account.

There is an exception, though, if you made the five-year election (as described previously) and died before the five-year period ended. In this case, the portion of the contribution allocated to the years after your death would be included in your federal gross estate. For example, assume you made a \$50,000 contribution to a college savings plan in Year 1 and elected to treat the gift as if made evenly over five years. You die in Year 2. Your Year 1 and Year 2 contributions of \$10,000 each (\$50,000 divided by 5 years) are not part of your federal gross estate. The remaining \$30,000 would be included in your gross estate.

Some states have an estate tax like the federal estate tax; many states calculate estate taxes differently. Review the rules in your state so you know how your 529 account will be taxed at your death.

When the account owner dies, the terms of the 529 plan will control who becomes the new account owner. Some states permit the account owner to name a contingent account owner, who'd assume all rights if the original account owner dies. In other states, account ownership may pass to the designated beneficiary. Alternatively, the account may be considered part of the account owner's probate estate and may pass according to a will (or through the state's intestacy laws if there is no will).

What if the beneficiary of a 529 account dies?

If the designated beneficiary of your 529 account dies, look to the rules of your plan for control issues. Generally, the account owner retains control of the account. The account owner may be able to name a new beneficiary or else make a withdrawal from the account. The earnings portion of the withdrawal would be taxable, but you won't be charged a penalty for terminating an account upon the death of your beneficiary.

Keep in mind that if the beneficiary dies with a 529 balance, the balance may be included in the beneficiary's taxable estate.

Note: *Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about specific 529 plans is available in the issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.*

Life Insurance and Estate Planning

Life insurance has come a long way since the days when it was known as burial insurance and used mainly to pay for funeral expenses. Today, life insurance is a crucial part of many estate plans. You can use it to leave much-needed income to your survivors, provide for your children's education, pay off your mortgage, and simplify the transfer of assets. Life insurance can also be used to replace wealth lost due to the expenses and taxes that may follow your death, and to make gifts to charity at relatively little cost to you.

To illustrate how life insurance can help you plan your estate wisely, let's compare what happened upon the death of two friends: Frank, who bought life insurance, and Dave, who did not. (Please note that these illustrations are hypothetical.)

Life insurance can protect your survivors financially by replacing your lost income

Frank bought life insurance to help ensure that his survivors wouldn't suffer financially when he died. When Frank died and his paycheck stopped coming in, his family had enough money to maintain their lifestyle and live comfortably for years to come.

And since Frank's life insurance proceeds were available very quickly, his family had cash to meet their short-term financial needs. Life insurance proceeds left to a named beneficiary don't pass through the process of probate, so Frank's family didn't have to wait until his estate was settled to get the money they needed to pay bills.

But Dave didn't buy life insurance, so his family wasn't so lucky. Even though Dave left his assets to his family in his will, those assets couldn't be distributed until after the probate of his estate was complete. Since probate typically takes six months or longer, Dave's survivors had none of the financial flexibility that a life insurance policy would have provided in the difficult time following his death.

Life insurance can replace wealth that is lost due to expenses and taxes

Frank planned ahead and bought enough life insurance to cover the potential costs of settling his estate, including taxes, fees, and other debts that his estate would have to pay. By comparison, these expenses took a big bite out of Dave's estate, which had to sell valuable assets to pay the taxes and expenses that arose as a result of his death.

Life insurance lets you give to charity, while your estate enjoys an estate tax deduction

Using life insurance, Frank was able to leave a substantial gift to his favorite charity. Since gifts to charity are estate tax deductible, this gift was not subject to estate taxes when he died. Dave always dreamed of leaving money to his alma mater, but his family couldn't afford to give any money away when he died.

Life insurance won't increase estate taxes--if you plan ahead

Before buying life insurance, Frank talked to his attorney about the potential tax consequences. Frank's attorney told him that if he was leaving behind a taxable estate worth less than a certain amount (\$3.5 million in 2009, under the applicable exclusion amount), his survivors generally wouldn't owe estate taxes on a life insurance policy left to them. Since Frank's estate was larger than that, Frank and his attorney put a plan in place that helped minimize the estate tax burden on his family.

Be like Frank, not like Dave

Throughout his life, Dave worked hard to support his family. Frank did, too, but went one step further--he bought life insurance to protect his family after his death. Here's how you can be like Frank:

- Use life insurance to ensure that your family has access to cash to help them meet both their short-term and long-term financial needs
- Plan ahead--buy enough life insurance to cover the potential costs of settling your estate and to ensure that the assets you leave to your survivors aren't less than you intended
- Consider using life insurance to give to charity
-

Consult an experienced attorney about income and estate tax consequences before purchasing life insurance

Understanding Probate

When you die, you leave behind your estate. Your estate consists of your assets--all of your money, real estate, and worldly belongings. Your estate also includes your debts, expenses, and unpaid taxes. After you die, somebody must take charge of your estate and settle your affairs. This person will take your estate through probate, a court-supervised process that winds up your financial affairs after your death. The proceedings take place in the state where you were living at the time of your death. Owning property in more than one state can result in multiple probate proceedings. This is known as ancillary probate.

How does probate start?

If your estate is subject to probate, someone (usually a family member) begins the process by filing an application for the probate of your will. The application is known as a petition. The petitioner brings it to the probate court along with your will. Usually, the petitioner will file an application for the appointment of an executor at the same time. The court first rules on the validity of the will. Assuming that the will meets all of your state's legal requirements, the court will then rule on the application for an executor. If the executor meets your state's requirements and is otherwise fit to serve, the court generally approves the application.

What's an executor?

The executor is the person whom you choose to handle the settlement of your estate. Typically, the executor is a spouse or a close family member, but you may want to name a professional executor, such as a bank or attorney. You'll want to choose someone whom you trust will be able to carry out your wishes as stated in the will. The executor has a fiduciary duty--that is, a heightened responsibility to be honest, impartial, and financially responsible. Now, this doesn't mean that your executor has to be an attorney or tax wizard, but merely has the common sense to know when to ask for specialized advice.

Your executor's duties may include:

- Finding and collecting your assets, including outstanding debts owed to you
- Inventorying and appraising your assets
- Giving notice to your creditors (e.g., credit card companies, banks, retail stores)
- Filing an estate tax return and paying estate taxes, if any
- Paying any debts or other taxes
- Distributing your assets according to your will and the law
- Providing a detailed report of how the estate was settled to the court and all interested parties

The probate court supervises and oversees the entire process. Some states allow a less formal process if the estate is small and there are no complicated issues to resolve. In those states allowing informal probate, the court may be involved only indirectly. This may speed up the probate process, which can take years.

What if you don't name an executor?

If you don't name an executor in your will, or if the executor can't serve for some reason, the court will appoint an administrator to settle your estate according to the terms of your will. If you die without a will, the court will also appoint an administrator to settle your estate. This administrator will follow a special set of laws, known as intestacy laws, that are made for such situations.

Is all of your property subject to probate?

Although most assets in your estate may pass through the probate process, other assets may not. It often depends on the type of asset or how an asset is titled. For example, many married couples own their residence jointly with rights of survivorship. Property owned in this manner bypasses probate entirely and passes by "operation of law." That is, at death, the property passes directly to the joint owner regardless of the terms of the will and without going through probate. Other assets that may bypass probate include:

- Investments and bank accounts set up to pass automatically to a named person at death (payable on death)

- Life insurance policies with a named beneficiary (someone other than the estate)
- Retirement plans with a named beneficiary
- Other property owned jointly with rights of survivorship

Charitable Giving

When developing your estate plan, you can do well by doing good. Leaving money to charity rewards you in many ways. It gives you a sense of personal satisfaction, and it can save you money in estate taxes.

A few words about estate taxes

Current law repeals the estate tax for 2010 only, then reinstates it in 2011, with an exemption amount of \$1 million and a top tax rate of 55 percent. The federal gift tax, however, remains in effect through 2010, with a top rate of 35 percent and an exemption amount of \$1 million. The gift tax rate is scheduled to increase to 55 percent in 2011 and the \$1 million exemption will remain the same.

Whether you are subject to federal estate taxes depends on the size of your estate and the year you die. Tax law changes only increase the need for careful planning, and charitable giving can play an important role in many estate plans. By leaving money to charity either during life or when you die, the full amount of your charitable gift may be deducted from the value of your taxable estate.

Make an outright bequest in your will

The easiest and most direct way to make a charitable gift is by an outright bequest of cash in your will. Making an outright bequest requires only a short paragraph in your will that names the charitable beneficiary and states the amount of your gift. The outright bequest is especially appropriate when the amount of your gift is relatively small, or when you want the funds to go to the charity without strings attached.

Make a charity the beneficiary of an IRA or retirement plan

If you have funds in an IRA or employer-sponsored retirement plan, you can name your favorite charity as a beneficiary. Naming a charity as beneficiary can provide double tax savings. First, the charitable gift will be deductible for estate tax purposes. Second, the charity will not have to pay any income tax on the funds it receives. This double benefit can save combined taxes that otherwise could eat up a substantial portion of your retirement account.

Use a charitable trust

Another way for you to make charitable gifts is to create a charitable trust. There are many types of charitable trusts, the most common of which include the charitable lead trust and the charitable remainder trust.

A charitable lead trust pays income to your chosen charity for a certain period of years after your death. Once that period is up, the trust principal passes to your family members or other heirs. The trust is known as a charitable lead trust because the charity gets the first, or lead, interest.

A charitable remainder trust is the mirror image of the charitable lead trust. Trust income is payable to your family members or other heirs for a period of years after your death or for the lifetime of one or more beneficiaries. Then, the principal goes to your favorite charity. The trust is known as a charitable remainder trust because the charity gets the remainder interest. Depending on which type of trust you use, the dollar value of the lead (income) interest or the remainder interest produces the estate tax charitable deduction.

Why use a charitable lead trust?

The charitable lead trust is an excellent estate planning vehicle if you are optimistic about the future performance of the investments in the trust. If created properly, a charitable lead trust allows you to keep an asset in the family while being an effective tax-minimization device.

For example, you create a \$1 million charitable lead trust. The trust provides for fixed annual payments of \$80,000 (or 8 percent of the initial \$1 million value of the trust) to ABC Charity for 25 years. At the end of the 25-year period, the entire trust principal goes outright to your beneficiaries. To figure the amount of the charitable deduction, you have to value the 25-year income interest going to ABC Charity. To do this, you use IRS tables. Based on these tables, the value of the income interest can be high--for example, \$900,000. This means that your estate gets a \$900,000 charitable deduction when you die, and only \$100,000 of the \$1 million gift is subject to estate tax.

Why use a charitable remainder trust?

A charitable remainder trust takes advantage of the fact that lifetime charitable giving generally results in tax savings when compared to testamentary charitable giving. A donation to a charitable remainder trust has the same estate tax effect as a bequest because, at your death, the donated asset has been removed from your estate. Be aware, however, that a portion of the donation is brought back into your estate through the charitable income tax deduction.

Also, a charitable remainder trust can be beneficial because it provides your family members with a stream of current income--a desirable feature if your family members won't have enough income from other sources.

For example, you create a \$1 million charitable remainder trust. The trust provides that a fixed annual payment be paid to your beneficiaries for a period not to exceed 20 years. At the end of that period, the entire trust principal goes outright to ABC Charity. To figure the amount of the charitable deduction, you have to value the remainder interest going to ABC Charity, using IRS tables. This is a complicated numbers game. Trial computations are needed to see what combination of the annual payment amount and the duration of annual payments will produce the desired charitable deduction and income stream to the family.

Bypassing Probate

You may have heard about the horrors of probate, but in truth, probate has gotten an undeservedly bad reputation, especially in recent years. If you bypass probate, your estate will go to your beneficiaries without any court proceeding, and you may save a certain amount of time and expenses. However, there is usually little reason for most people to avoid probate today. States continue to revise their probate laws, making them more consumer friendly, particularly for small estates. For most modestly sized estates, the probate process now costs little. In fact, there are some good reasons to distribute your property by will. Decisions are binding and have legal finality once your will is probated. Creditors who fail to file claims against your estate within a specific amount of time--usually six months after receiving notice--are out of luck.

However, some major drawbacks to probate do exist, including the time it can take. The process averages six to nine months to complete but may take up to two years or more for some complex estates, tying up the assets that your family may need immediately. Also, for a larger estate, the cost may be as high as 5 percent of the estate's value.

If you feel that the size and complexity of your estate warrant exploring alternatives to probate, you may want to consider one or more of the following:

Transfer your assets to a revocable living trust

A trust is like a basket that holds your assets. A revocable living trust (also known as an inter vivos trust) is flexible enough to include almost any asset that you own. While you are living, you can act as the trustee and can add or remove property as you see fit. You can also terminate or amend the trust at any time. When you die, your successor trustee distributes the trust assets to the trust beneficiaries, according to the trust agreement. Trusts require a significant amount of paperwork, are costly to create and maintain, and usually require a lawyer to draw up the trust documents. Also, a revocable living trust does not shield your estate from your creditors, creditors of your estate, or estate taxes.

Own property as joint tenancy with rights of survivorship

Assets owned as joint tenancy with rights of survivorship pass automatically to the surviving joint owner(s) at your death. To establish joint ownership, you may need to record new real estate deeds, titles for your car or boat, stock and bond certificates, statements of account for mutual funds, registration cards for your bank accounts, and other assets. This costs little and usually does not require a lawyer. Some drawbacks are that the joint owner has immediate access to your property, and your joint owner's creditors may reach the jointly held property.

Designate beneficiaries

Assets pass outside of probate if you establish payable-on-death provisions for your savings accounts and CDs. Ask your agent to set up transfer-on-death provisions for brokerage accounts containing stocks, bonds, or mutual funds. Your retirement accounts, such as profit-sharing plans, 401(k)s, and IRAs can also pass along to designated beneficiaries. Finally, life insurance death proceeds will avoid probate, provided you name a beneficiary other than your estate.

Make lifetime gifts

Another way to avoid probate is to simply give away your property to your beneficiaries while you are living. Carefully planned gifting can also free those assets from gift and estate taxes. The following are usually nontaxable gifts:

- Gifts to your spouse

- Gifts to qualified charities
- Gifts totaling \$13,000 or less per person, per year (\$26,000 if you and your spouse can split the gifts)
- Tuition payments on behalf of an individual directly to an educational institution
- Medical care expenses paid directly to the provider on behalf of an individual

Other ways to bypass or minimize probate

If your estate is small enough to meet state guidelines, your beneficiaries can simply claim your assets by presenting a notarized affidavit. About half of the states set a limit of \$10,000 to \$20,000 of the qualified estate value; most of the other states allow as much as \$100,000. You can generally deduct estate expenses from your qualified estate value, such as taxes, debts, loans, or family allowance payments, plus the value of any other assets that pass outside probate (e.g., a home jointly owned with a spouse). Real estate is usually disqualified from claims by affidavit. Therefore, your estate may qualify even if it is fairly large. Expect the process to take 30 to 45 days. Another method is for your executor to file for summary, or simplified probate. This streamlined process is generally a paper filing only, requiring no attorney. States vary widely regarding the allowable size of an estate for simplified probate.

Transferring Your Family Business

As a business owner, you're going to have to decide when will be the right time to step out of the family business and how you'll do it. There are many estate planning tools you can use to transfer your business. Selecting the right one will depend on whether you plan to retire from the business or keep it until you die.

Perhaps you have children or other family members who wish to continue the business after your death. Obviously, you'll want to transfer your business to your successors at its full value. However, with income, gift, and potential estate taxes, it takes careful planning to prevent some (or all) of the business assets from being sold to pay them, perhaps leaving little for your beneficiaries. Therefore, business succession planning must include ways not only to ensure the continuity of your business, but also to do so with the smallest possible tax consequences.

Some of the more common strategies for minimizing taxes are explained briefly in the following sections. Remember, none are without drawbacks. You'll want to consult a tax professional as well as your estate planning attorney to explore all strategies.

You and your estate may get some relief under the Internal Revenue Code

If you are prepared to begin transferring some of your business interest to your beneficiaries, a systematic gifting program can help accomplish this while minimizing the gift tax liability that might otherwise be incurred. This is done by utilizing your ability to gift up to \$13,000 per year per recipient without incurring gift tax. By transferring portions of your business in this manner, over time you may manage to transfer a significant portion of your business free from gift tax. Clearly, the disadvantage of relying solely on this method of transferring your business is the amount of time necessary to complete the transfer of your entire estate.

In addition, Section 6166 of the Internal Revenue Code allows any estate taxes incurred because of the inclusion of a closely held business in your estate to be deferred for 5 years (with interest-only payments for the first four years and interest plus principal due in the fifth year), and then paid in annual installments over a period of up to 10 years. This allows your beneficiaries more time to raise sufficient funds or obtain more favorable interest rates. The business must exceed 35 percent of your gross estate and must meet other requirements to qualify.

Selling your business interest outright

When you sell your business interest to a family member or someone else, you receive cash (or assets you can convert to cash) that can be used to maintain your lifestyle or pay your estate taxes. You choose when to sell--now, at your retirement, at your death, or anytime in between. As long as the sale is for the full fair market value (FMV) of the business, it is not subject to gift tax or estate tax. But if the sale occurs before your death, it may be subject to capital gains tax.

Transferring your business interest with a buy-sell agreement

A buy-sell agreement is a legal contract that prearranges the sale of your business interest between you and a willing buyer.

A buy-sell agreement lets you keep control of your interest until the occurrence of an event that the agreement specifies, such as your retirement, disability, or death. Other events like divorce can also be included as triggering events under a buy-sell agreement. When the triggering event occurs, the buyer is obligated to buy your interest from you or your estate at the FMV. The buyer can be a person, a group (such as co-owners), or the business itself. Price and sale terms are prearranged, which eliminates the need for a fire sale if you become ill or when you die.

Remember, you are bound under a buy-sell agreement: You can't sell or give your business to anyone except the buyer named in the agreement without the buyer's consent. This could restrict your ability to reduce the size of

your estate through lifetime gifts of your business interest, unless you carefully coordinate your estate planning goals with the terms of your buy-sell agreement.

Grantor retained annuity trusts or grantor retained unitrusts

A more sophisticated business succession tool is a grantor retained annuity trust (GRAT) or a grantor retained unitrust (GRUT). GRAT/GRUTs are irrevocable trusts to which you transfer appreciating assets while retaining an income payment for a set period of time. At either the end of the payment period or your death, the assets in the trust pass to the other trust beneficiaries (the remainder beneficiaries). The value of the retained income is subtracted from the value of the property transferred to the trust (i.e., a share of the business), so if you live beyond the specified income period, the business may be ultimately transferred to the next generation at a reduced value for estate tax or gift tax purposes.

Private annuities

A private annuity is the sale of property in exchange for a promise to make payments to you for the rest of your life. Here, you transfer complete ownership of the business to family members or another party (the buyer). The buyer in turn makes an unsecured promise to make periodic payments to you for the rest of your life (a single life annuity) or for your life and the life of a second person (a joint and survivor annuity). A joint and survivor annuity provides payments until the death of the last survivor; that is, payments continue as long as either the husband or wife is still alive. Again, because a private annuity is a sale and not a gift, it allows you to remove assets from your estate without incurring gift tax or estate tax.

Until recently, exchanging property for an unsecured private annuity allowed you to spread out any capital gain realized, deferring capital gains tax. However, this tax benefit has generally been eliminated. If you're considering a private annuity, be sure to talk to a tax professional.

Self-canceling installment notes

A self-canceling installment note (SCIN) allows you to transfer the business to the buyer in exchange for a promissory note. The buyer must make a series of payments to you under that note. A provision in the note states that at your death, the remaining payments will be canceled. SCINs provide for a lifetime income stream and avoidance of gift tax and estate tax similar to private annuities. Unlike private annuities, SCINs give you a security interest in the transferred business.

Family limited partnerships

A family limited partnership can also assist in transferring your business interest to family members. First, you establish a partnership with both general and limited partnership interests. Then, you transfer the business to this partnership. You retain the general partnership interest for yourself, allowing you to maintain control over the day-to-day operation of the business. Over time, you gift the limited partnership interest to family members. The value of the gifts may be eligible for valuation discounts as a minority interest and for lack of marketability. If so, you may successfully transfer much of your business to your heirs at significant transfer tax savings.

Asset Protection in Estate Planning

You're beginning to accumulate substantial wealth, but you worry about protecting it from future potential creditors. Whether your concern is for your personal assets or your business, various tools exist to keep your property safe from tax collectors, accident victims, health-care providers, credit card issuers, business creditors, and creditors of others.

To insulate your property from such claims, you'll have to evaluate each tool in terms of your own situation. You may decide that insurance and a Declaration of Homestead may be sufficient protection for your home because your exposure to a claim is low. For high exposure, you may want to create a business entity or an offshore trust to shield your assets. Remember, no asset protection tool is guaranteed to work, and you may have to adjust your asset protection strategies as your situation or the laws change.

Liability insurance is your first and best line of defense

Liability insurance is at the top of any plan for asset protection. You should consider purchasing or increasing umbrella coverage on your homeowners policy. For business-related liability, purchase or increase your liability coverage under your business insurance policy. Generally, the cost of the premiums for this type of coverage is minimal compared to what you might be required to pay under a court judgment should you ever be sued.

A Declaration of Homestead protects the family residence

Your primary residence may be your most significant asset. State law determines the creditor and judgment protection afforded a residence by way of a Declaration of Homestead, which varies greatly from state to state. For example, a state may provide a complete exemption for a residence (i.e., its entire value), a limited exemption (e.g., up to \$100,000), or an exemption under certain circumstances (e.g., a judgment for medical bills). A Declaration of Homestead is easy to file. You pay a small fee, fill out a simple form, and file it at the registry where your deed is recorded.

Dividing assets between spouses can limit exposure to potential liability

Perhaps you work in an occupation or business that exposes you to greater potential liability than your spouse's job does. If so, it may be a good idea to divide assets between you so that you keep only the income and assets from your job, while your spouse takes sole ownership of your investments and other valuable assets. Generally, your creditors can reach only those assets that are in your name.

Business entities can provide two types of protection--shielding your personal assets from your business creditors and shielding business assets from your personal creditors

Consider using a corporation, limited partnership, or limited liability company (LLC) to operate the business. Such business entities shield the personal assets of the shareholders, limited partners, or LLC members from liabilities that arise from the business. The liability of these owners will be limited to the assets of the business.

Conversely, corporations, limited partnerships, and LLCs provide some protection from the personal creditors of a shareholder, limited partner, or member. In a corporation, a creditor of an individual owner is able to place a lien on, and eventually acquire, the shares of the debtor/shareholder, but would not have any rights greater than the rights conferred by the shares. In limited partnerships or LLCs, under most state laws, a creditor of a partner or member is entitled to obtain only a charging order with respect to the partner or member's interest. The charging order gives the creditor the right to receive any distributions with respect to the interest. In all respects, the creditor is treated as a mere assignee and is not entitled to exercise any voting rights or other rights that the partner or member possessed.

Certain trusts can preserve trust assets from claims

People have used trusts to protect their assets for generations. The key to using a trust as an asset protection tool is that the trust must be irrevocable and become the owner of your property. Once given away, these assets are no longer yours and are not available to satisfy claims against you. To properly establish an asset protection trust, you must not keep any interest in the trust assets or control over the trust.

Trusts can also protect trust assets from potential creditors of the beneficiaries of the trust. The extent to which a beneficiary's creditors can reach trust property depends on how much access the beneficiary has to the trust property. The more access the beneficiary has to the trust property, the more access the beneficiary's creditors will have. Thus, the terms of the trust are critical.

There are many types of asset protection trusts, each having its own benefits and drawbacks. These trusts include:

- Spendthrift trusts
- Discretionary trusts
- Support trusts
- Blend trusts
- Personal trusts
- Self-settled trusts

Since certain claims can pierce domestic protective trusts (e.g., claims by a spouse or child for support and state or federal claims), you can bolster your protection by placing the trust in a foreign jurisdiction. Offshore or foreign trusts are established under, or made subject to, the laws of another country (e.g., the Bahamas, the Cayman Islands, Bermuda, Belize, Jersey, Liechtenstein, and the Cook Islands) that does not generally honor judgments made in the United States.

A word about fraudulent transfers

The court will ignore transfers to an asset protection trust if:

- A creditor's claim arose before you made the transfer
- You made the transfer with the intent to defraud a creditor
- You incurred debts without a reasonable expectation of paying them



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