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Estate Planning Concerns for the Professional Athlete

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ESTATE PLANNING CONCERNS FOR THE PROFESSIONAL ATHLETE

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I. OVERVIEW OF ESTATE PLANNING

Estate planning is generally defined as the orderly disposition of property, with primary emphasis on family needs. A secondary consideration is a desire to minimize taxes and other costs that may reduce the net assets available for the satisfaction of family needs. A broader definition of estate planning would include the orderly and economical creation of property for the ultimate enjoyment of the estate creator, his or her family and any others he or she may want to benefit.

For most people, the creation stage of estate planning takes many years with early emphasis on creating enough wealth to enable the estate owner to enjoy the fruits of his or her efforts. For a successful professional athlete, the creation stage is quite short. The early emphasis is on the preservation and protection of the wealth that has been accumulated while the athlete is relatively young. Although many of the estate planning considerations and techniques used in the more conventional case of an estate owner who has accumulated his or her wealth over a long time are applicable to the professional athlete, the relative youth of the athlete forces a different perspective on the advisor. Planning strategies that require irrevocable decisions assume a much longer time horizon and may not be as palatable as the same strategies are to the estate owner who is advanced in years. In addition, while the amount of wealth accumulated by the professional athlete may be substantial, the need to rely on that wealth to maintain a desirable lifestyle could extend for a substantial time period.

The relative inexperience of the professional athlete in managing wealth is also an important consideration in advising the athlete. In fact, the sudden acquisition of large amounts of wealth can often result in a state of shock. As such, the athlete may not comprehend the necessity of planning to preserve and protect the wealth suddenly acquired. The estate planning advisor should work with the other members of the investment and financial planning team in order to conceive an estate plan consistent with the personal and financial goals of the athlete.

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The role of the estate planning advisor on the team should be clearly defined. In general, the estate planner is not the financial or investment advisor, insurance agent, accountant or banker. Rather, the estate planner's role is to focus on the preservation of wealth, the reduction of taxation, and the ultimate transfers of wealth in a carefully structured plan tailored to the individual's personal, family, financial and, possibly, charitable goals. The objective of the estate planner should be to assist the athlete in realizing both "lifetime" and "at death" goals from a tax and non-tax perspective. The estate planner can achieve this objective only by working with the athlete to coordinate accounting and investment decisions that will fit into a comprehensive plan.

II. Forms of Ownership and Methods of Passing Property

Once the athlete has accumulated a substantial amount of wealth and has established a plan for preserving that wealth to meet his or her personal needs, the next step is to determine who should receive that wealth after the athlete's personal needs have been fully satisfied or have ended as a result of death. There are a number of property ownership forms and the form of ownership can affect how that property is passed on to the objects of the athlete's bounty.

For the married athlete, a large percentage of assets may be held in joint tenancy with a right of survivorship. Upon the death of either joint tenant, full ownership of the property passes by property right to the survivor. This form of ownership has the advantage of simplicity and the transfer of a joint tenant's interest at death avoids the publicity attendant with probate proceedings. On the other hand, joint tenancy is inflexible.

With individually owned property, the owner can transfer the property at death by will, if he or she has executed one. Otherwise, the property will pass according to the rule of intestate succession for the state of residence. In addition, the owner is free to make a gift of the property without the consent of any other person since the entire ownership right is held by one owner.

A number of states have a system of community property that applies to married couples. Generally, in a community property state one-half of all property acquired during marriage, other than gifts or inheritances, is owned by each spouse. For the most part, the spouse in whose name the property is titled has the right to manage and control the property, but is liable to the other for any transfers of that spouse's interest without the consent of the non-managing spouse. Unlike joint tenancy property, spouses can pass their interest in community property to children or others by will upon death. While the presumption in community property states is that property held by married couples is community property, it is possible to have property titled as joint tenancy property with a right of survivorship, except in Louisiana. The states which have a community property system are Louisiana, Texas, New Mexico, Arizona, Nevada, California, Washington and Idaho. Wisconsin adopted a system of marital property in 1986 similar in many ways to community property.

A fourth form of ownership that has recently gained popularity is the trust. Trusts come in many shapes and sizes. One type of trust that has enjoyed increasing popularity among estate planners is the living trust. A living or *inter vivos* trust is a trust established while the grantor of the trust is alive. The testamentary trust, in contrast, is established by the will of the estate owner and does not become effective until the estate owner has died and the will has been admitted to probate. The most common form of a living trust is a revocable trust that can provide for management of assets while the grantor of the trust is living and avoids the probate of trust-owned assets at the death of the grantor because ownership of the assets has already been transferred to a trust which survives the grantor. Management and control of trust assets can be retained by the grantor acting as trustee for as long as he or she is capable and willing to do so with a provision for a qualified successor trustee upon the death, incapacity or resignation of the grantor as the initial trustee. While the living trust has many advantages with respect to the smooth transfer of control of estate assets and the avoidance of the probate process, it does not provide any relief from the burden imposed by death taxes on the property held by the estate owner.

In cases where transfer tax avoidance is a primary concern, trust planning could include the creation of one or more irrevocable living trusts. In contrast to the more common revocable living trust, the irrevocable living trust involves the unconditional transfer of assets for the benefit of other members of the family with no retention of any beneficial interest by the grantor who establishes the trust. The major advantage to an irrevocable trust is that the assets held in the trust will not be included in the estate of the grantor for estate or inheritance tax purposes upon his or her death, provided the trust has been properly established. The obvious disadvantage of establishing an irrevocable living trust is that the grantor must give up any direct interest in the property transferred to the trust and cannot take the property back at a later time if the trust no longer meets his or her objectives, or changes in family or financial status eliminate the need for such a trust as part of the estate plan. In the case of an athlete who has accumulated a substantial estate, utilizing this type of planning technique can provide a tremendous benefit from a tax planning standpoint. On the other hand, the youth of the athlete and the likelihood of significant changes in his or her goals or financial and family status make the decision to go forward with this type of plan problematic.

III. Form of Ownership and Disposition of Wealth

The form of ownership can affect how the estate is ultimately disposed of at death. With property that is held in joint tenancy, the surviving joint tenant automatically takes over complete ownership. If a trust has been established, the terms of the trust determine who will receive the assets held in trust and the timing of any distributions. Certain types of assets pass according to beneficiary designations. These include employee benefits such as pension plans and group life insurance, annuities, IRAs and personal life insurance. In the case of property that is owned individually or as an interest in community property, the owner can designate who will receive those assets by executing a will. In the absence of a valid will, the state intestacy statute will determine what happens to the assets owned at the time of death.

State intestacy statutes are inflexible and often work to the detriment of the surviving family members. They make no provision for unusual family needs, do not take tax planning objectives into account, and do not allow for special treatment of unique assets. Typically, if no spouse or children survive, the estate passes to the parents of the decedent or, if the parents are not living, to the siblings. If the decedent is survived by a spouse, the estate passes in its entirety to the spouse. If the spouse and one or more children survive, most statutes provide for a split of the estate between the surviving spouse and the children. On the other hand, a number of state intestacy statutes direct that the entire estate pass to the surviving spouse even if there are surviving children. This is typically the case in community property states with respect to the deceased spouse's share in community property. The separate property is likely to be split between the surviving spouse and the children.

Because the state intestacy statutes will most likely not meet the estate planning goals of the athlete, regardless of age, family status and amount of wealth, it is imperative that, at minimum, the athlete have a will drafted and executed. Aside from directing the disposition of assets, a will enables the athlete to: choose a guardian for children if a spouse does not survive; choose an executor; direct how and by whom taxes are to be paid; provide for the management and control of assets through trusts; give discretion over distributions of income and principal to trustees; avoid misunderstanding and conflicts among family members over the athlete's intentions; provide for any special needs of dependents, especially minor children;

coordinate the distribution of various employment benefits; and, if desired, provide for charities.

IV. Transfer Taxes and the Estate Plan

The federal government, as well as most states, imposes a tax on the transfer of wealth. The federal system is unified with respect to both gifts made during lifetime and the estate passing at death. The unification of the system extends to both the rate of tax imposed and the transfers subject to tax. The tax imposed is based on the cumulative transfers made both during lifetime and at death. As a result, an individual who makes substantial gifts over a number of years is subject to an increasing threshold rate of tax imposed on the taxable transfers made from year to year. The accumulation of taxable transfers made during a lifetime also carries over to the calculation of the estate tax imposed at death. This unified system contrasts with the income tax which is applied only to the income earned or received during the tax year and which is not affected by the amount of income earned or received in prior years, with the exception of certain carry forwards of losses or credits. The structure of the unified transfer tax system eliminates, with limited exceptions, the ability to take advantage of the lowest marginal brackets from year to year.

In addition to being cumulative, the federal estate and gift tax is imposed at a maximum rate higher than the federal income tax. The unified transfer tax rates begin at 18% on taxable transfers of up to $10,000 and increases to 55% on cumulative taxable transfers in excess of $3,000,000. The 55% bracket was scheduled to phase out at the end of 1992, leaving the 50% bracket on taxable transfers in excess of $2,500,000 as the highest bracket. However, there have been proposals to make the 55% bracket permanent.

As an offset to the cumulative nature of the transfer tax system, there are a number of credits, deductions and exclusions available that can result in significant tax savings if utilized effectively. Each taxpayer is allowed a "unified credit" of $192,800. This credit offsets the tax on the first $600,000 of taxable transfers. This $600,000 "credit equivalent exemption" is the amount an estate owner can pass to beneficiaries, absent any other deductions or credits, without incurring any federal gift or estate taxes. Because both a husband and wife have a unified credit available, they could pass a total of $1,200,000 to their children or other beneficiaries with no transfer tax liability.

V. Calculating Transfer Taxes

While the availability of the unified credit presents an opportunity to do some effective estate and gift tax planning, it is important to understand the effect of the transfer tax system once the amount of taxable transfers sheltered by the unified credit has been exceeded. Because the credit is applied to offset the tax calculated on the first dollar of taxable transfers, it offsets the tax imposed at the lowest marginal brackets. Once the estate owner makes taxable transfers equal to the "credit equivalent exemption," the rate of tax imposed is 37%. For example, if an individual made a taxable gift of $700,000, the tentative tax determined according to the rate schedule would be $229,800. The tentative tax would then be offset by the unified credit of $192,800, resulting in a tax payable of $37,000, which is 37% of the amount by which the gift exceeded the equivalent exemption of $600,000. Because the nature of the transfer tax system is cumulative, should that individual make another taxable gift of $700,000 the following year, the tentative tax would be calculated by applying the rate table to the cumulative taxable transfers of $1,400,000. The result is a tentative tax of $512,800. This tentative tax is then reduced by the unified credit of $192,800 and the tax payable on prior transfers of $37,000 to yield a tax payable of $283,000. Failure to reduce the tentative tax by those items would result in double taxation since the prior transfer was added to the current year's transfer in making the calculation. The second transfer would move the marginal rate of tax up to 43% and the effective rate of tax on the gift is slightly more than 40%.

As mentioned previously, the cumulation of taxable transfers carries through to the calculation of the estate tax. If the same individual died with a taxable estate of $2,000,000, the calculation of the estate tax due would take into consideration the taxable gifts he made during his life. The tentative estate tax would be calculated by applying the rate table to the sum of the taxable estate plus the cumulative taxable gifts, which equals $3,400,000. The tentative tax of $1,510,000 is reduced by the unified credit of $192,800 and the gift tax payable of $320,000 to yield an estate tax due of $997,200. The cumulative nature of the transfer tax system has not only pushed the estate into the highest marginal bracket of 55% but also has caused an effective estate tax rate of just under 50%.

VI. Gift Tax Planning

Besides the unified credit, there are other provisions that mitigate the effect of the gift tax on lifetime transfers. An annual exclusion of $10,000 is available for each recipient to whom the property owner makes a gift. A gift qualifying for the annual exclusion is not classified as a taxable gift and is not included in the calculation of the tentative tax for either gift or estate purposes. An additional feature of the annual exclusion is the availability of "gift-splitting" between married couples. This enables the spouse who owns the property subject to a gift to use the annual exclusion of the other spouse in determining the amount of taxable gifts, if any, subject to the gift tax calculation. An athlete who wanted to help provide for his or her nieces and nephews could make annual gifts of as much as $10,000 to each niece and nephew without incurring any taxable gifts. If the athlete's spouse agreed to split the gifts to the nieces and nephews, the amount that the athlete could transfer without incurring any taxable gifts would be doubled to as much as $20,000. The one condition that must be satisfied for the annual exclusion to be available is that the gifts must be of a "present interest," meaning that the recipient of the gift must have the immediate and unrestricted right to use the property transferred. In general, outright gifts and gifts to custodial accounts or special trusts for the benefit of minors will qualify as present interest gifts. Absent special withdrawal rights on the part of the beneficiaries, gifts in trust generally will not qualify as present interest gifts.

In addition to the $10,000 annual exclusion, there is an exclusion for certain "qualified transfers" for educational or medical expenses that is not limited by a dollar amount. Qualified transfers are defined as any amount paid on behalf of an individual as tuition to an educational organization for the education or training of that individual or paid as medical expenses to any person who provides medical care to that individual. An athlete who wants to help relatives with education or medical expenses can do so without any adverse transfer tax consequences as long as the payments satisfy the definition of "qualified transfers."

Certain deductions are also available for gift taxes. There is an unlimited marital deduction for gifts between spouses. The deduction is available whether the gift is made outright or in trust. However, if the gift is made to a trust, there are certain conditions that must be satisfied for the gift to qualify for the deduction. The trust must provide that all income on assets held in the trust be paid at least annually to the spouse for as long as he or she lives. The spouse must also have the right to either withdraw the property or to designate who is to receive the property at the termination of the trust. As an alternative to the latter condition, the spouse making the gift can elect to treat the property transferred to the trust as "qualified terminable interest property" (QTIP). The QTIP election allows the gift to qualify for the marital deduction without giving the beneficiary spouse control over the ultimate disposition of the trust property. The availability of the QTIP alternative is particularly useful in the case of second marriages where the property owner wants not only to take advantage of the marital deduction but also retain control over the disposition of the trust assets after the income interest of his or her spouse has terminated.

A marital deduction is not allowed if the spouse who receives a gift is not a citizen of the United States. This exception is intended to preclude avoidance of transfer taxes that would result if a marital deduction were allowed and after receiving the property, the spouse returned to the country in which he or she is a citizen. To compensate for the lack of a marital deduction, the gift tax allows a $100,000 annual exclusion to a noncitizen spouse rather than the $10,000 annual exclusion for gifts.

In addition to the marital deduction, there is an unlimited deduction for gifts to charity. Keep in mind that the charitable deduction is unlimited for gift tax purposes. This is completely unrelated to the income tax deduction which is subject to limitations based on adjusted gross income.

VII. Estate Tax Planning

The federal estate tax is a tax on the right to transfer property at death and is imposed on the decedent's taxable estate. The tax is imposed on the estate of anyone who was a citizen or resident of the United States at the time of death. There is no exception for residents who are not citizens. In the case of an individual who is neither a citizen nor a resident of the United States, a tax is imposed on property located in this country, such as real estate. The taxable estate is calculated by starting with the gross estate, comprised of everything the decedent owned plus some things that the decedent did not own but had some control over, and subtracting allowable deductions. The tentative tax is determined by applying the rate table to the tax base, which consists of the taxable estate plus the taxable gifts made during lifetime. After calculating the tentative tax, the estate tax due is determined by subtracting credits available, such as the unified credit, the credit for state death taxes paid, and a credit for any gift taxes payable.

The first step of the process is determining what is included in the gross estate. The most obvious assets are things owned by the decedent outright. This category includes assets owned in foreign countries. In the event federal estate tax is imposed with respect to property that also generates a transfer tax in a foreign jurisdiction, a credit is available for foreign death taxes. In addition, the gross estate includes the decedent's share of jointly owned and community property. In the case of property jointly owned with a spouse or community property, one-half of the value of the property is included in the estate. For property jointly owned with someone other than the spouse, such as a sibling, the amount included in the estate is the value of the property representing the proportionate contribution made by the decedent. For example, if a professional athlete wanted to assist a sibling financially by naming the sibling as a joint owner of an investment purchased entirely with the athlete's funds, the full value of the investment would be included in the gross estate for estate tax purposes in the event of the athlete's death, not just the one-half interest retained by the athlete.

The gross estate also includes the value of property that the decedent transferred but did not give up full control or beneficial interest. A typical example would involve property transferred to a revocable living trust. While title to the property may be in the name of the trust, the value of the property is included in the gross estate because the transferor retained the right to revoke the trust. Likewise, if an irrevocable trust has been established but the grantor acts as trustee or names himself as a beneficiary, the value of the trust property will be included in the grantor's estate. Caution should be taken with respect to irrevocable trusts even where the grantor retains no control or beneficial interest in the trust. With most irrevocable trusts, the beneficiaries are the spouse and children of the grantor. Although the grantor has retained no interest in the trust directly, in many cases the purposes for which the trustee is authorized to make distributions to the spouse or children can be construed as providing a benefit to the grantor. The most common example of this is the power of the trustee to make distributions for the purpose of the children's higher education. A number of state courts have ruled, primarily in the context of child support obligations pursuant to divorce, that providing for higher education is an obligation of parental support. If that is true in the state of domicile of an athlete who establishes an irrevocable trust for his or her children, the goal of excluding the trust assets from his or her gross estate could be defeated if the trust authorizes the trustee to pay for higher education, thereby relieving the athlete of a parental obligation.

Life insurance is subject to a special set of rules in the estate tax arena. Obviously, the death proceeds would be included in the estate of the insured if he or she owned the policy. In addition, death proceeds would be included in the estate if the insured possessed, at the time of death, any of the "incidents of ownership" in the policy. The term "incidents of ownership" refers not only to direct ownership of the policy but also includes the right of the insured or his or her estate to the economic benefits of the policy. Examples of rights that are considered "incidents of ownership" are the right to change the beneficiary, to surrender the policy, or to obtain a loan against the cash surrender value of the policy. The death proceeds will also be included in the estate under section 2035 of the Internal Revenue Code if the insured transferred a policy or any incidents of ownership in a policy within three years prior to death.

In the case of professional athletes, items of deferred income deserve special mention. In many cases, the future income, whether in the form of guaranteed contract payments or deferral of income earned in prior years, constitutes a significant portion of the athlete's estate. The value of any future income payable after the death of the athlete will be included in the estate for federal estate tax purposes. The valuation is based on the current discount rate, adjusted by the Internal Revenue Service monthly, and the gross payments due. Absent an offsetting deduction such as a marital deduction, the value of the future payments could generate a substantial estate tax due within nine months after the date of death. In addition to the potential estate tax arising from the value of the future income, the recipient will be subject to income tax as payments are made. Partial relief is available in an income tax deduction for the estate tax attributable to the compensation included in the gross estate. However, this relief is not a complete offset and assets of this type can be substantially depleted by this double taxation.

After determining which assets are included in the gross estate, the next step is to subtract those items allowable as deductions. Expenses incurred for estate administration and a funeral, as well as any claims against the estate or indebtedness against assets included in the estate are allowed as a deduction under section 2053 of the Internal Revenue Code. Similar to the gift tax, there is an unlimited deduction allowed for contributions for public, charitable, or religious uses.

Aside from the unlimited charitable deduction, there is also an unlimited marital deduction available. As with the gift tax, property passing outright to the surviving spouse qualifies for the marital deduction, as does property passing to trusts that meet certain conditions. The use of QTIP trusts has enjoyed increasing popularity, reflecting the frequency of second marriages. A QTIP trust has other advantages in addition to giving the estate owner control over the disposition of the trust property after the lifetime income interest of the surviving spouse ends. When a QTIP trust is included in the estate plan, the executor must elect to qualify all or a portion of the trust assets for the marital deduction. In many cases, especially with very large estates or estates holding assets that are likely to appreciate substantially in value, use of the full marital deduction available may not be the most prudent tax planning strategy. Although the marital deduction is attractive because of the ability to completely avoid estate taxes at the death of one spouse, whatever assets qualify for the marital deduction will be included in the estate of the survivor and subject to estate tax at his or her death. The advantage of postponing taxes must be weighed against the advantage of using the lower estate tax brackets for the estates of both spouses, as well as the value of excluding future appreciation on estate assets from the gross estate of the survivor. Due to the relatively high rates of tax imposed, substantial tax savings can be realized through optimum planning. The difficulty in devising an optimum plan is the constant change in the variables considered in estate tax planning. Because the QTIP provision gives the executor control over the amount of the estate that will qualify for the marital deduction, it presents the opportunity for post-mortem estate planning and improves the chances that the optimum plan will be effected.

As with the gift tax, no marital deduction is allowed for property passing to a spouse who is a noncitizen. However, the estate tax allows a marital deduction if property passes to a "qualified domestic trust" (QDOT). In order to meet the requirements of a QDOT, the trust must have at least one trustee who is a citizen of the United States or a domestic corporation. It must also provide that no distribution may be made other than income unless one of the trustees has the right to withhold tax from the amount distributed. Any distributions of trust principal are subject to estate tax as if they were included in the taxable estate of the deceased spouse who established the trust. As with the gift tax, the intent of the limitation on allowing the marital deduction for transfers to noncitizen spouses is to preclude avoidance of transfer taxes resulting if the surviving spouse returned to his or her homeland.

VIII. CASE STUDY

John Doe, age 27, plays second base and is a rising star with the Florida Oranges. John and his wife, Jane, who is also 27, have two children, Judy and Jack, who are 6 months old and 3 years old, respectively. They make their permanent home in San Diego. John's parents are both living and he has one brother and one sister. Jane's father is 59, but her mother passed away at an early age. She has no siblings. John has a will in which he leaves his entire estate to Jane. Jane has not executed a will. Their primary estate planning concern is to make certain that their children are taken care of in the event anything happens to them. They are also interested in avoiding estate taxes as much as possible.

Earlier this year, John signed a five-year contract with the Oranges. The contract provides a $1 million signing bonus and salaries of $1 million for 1992, $1.5 million for 1993, $2 million for 1994, $2.5 million for 1995, and $3 million for 1996. The compensation is fully guaranteed. Their net worth statement lists the following assets and liabilities:

ASSETS	
Cash and Investments	
Cash	$ 1,250,000
Life Insurance CSV	200,000
Stocks & Bonds	500,000
Present Value of Contract	$ 7,870,000
	$ 9,820,000
Personal Assets	
House	$ 1,500,000
Personal Property, Jewelry, Automobiles	430,000
	$ 1,930,000
TOTAL ASSETS	$11,750,000

LIABILITIES AND NET WORTH	
Liabilities	
Tax Due 4-15-93	$ 200,000
Credit Cards, etc. . .	50,000
Mortgage (10.75%, 30 yrs.)	1,250,000
Home Equity Line of Credit (7%)	200,000
	$ 1,700,000
Net Worth	$10,050,000
TOTAL LIABILITIES AND NET WORTH	$11,750,000

The life insurance cash value is the current value of a $5,000,000 policy that John owns on his own life. The present value of the contract is the value of the remaining four years of payments due under John's new contract discounted at 5%. In the event of John's death, they would like to pay off the $50,000 credit card debt, but probably would keep the line of credit open. The mortgage would be maintained.

A cursory review of the net worth statement leads to the conclusion that estate tax planning will play a significant role in their plans. Because of their ages and the availability of the unlimited marital deduction, the need to devise a plan to accommodate estate taxes in the event one or the other should die is not particularly compelling. Preventive planning is critical, however, to anticipate the consequences of a worst-case scenario, a common disaster.

Based on their current status, the liquid assets available would be insufficient to pay taxes and other expenses arising as a result of their deaths in the event of a common disaster. Two factors contribute to the shortage. First, the life insurance proceeds on the policy John owns on his own life would be included in his estate and ultimately subject to estate taxes. Second, the structure of John's will, which directs everything to Jane, could result in a bunching of assets in her estate which pushes her estate into a higher marginal bracket and precludes his estate from utilizing the unified credit and lower brackets. The following analysis assumes that Jane survives John long enough for his will to pass everything to her estate.

CURRENT ESTATE PLAN
RESULTS IN THE EVENT OF COMMON DISASTER

ASSETS AVAILABLE AT DEATH

Cash	1,250,000	
Stocks & bonds	500,000	
Life Insurance	5,000,000	
		6,750,000

CASH NEEDS AT DEATH

Income Tax Due	200,000	
Credit Card Debt	50,000	
Funeral	10,000	
Admin. Exp	600,000	
Fed. Estate Tax	5,800,000	
State Death Tax	1,765,000	
		8,425,000
ADDITIONAL CASH NEEDED		$1,675,000

By implementing two estate tax planning strategies, John and Jane can dramatically reduce the potential estate tax liability faced by their estates. The first step is for John to transfer ownership of the $5,000,000 policy on his life to an irrevocable trust in order to exclude the death proceeds from both his and Jane's estates. Transferring a policy with $200,000 of cash value presents some gift tax concerns and is not an immediate cure because of the inclusion of the death proceeds in John's estate if he dies within three years of the transfer. Application of the three-year rule can be mitigated by including a marital deduction savings clause in the trust so that in the event the death proceeds are brought back into John's estate, the marital deduction would shelter the proceeds from estate tax. In the event of a worst case scenario, however, this strategy does not improve matters.

If, as part of their overall financial review, they decide that the current policy does not satisfy their goals and decide to replace it, or purchase additional life insurance, serious consideration should be given to establishing an irrevocable trust so that the trustee can apply for the replacement policy. Under that scenario, the three-year rule would not apply to bring the death proceeds back into John's estate.

Another consideration about the role of life insurance in estate tax planning is survivorship joint life. A survivorship joint life policy covers two lives and pays a death benefit upon the death of the second insured to die. When combined with the marital deduction, which postpones estate taxes until the death of the second spouse, survivorship joint life is an extremely efficient tool for funding the ultimate estate tax liability. Because the policy pays a benefit only on the second death, the mortality charges are much lower than the charges on a single life policy and, at their ages, the cost of a joint life policy covering John and Jane would be very inexpensive.

Aside from estate tax planning advantages and the utility of joint life insurance in an irrevocable life insurance trust, there are also some personal concerns that must be addressed in life insurance planning. Despite the potential estate tax advantages of an irrevocable trust, many couples, especially couples as young as John and Jane, feel uncomfortable embarking on strategies that cannot be changed. In addition, they may want to give Jane direct access to a source of cash in the event of John's death without the formalities attendant with a trust. The final decision on their life insurance planning may include a combination of insurance on John payable directly to Jane and joint life insurance held by an irrevocable trust. While there may be a number of visible strategies that will accomplish their goals, for purposes of the case study, we will assume that $5,000,000 of insurance on John's life is held in trust and is excluded from both estates.

In addition to life insurance planning, John and Jane can save additional taxes through effective will planning. At a minimum, both John and Jane should execute wills or a combination of wills and living trusts that enable both of their estates to take advantage of the unified credit. This is accomplished by creating a "bypass trust," which receives assets equal in value to the credit equivalent exemption, generally $600,000, with the balance of the estate qualifying for the marital deduction. Even greater estate tax savings can be realized by providing for equalization of their estates, especially in the event of a common disaster. Because they are residents of a community property state, equalization is fairly simple since they both own a one-half interest in all community property under state law. Their estate planning documents can ensure equalization by providing that in the event of a common disaster, neither estate passes any property to the other spouse. In states that do not have a community property system, equalization of estate becomes more complicated and, in some cases, cannot be fully achieved.

By implementing the two strategies discussed above, excluding the life insurance from both estates and utilizing "bypass trusts," the estate tax savings are dramatic. The following analysis assumes implementation of those two strategies:

RECOMMENDED ESTATE PLAN
RESULTS IN THE EVENT OF COMMON DISASTER

ASSETS AVAILABLE AT DEATH

Cash	1,250,000	
Stocks & bonds	500,000	
Life Insurance	5,000,000	
		6,750,000

CASE NEEDS AT DEATH

Income Tax Due	200,000	
Credit Card Debt	50,000	
Funeral	10,000	
Admin. Exp	600,000	
Fed. Estate Tax	3,440,000	
State Death Tax	740,000	
		5,040,000
ADDITIONAL CASH AVAILABLE		$1,710,000

The combined estate and state death taxes are reduced from $7,565,000 to $4,180,000 for a savings of $3,385,000.

The analysis demonstrates the obvious need for John and Jane to do some estate tax planning. Aside from the dramatic reduction in death taxes, a final note regarding the combined effect of death and income taxes on the payments due under John's contract will demonstrate that planning to reduce taxes does not eliminate the need to plan to fund the taxes that cannot be avoided.

The value of John's contract cannot be excluded from his estate. It is the most valuable asset he and Jane have, generating the bulk of the total death taxes due in the event of a common disaster. However, the tax collector will call again when the payments are made and income taxes are due. While there is a deduction allowed for estate taxes attributable to the inclusion of the value of the contract in John and Jane's estates, the deduction only provides partial relief. The following analysis quantifies the combined effect of death and income taxes on this item of income with respect to a decedent.

RECOMMENDED ESTATE PLAN
RESULTS IN THE EVENT OF COMMON DISASTER

COMBINED TAX EROSION OF
INCOME IN RESPECT OF A DECEDENT

	Present Value of Contract	$7,870,000
LESS:	Estate Tax Attributable to IRD	(3,130,000)
	State Death Tax Attributable to IRD	(680,000)
	Present Value of Income Taxes	(2,056,000)
	Present Value of Contract A/T	$2,004,000
	Effective Rate of Tax	75%

IX. CONCLUSION

The highly publicized reports of professional athletes who have found themselves facing insolvency because of imprudent investment decisions and poor money management highlight the need for sound financial and investment strategies. However, the value of a well structured financial plan can be needlessly depleted without a sound estate plan. As we have seen, death and taxes go hand in hand.