

Leimberg's Think About It

Think About It is written by Stephan R. Leimberg, JD, CLU
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#379

Estate and Financial Planning for Non-Traditional Relationships

Demographics: Forging Financial Destiny

If you study the results of the 2000, 2001, and 2003 Census reports conducted by the U.S. Census Bureau (America's Families and Living Arrangements), you'll find that:

- Roughly 11 million U.S. citizens (roughly 9% of "coupled households") live with another person to whom he or she is not married (Same-gender and different-gender couples are both included in this number – comprised mainly of close to 10 million living with a different-gender person). These 11 million or more people consider themselves to be "partners" rather than merely room or housemates. They live in a "marriage-like" relationship but may have none of the benefits and legal protections available to spouses.
- The number of unmarried individuals living together increased significantly (more than a 70% growth) in the last decade.
- Over 40% of unmarried partner households have children under 18 living in them and over 40% of first births to unmarried women are born to cohabiting couples. (See Bumpass, Larry and Lu, Hsien-Hen(2000) and "Trends in Cohabitation and Implications for Children's Family Contexts in the United States." Population Studies, 54: 29-41) with almost half (2/5) of all children expected to live in a cohabiting household at some point.

In many cases these are people who have entered into a committed, long-term relationship. They may express toward each other a great trust and responsibility. They may share common values, wishes, attitudes, beliefs, and have concerns – as other couples do – about medical issues, finances, their homes, in many cases children and relatives, and even their pets.

These statistics illustrate the need for planners to understand more fully the legal and financial dynamics of a growing segment of our population – and your market. Working knowledge and

expertise in a wide range of disciplines is essential in serving those desiring greater and more certain rights, privileges, and obligations with respect to each other's property.

Although a great deal of the service such people need or want will be of a legal nature and should be provided only by a competent state-licensed attorney, insurance agents and financial planners can play a major role in helping such partners:

- identify and clarify their mutual financial expectations and desires,
- accumulate, conserve, and distribute each partner's assets in a manner that most efficiently and effectively accomplishes their individual and joint estate and financial objectives,
- memorialize their intents and preserve and protect their interests in the event the relationship is ended, and
- provide as much financial security as is possible.

This commentary is based on a major chapter in my book, **TOOLS AND TECHNIQUES OF ESTATE PLANNING** – 14th Edition (800 543 0874).

WHY NO MARRIAGE

There are many reasons individuals who are living together and who consider each other "partners" and who care deeply about each other's welfare do not marry. Many opposite gender partners are older and worry (in many cases rightfully so) about the possible adverse tax, social security, alimony, or retirement benefit implications of a marriage. Some don't feel the need to validate their relationship through a civil or religious ceremony.

Same gender couples are not allowed – in most states – to enter into a legal marriage or a "civil union." There are, however, some states that recognize what is known as "domestic partners." Formal registration as a domestic partner affords a legal status similar in many respects to a normal marriage. That means such couples are entitled under state law to many of the same protections as married couples including inheritance rights, elective shares, certain rules with respect to divorce, and quite importantly to many, the right to make decisions involving medical care for the other partner.

Incidentally, domestic partners of the opposite gender should check state law (both current and previous residence) to see if they may have contracted a common law marriage. Even if that common law marriage occurred in a prior state, the Full Faith and Credit Clause of the U.S. Constitution may mean that the state in which the couple now lives will be required to recognize a marriage that was legal in a prior domicile. That in turn, would force the Federal government to respect and treat their marriage as valid – even if common law marriages are not recognized in the state in which they now live.

FEDERAL TAX LAW IMPLICATIONS OF UNMARRIED RELATIONSHIP

A same gender (or heterosexual unmarried couple), regardless of their status under state law, are not considered for federal income or estate or gift or generation-skipping purposes as married. The 1996 Defense of Marriage Act makes it clear “marriage” is defined as a legal union between – and only between – a woman and a man. Therefore, a “spouse” for federal tax purposes can not be someone other than a husband or wife of the opposite gender. Although this very stringent restriction causes such couples many problems, as I’ll point out later, it offers some opportunities that are not available to those recognized under federal tax law as “married.”

PROBLEMS FACED AND QUESTIONS ASKED BY UNMARRIED COUPLES

There are many problems unmarried couples face and questions these problems present, whether or not they are of the same gender. These include:

- How do we manage our assets if one or both of us becomes disabled?
- How can we best assure financial security and assure a continued level of lifestyle for each other not only during life but at the death of either of us?
- If one of us becomes ill or otherwise incapacitated, how can the other have a measure of control in the handling of the sick or injured person’s financial affairs and medical needs?
- If either or both of us have children (either born before or during our relationship, legally adopted by one or both, or born through artificial means), what is the best way to help the surviving or well partner take care of that child and have some say in the child’s future in the event of a death or disability of the other? (An especially difficult problem where the couple is co-parenting a child or children but he/she/they are related by blood or law to only one of the partners).
- What if, when I die, someone contests my will leaving everything to my partner?
- What happens if I die without a will; does my partner get anything?
- What plans should we make for death, disability, or retirement if one of us is significantly wealthier or provides much more of the income for the couple than the other?

It is important for planners to realize that, absent careful planning:

- the surviving partner of an unmarried couple will have no legal right to the property acquired with the deceased partner’s funds,
- a partner has no right to manage the other partner’s property in the event of the other’s disability,
- legally, no healthcare decisions can be made by the healthy partner,
- the ill partner’s family could even bar the healthy partner from a hospital or hospice visit,
- at the death of a partner who owned a home in which the two lived, the surviving partner may be removed from that house.

FEDERAL TAX PROBLEMS

Gift Marital Deduction Unavailable: No gift tax marital deduction is available under federal tax law for individuals who do not fit the federal definition of “married.” So any transfer of cash or other property or property right from one partner to the other may trigger a taxable gift – to the extent the gift does not qualify for an annual exclusion. For example, if one unmarried partner pays the greater share (or all) of the couple’s living expenses, the IRS could claim some or all of those amounts (to the extent in excess of the annual exclusion) are taxable gifts. If the total cumulative taxable amount transferred during lifetime exceeds the unified credit equivalent (currently \$1,000,000 for gift tax purposes), the excess will generate a gift tax. (**Beware:** local and state tax may be triggered by adding the name of an unmarried partner to a real estate deed – or a tax may be imposed upon the separation of the couple when the deed is changed to reflect the dissolution of the relationship. Most states provide no exemption for unmarried individuals from real estate transfer taxes).

Remember, however, that the annual exclusion, which is not dependant on marital status, is actually three exclusions: (1) the \$12,000 (currently) shelter for gifts of a present interest, (2) the exclusion for payment of qualified medical expenses, and (3) the exclusion for payment of qualified educational expenses. These should be used to the full extent possible in planning for unmarried couples and any children they may be parenting or have through prior relationships.

Gift Splitting Not Available: Since only married individuals may split gifts under federal law, an unmarried couple can not take advantage of the lowered rates available when gifts are made by the couple to third parties such as children, relatives, or friends. So instead of all gifts made by either partner during the year being treated as if made one half by each (thus maximizing the utility of the couple’s annual exclusions and unified credits), the estate reducing technique of a life time gifting program is made less effective than if the couple were married. Because the unmarried couple can’t split gifts or shift wealth gift tax free between themselves to better take advantage of the unified credit where one is significantly more wealthy than the other, the problem is compounded.

Gain on Sale of Personal Residence: If an unmarried partner sells a home he/she owns, the amount excludable from income tax is only \$250,000. (A married couple could have excluded, if they filed jointly, up to \$500,000 of gain).

Dependency Exemption Not Permitted: An unmarried partner who provides support for a dependent who is a co-habitant will not be allowed a dependency exemption if the relationship between the two people is not legal under and is violative of state law. This means civil union or same gender partners will typically not be eligible for the dependent exemption even if one provides the other with half or more of his support and the co-habitant is a household member.

Estate Tax Marital Deduction Unavailable: No estate tax marital deduction is allowed for individuals who do not fit the federal definition of married. So a transfer of wealth at the death of either partner may (to the extent in excess of the value of the property over the estate tax unified credit equivalent (currently \$2,000,000)) will trigger federal estate tax. So unless a

wealthy unmarried couple takes steps to avoid the federal estate tax, it may cause a considerable liquidity problem and possibly cause a forced and then a fire sale of the couple's assets. At the very least, the inability to avail the decedent partner's estate of a marital deduction might result in significantly less capital and less income remaining for the surviving partner. (**Beware:** Many states impose stiff inheritance taxes for transfers at death to non-family members. For instance, Pennsylvania levies a 15% tax on such transfers.)

Generation Skipping Advantages Unavailable: A transfer of property to persons who are – or who are deemed to be – two or more generations below that of the transferor (or to certain trusts benefiting such persons) can trigger an odious and confiscatory tax called the generation-skipping tax. For instance, a large transfer to a grandchild or to a trust for a grandchild may result in this tax. Without getting into the complex technicality of how this arcane tax works, a large enough transfer from one unmarried partner to another – at death – and even during lifetime – could potentially set off the tax! This is because – depending on the ages of the two individuals – the younger of the two unmarrieds could be treated as being not the same but two generations below! (This particular problem would only happen in situations where the younger of the two partners is more than 37.5 years younger. “Married” individuals, regardless of their age differences, are treated as being of the same generation).

Termination of Relationship Issues: The separation of an unmarried couple can lead to numerous tax (as well as non-tax) issues. For instance, when an unmarried couple terminates the relationship, the transfer of assets from one to the other often leads to income (as well as gift) tax problems. The IRS could argue that upon the dissolution, there is a deemed “sale” or “exchange” resulting in taxable gain.

Retirement Plan and IRA Issues: A surviving unmarried partner benefiting from the qualified retirement plan by receiving a joint and survivor annuity will receive a reduced (compared to a married survivor) annuity. Also, an unmarried couple has a lower IRA contribution level than a married couple.

INTESTACY PROBLEMS

Impact of Intestacy: If an unmarried partner dies without a valid will, typically the property will pass by contract – in the case of life insurance, an IRA, qualified pension or profit-sharing plan, P.O.D. (payable on death) Account, or other contract.

In the case of a joint tenancy that states that it is to pass “with right of survivorship”, it will pass to the named joint tenant by operation of law. Assuming other property, which there almost always is, that asset will pass under the intestacy laws of the state where the decedent partner was domiciled.

Intestacy is a “one size fits all” type of law; the state does its best to ascertain where property should pass – in a traditional situation. So most states' laws provide that assets that do not pass under a valid will or by contract or joint tenancy with right of survivorship will go to the spouse

of the decedent, if any. Then (or in some cases additionally) property will go to the decedent's children, parents, or if none are alive, to the nearest living family members.

In the case of a decedent who lived in a state that grants inheritance rights to "registered" domestic partners (e.g. California, Maine, and New Jersey), the surviving registered domestic partner would be treated for these purposes as the decedent's spouse. But even in those states, an unregistered partner, no matter for how long the relationship lasted, would receive nothing under the intestacy law. Note also that even in a state that grants a domestic partner the same inheritance rights as a spouse under intestacy laws, if the decedent partner was also survived by a child or parents, he or she may have to split the inheritance with that issue or with the decedent's parents.

In most cases the result of the death of an unmarried partner, absent a valid will providing to the contrary, is that his or her estate will pass to surviving children or their children, to parents, to surviving siblings or their decedents, or to surviving parents. It's important to understand that, overwhelmingly, the decedent partner's estate does not go to the surviving partner – absent careful and deliberate planning.

These problems highlight the urgency and significance of a proper utilization of the entire gamut of available estate planning tools and techniques. So wills, trusts, financial powers of attorney are all highly indicated for unmarried couples.

PRACTICAL PROBLEMS

Funeral, body disposition, and burial arrangements: Terrible anguish and pain accompany death in a normal situation. But these intense emotions (See **How To Settle An Estate:** <http://www.leimberg.com> or call (610) 924-0515) are exacerbated where the long-time surviving partner is shut out from these most personal decisions because state law generally entitles only next of kin to legally make these arrangements. (**Note:** Some states specifically allow an individual to name a specific person other than next of kin to make these arrangements and decisions. But this entails deliberate action: In those states a person can state specifically who is to make the arrangements and what funeral and burial provisions are to be carried out. It is suggested that, if state law permits, that these directions be made in a writing separate from the will so that at the time a partner dies, it is quickly and easily accessible. Wills, of course, are generally read well after the funeral takes place).

Employment-Related Health Insurance Benefits: In many cases, the provisions of the contract providing health benefits allow an unmarried partner to specify who will receive these benefits. It is essential to check to be sure that the wording conforms with the employer or insurer's requirements – as well as the employee partner's wishes - and that it is up-to-date.

Financial and other Provisions for children – including how they are to be raised: This is one of the most difficult of all problems to deal with and it is essential that the advice of competent counsel be obtained. Adoption should be considered by the non-parent partner to secure future custody of the child and to address child support and inheritance rights.

Assisted Reproductive Technology – and the consequent personal and legal issues: The parties can, in most states, enter into an agreement – pre or post conception – spelling out their parental rights and responsibilities.

Medical Consent Issues: The parties can sign a document, similar to a power of attorney, conferring the power to consent to medical and mental health treatment for themselves and/or their children. Such a document, in states which permit them, would enable those who are temporarily unable to care for their own – or their children’s needs – to ensure that the health needs are addressed – without terminating or limiting the unmarried individual’s legal rights.

Potential for Will Contests: One of the most frequent (and warranted) fears of unmarried couples is that a family member will contest the will of a decedent partner who has left all or the bulk of his/her estate to the surviving partner. In most states, a will may be challenged by someone whose share in the estate would be greater if the will is not probated (e.g. intestate heirs, beneficiaries under a prior will, a surviving spouse who would receive a larger share under a prior will, or someone who would take in default of the exercise of a power of appointment), or someone else who would benefit significantly if the will is not accepted for probate (e.g. the trustee of a trust estate, an heir’s secured creditor, or the state as a default heir if there were no legal relatives of the decedent).

Typical grounds for contesting a will include

- the lack of testamentary capacity, undue influence (Wills are presumed to be valid. The burden rests on the contestant who must prove that the deceased partner had a weakened intellect, that there was a confidential relationship between him/her and the person benefiting, and that person gains significantly under the will from that relationship),
- fraud or mistake (e.g. failure to disclose or deliberate concealment of an action – such as the misappropriation of funds - that, had it been known, would have resulted in the changing or deletion of the bequest, or the decedent was told, wrongly, that his only child was dead, etc.),
- forgery,
- insane delusion, or
- improper execution.

The unmarried client has a great deal of exposure to a will contest and is right to be concerned. Both federal and state law favor “traditional” (the latest few census reports certainly show that term is at the least rapidly changing) relationships, i.e. husband and wife. Family members, if excluded in the will of an unmarried individual, are likely to contest it. Likewise, if the will provides them with less than they think they “deserve,” or are “entitled to”, there is a strong incentive to contest. The more estranged the recipient partner is from the family, the more likely they are to contest. Of course, anyone can contest a will. To win a will contest, the contestant has an uphill battle in most states, even in the case of a non-family member recipient.

Wise counsel will typically suggest that unmarried individuals short circuit these problems by forging a strong and friendly relationship with the other partner's family. As far as tactics that will minimize the risk of a will contest, the following steps will generally help:

- counseling of each partner by different attorneys to document the independence and objectiveness of advice, the mental capacity, and the lack of undue influence,
- execution of the will without the other partner in the room (some suggest videotaping to show testamentary capacity and bulwark the claim of independence and a lack of undue influence),
- the use of alternatives to a will (discussed in detail below including revocable trusts, FLPs, LLC, jointly owned property with rights of survivorship, lifetime gifts, and life insurance),
- and a "no-contest" (forfeiture) provision that states in essence, "I'm leaving my brother Paul \$X but if he challenges this will and my bequest to my partner whom I dearly love and who has supported me and lived with me for 20 years, Paul's bequest is to be changed to \$Y dollars." (Depending on the state and circumstances, courts will enforce such provisions – but only if the clause is tailored to address the specific situation and is reasonable under the circumstances).

TOOLS AND TECHNIQUES AVAILABLE FOR NON-TRADITIONAL FAMILIES

There are numerous tactics that unmarried couples should aggressively consider. Each has pros, cons, downsides and costs.

These include:

Joint Tenancy: Joint Tenancy With Right of Survivorship (JTRS) is co-ownership of real or personal property in which each party owns an equal, undivided interest in the property and in which each grants to the other a right to take the entire property at the death of the other(s). So when one partner dies, the jointly held property passes by operation of law absolutely and entirely to the survivors(s).

Unmarried partners can hold property this way. Unlike a will, a JTRS passes in a manner that is not subject to contest. So it provides unmarried partners much more dispositive certainty than a will. Joint tenancy also avoids the costs and delays and privacy issues of probate.

The problem with JTRS is that there may be severe gift, estate, and generation-skipping taxes triggered upon the formation or termination of the tenancy:

- If the asset is other than a joint bank or brokerage account (as long as the contributor can take back the money contributed without the other joint owner's consent, there is no immediate federal gift tax consequence. However, the moment the noncontributing partner takes money out with no liability to return it, a completed gift has been made by the contributing partner), the partner paying for and buying the property in joint names with the other partner is making

a gift to that other partner. That gift will be half of the value of the property purchased and to the extent it exceeds the annual exclusion, it is taxable.

- Estate taxes may be imposed at the death of an unmarried partner. The general rule is that 100% of the value of the jointly held property is includable in the estate of the first to die of the tenants – except to the extent the survivor can prove contribution – even though each joint tenant during lifetime was deemed to own an equal interest. The executor of the decedent has the burden of proving the value of the consideration the decedent made. The estate must show not only that the survivor in fact contributed and the amount; it must also prove that amount was not acquired with money or other consideration that came from the decedent. Note also that it is not the amount the survivor contributed that is deducted from the deceased's estate; it is the percentage of the original purchase price. So if the estate can prove the surviving tenant contributed 40% of the original price from her own money, 40% of the value of the property at its estate tax valuation date will be excluded from decedent's estate. Of course, the devil is in the details. Few people keep records for the purchase and improvement of property over a long period of time – and can also prove who contributed what – and the source of that contribution. Again, absent authoritative documentation, the entire value of jointly-held property is includable in the estate of the first to die.
- Where unmarried partners are more than 37.5 years apart in age, and one partner has contributed more than half of the money to buy the asset, the generation skipping transfer tax discussed above may be imposed.
- Creditors of either joint tenant can attach the debtor-tenant's interest in the property to satisfy their claims. This may force the estate to sell the entire property at fire sale prices.

Annual Exclusion Gifts: Unmarried partners are able to make full use of the gift tax annual exclusion. Each can give up to (currently) \$12,000 a year to the other or to anyone else – regardless of relationship – without gift tax consequence – as long as the gift is one of a “present interest.” (The donee must have the immediate, unfettered, and ascertainable right to use, possess, or enjoy the gift). Over a period of time, such gifts can amount to a very large sum of money (as well as the appreciation) that is removed from the donor's estate. Gifts can be made by the wealthier of the two to the less wealthy in order to take full advantage of the less wealthy partner's federal estate tax unified credit. Gifts can also be made to children, relatives, or even unrelated friends of either of the unmarried partners through the annual exclusion.

Tuition and Medical Care Gifts: A vastly underestimated estate planning tool is the ability for one unmarried partner to make payments of the other's tuition or medical care (to the extent costs of that care are not reimbursed by insurance coverage). The amazing thing is that – assuming these payments are made directly by the unmarried partner directly to the service provider (e.g. college or hospital) they will not be subject to gift tax – regardless of the amount involved! (This even includes the payment of premiums for medical insurance since it falls within the definition of medical care). Not only can the wealthier of the two partners pay for the other; he or she can pay tuition or medical expenses for the other's children or friends!

Unified Credit: The gift tax unified credit, which is used against taxable gifts (i.e. gifts in excess of those qualifying for the annual exclusion) can be used by unmarried partners. So up to \$1,000,000 can be used during lifetime – in addition to annual exclusion gifts – to enrich the life

of a partner – or anyone else! Smart planning suggests these be assets that are likely to appreciate (think life insurance or rapidly growing real estate or a business interest) and property that can be transferred at a valuation “discount”, i.e. a minority interest in a closely-held business, a fractional interest in real estate, etc.

Bypass Trust: Nothing in the tax law prevents an unmarried partner from setting up a trust which, when he/she dies will receive assets that will be taxable in his/her estate but which will by-pass estate taxation when the surviving partner dies. Such a trust could provide income, health, education, maintenance, and support payments, and other flexibility (e.g. a limited power of appointment) for the surviving partner – yet pass to either party’s children, relatives, or friends without estate taxation at the surviving partner’s death. It would serve to reduce the overall estate tax by fully utilizing the wealthier partner’s unified credit – and can be set up to maximize generation skipping possibilities (i.e. hold assets in trust through the lives of successive beneficiaries). Most importantly, this is a device which can assure the ability to provide financial security for the surviving partner while also locking in the right to name the beneficiaries who will receive the assets in the trust at the surviving partner’s death.

Valuation Freezes: Amazingly, unmarried partners have the opportunity under the tax law to employ certain devices that are barred to married or related individuals. Although space does not permit a full explanation (See **TOOLS AND TECHNIQUES OF ESTATE PLANNING** – 14th Edition (800 543 0874) Chapter 57), the bottom line is that Congress, concerned about intra-family abuses in buy-sell agreements, split-interest purchases, grantor-retained interest trusts (GRITs), and other sophisticated techniques, enacted a series of Code Sections, 2701 to 2704 – designed to thwart such tactics. The vehicle used to accomplish this goal of discouraging taxpayers from entering into these freezes was to increase the transfer (gift and estate) taxes relating to transactions among “family” members. The point is that unmarried partners – whether same or opposite gender – are not within the definition of family member – even though they live together as a family - and so many of these harsh and restrictive provisions do not apply to them. This opens a door to a wide variety of tools and techniques that, as I said above, are not available to most U.S. citizens.

Life Insurance: Of all the tools and techniques available to provide financial security between unmarried partners, none is as simple, certain, and powerful as life insurance. Assuming insurable interest (which there should be – at least to the extent of any joint liability or provable financial responsibility), one partner can purchase insurance on the life of the other partner in an amount sufficient to pay off a mortgage, other debt, or maintain a lease that the two are responsible for.

Since a person has insurable interest in his/her own life, a reasonable amount of coverage can be obtained and the other partner can be named as beneficiary. In fact, at some time after the purchase of the policy, the insured owner may chose to make a gift of that policy to the other partner who can then name him/her self as owner and beneficiary.

An irrevocable life insurance trust could be created. In a smaller estate where the unified credit (scheduled to reach \$3,500,000 in 2009) will absorb all or most of the estate tax, a by-pass trust

could own the coverage. Even though it would be included in the insured's estate, the unified credit would wipe out all or most of the tax and then the assets purchased with the remaining policy proceeds (plus all the appreciation) could be passed to the ultimate beneficiary estate tax free at the second partner's death.

Insurable interest from both an underwriting and a state law perspective is essential. Absent insurable interest, the policy is void or voidable and even if an insurer is willing to pay at the insured's death, the IRS may claim the proceeds are ordinary income because the coverage does not meet state law insurable interest tests. But this should not be a problem as long as the amount of coverage is reasonable in relation to a demonstrable need and the noninsured partner can show an expectation of pecuniary advantage through the continuing life of the other partner and/or a financial loss at that person's death. Dependency on the insured for support or education or medical expenses or a legal obligation binding the parties – particularly if evidenced by one or more written documents defining financial obligations and spelling out the rights, and benefits of the domestic partnership relationship – should be helpful in showing insurable interest.

THE BOTTOM LINE

Estate and financial planning is essential to all people. But it is of particular importance to an unmarried couple. Although state and federal law discriminates against such couples in many respects, there is a vast array of tools and techniques that is available – and ironically unmarried couples have the legal right to use some devices barred to married individuals.

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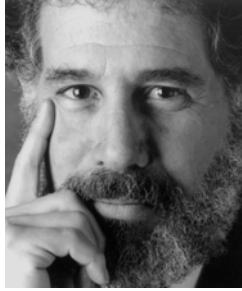
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Please fax back to Leimberg Associates, Inc., (610) 924-0514 or mail to Leimberg Associates, Inc., 144 West Eagle Road, Havertown, PA 19083