estate planning studies®

February 2013

New Year's present: ATRA 2012

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Congress gave us all the lovely New Year's gift of a new tax act. For most taxpayers it's a wonderful gift that will change the face of planning. For the very wealthy, it dashed all hopes of the "death tax" disappearing. The name for the new law, the American Taxpayer Relief Act of 2012, known by the simple acronym "ATRA," belies the complex implications to the estate planning process and profession. The face of estate planning has been forever changed. Key elements include:

- Inflation-indexed exemption of $5 million ($5.25 million in 2013) for federal estate, gift and generation-skipping transfer taxes;
- Portability of the federal estate tax exemption between spouses; and
- For the first time in more than a decade, the changes are permanent; that is, they have no explicit expiration dates. So while on the surface the law looks much akin to what we've had since the 2010 tax act, the permanence of the rules changes everything.

IDENTIFYING THE CATEGORY OF CLIENT WILL HELP IDENTIFY HOW TO PLAN FOR THEM

To facilitate the discussions following, and recognizing the risks of simplification, estate planning post-ATRA perhaps can be viewed as composed of three categories:

1. Moderate Wealth Clients. Moderate Wealth Clients are those who perceive that the estate tax will never apply to them. The possibility and consequent fear of the imposition of estate tax—that may have been a primary driver of action in the past—is now mostly irrelevant. These are clients "safely" below the approximately $5 million single person exemption amount and the approximately $10 million for married couples. These figures are "approximate" because each client's circumstances will influence how he or she should be categorized. Also, while these wealth levels are anything but "moderate" they are "moderate," relative to the now permanent exemption levels.

As planning in the post-ATRA environment unfolds, many planning conventions of the past will be turned on their heads. Several of these situations will be discussed below. Although this could have happened following the 2010 act to a degree, it did not, in part because of the perception at that time of the law's impermanence. This view may well have changed.

2. Potentially High Net Worth Clients. Potentially High Net Worth Clients are those

Published by
The Merrill Anderson Co. Inc.
1166 Barnum Avenue
Stratford, CT 06614

For bulk subscription sales, contact Sirvydas Vebra
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"in-between" or potentially in the third category. In other words, they might (if not currently, certainly in the foreseeable future) be subject to an estate tax. The "potentially wealthy" client also includes those clients domiciled in decoupled states, who will likely face a significant state estate tax. The term "significant" will in many instances be defined relative to the income tax implications of state estate tax planning. If a gift plan might save a client $250,000 of state estate tax, but lose the step-up in income tax basis that otherwise would have been available on death and that will cause heirs to bear perhaps $200,000 of additional capital gains tax, many clients may not view the possible state estate tax *net* savings as "significant."

This category of client will be the most challenging type of client to serve. It will likely require creativity to address the possibility of a federal estate tax, and perhaps the certainty of a state estate tax, in an environment in which fear of the federal estate tax, even for these "in-between" clients, is likely dramatically less than it has ever been.

These clients too will need the guidance of professional estate planners. But with fear of the federal estate tax so much less than it has ever been (remember that the exemption is not only permanent but also inflation indexed), the tax-driver may still motivate them, but perhaps much less so.

3. High Net Worth Clients. Ultra-high net worth clients are those who are clearly and certainly in the range where their estates will be subject to federal estate tax. For clients in this category, sophisticated planning should continue using the techniques and planning that have traditionally been used. However, planners and clients alike must be mindful that future fiscal cliff negotiations could still severely restrict planning options. ATRA may prove to be only a shortlived grace period to top off and perhaps expand the planning efforts consummated in 2012.

Planning Considerations Affecting All Clients

Many taxpayers' *initial* reaction to the 2013 tax law is that nothing needs to be done. Moderately wealthy taxpayers may believe, inasmuch as the federal estate tax will not apply to them, that no planning is necessary. Wealthy taxpayers may think that they completed all of their planning in 2012. But this is simply incorrect across the board. Many examples will be illustrated below.

Some estate planning tools and techniques, and estate planning opportunities, will apply to a broad cross section of wealthy taxpayers. These might include:

FLPs and LLCs. Clients generally do not enjoy the formalities of maintaining family LLCs or partnerships (FLPs). If they view the estate tax as no longer applicable to them, moderate wealth clients might well want to dissolve these entities. Professional advisors need to educate these clients that FLPs will continue to be vital to control assets, protect assets from creditors and irresponsible heirs, and more. Even if the federal estate tax benefits wane, these entities should remain the cornerstone of many plans. *Example:* If an FLP is no longer necessary for discounts, nothing done in Washington will have changed the client's susceptibility to lawsuits. If the client has significant life insurance holdings and one purpose of the FLP was to permit transfers of life insurance without triggering the transfer for value rules (because the parties were all partners), dismantling the FLP could trigger tremendous income tax costs.

Itemized Deductions, Residency and Domicile. The restrictions on itemized deductions will push wealthy taxpayers who can shift their domicile and residency to a no- or low-tax state to do so with greater vigor. This will not only save state income taxes and property taxes for which deductions may be far more limited, but it also will have a significant impact on where you should recommend that the client revise and sign new estate planning documents.

State Estate Taxes. With the federal estate tax now irrelevant to the vast majority of taxpayers, and the thought now gone that the $5 million exemption amount would be lowered, might some states re-evaluate the costs of administering state estate tax systems that were based on the assumption of a much larger number of wealthy taxpayers filing returns that were subject to federal audit?

The fact that so few estates will ever file *federal* estate tax returns for other than securing a portable exemption may have a significant impact on the administration of *state* estate tax systems. With a permanent inflation-adjusted exemption and portability, the number of returns that will be subjected to IRS audit will be miniscule compared to only a few years ago. Further, the portability regulations permit executors to use mere estimates. Although state tax authorities may have thought the $5 million estate tax exemption was temporary, that is no longer the case. This will raise practical issues as to the ability of states to administer their estate tax systems without the backstop of the federal filing system.

Asset Protection Planning. Practitioners are well aware that whatever happened in Washington, or might happen as future "cliffs" are addressed, it will have no impact on the litigious nature of our society. Clients at every wealth level need to be educated that the favorable $5 million plus exemption remains a golden opportunity to implement (or if the client started in 2012, *to continue* to implement) asset protection planning.

Clients should be counseled *not* to dismantle existing irrevocable trusts or family partnerships or LLCs, but instead to focus on them as asset protection tools, even if the discounts no longer affect their estate planning. Use of the rules on Roth conversion noted above to convert retirement assets into Roth IRAs might aid the asset protection process by using exposed funds to pay the income tax triggered on conversion.

Further, Roth IRAs, in contrast to regular IRAs, have no required minimum distributions, so assets can remain in what might be a protective Roth envelope for as long as the client desires. This, however, requires that applicable state law provide creditor protection for Roth IRAs.

Divorce Protection Planning. As with asset protection benefits, clients need to be reminded, or perhaps educated, that the risk posed by the reality of a high divorce rate will not change and may be a great threat to their transmission of wealth down the generational line.

Too many moderate wealth taxpayers will fall into the "Gee, I can get a simple will" attitude because "I won't face an estate tax." But the 50% oft-quoted divorce rate can decimate an estate to a more significant degree than a top 40% estate tax rate. And, unlike the estate tax, the divorce courts won't give your client's heirs the first $5 million plus free of claims. There is no divorce "exemption." *All* assets might be at risk.

So, regardless of whether estate taxes will ever be a concern, clients need to be counseled that they should almost assuredly use similar trust planning that perhaps they had used primarily for estate tax minimization in order for heirs to protect their assets from the ravages of divorce.

Moderate Wealth Clients

Many more clients will simply view the estate planning process as perfunctory, perhaps something to address with a low-cost website. Many moderate wealth clients may well believe the use of a professional estate planner's services is no longer relevant because they are safely under the permanent $5 million inflation-adjusted exemption amount.

Practitioners need to educate these clients to think again. Many taxpayers still may face state estate tax. Income tax considerations of estate planning will be more important than perhaps ever before. And all the traditional reasons to plan remain intact.

Fear Factor. Although practitioners are well aware that estate planning never was only about federal estate taxes, the tax "hook" has always been an easy marketing tool. And with a real fear of a $1 million exemption and 55% rate for 2013, a tidal wave of clients barraged practitioners seeking guidance. Much of the late 2012 deluge was pure fear by those clients who had neglected planning for years. But that fear has undoubtedly abated, and the worry of a lower exemption subjecting the moderate wealth client to estate tax is unlikely to be a motivating factor in the current environment, and perhaps never again.

Non-Tax Planning. Practitioners need to educate the moderate wealth clients as to the myriad benefits a proper estate plan can still afford post-ATRA: asset protection, succession planning, insurance and retirement planning, and much more. Even absent a federal estate tax, these issues remain relevant.

Moderate Wealth Planning Is Different. For moderate wealth taxpayers, the good news is that the focus of planning can now more securely be on those issues. The bottom line for every client is that *now* is the time to act, but how clients should do so has been decisively and perhaps permanently affected by the recent tax legislation and in ways that might be quite different for moderate wealth clients in contrast to high net worth clients.

Review and Revise. The prudent step for most moderate wealth clients is for them to re-evaluate their estate plans and documents. The reality is that many of these moderate wealth clients have been perennial fence sitters, reluctant to spend the money to update planning and documents because of the concern that yet another change in the law might make obsolete work they just paid for. That concern may be over. So even with a likely indifference to federal estate tax worries, many moderate wealth clients should come forward to update documents they know have been outdated for years. It is important to use these will/revocable trust update meetings to emphasize the myriad of *other* planning issues the client should address to help the client understand the value added of a professional advisor. But the most significant risk is that professional advisors need to educate clients that the inapplicability of the federal estate tax to them does not mean they can use a cheap internet website to obtain planning and documents. That danger is significant, but so is the risk that clients not perceiving the myriad of planning benefits the professional advisor can provide will pursue the least costly option regardless of the consequences.

Will Update. Practitioners should guide the moderate wealth client not to forget the lessons of the estate tax roller-coaster ride of the past few years: Draft and plan flexibly. What if the exemption changes or *state* estate tax laws change?

Many moderate wealth clients have wills that are five, ten or even more years old. Many of these were planned and drafted when exemption amounts were much lower, and states had not "decoupled" from the federal estate tax. Some may result in assets being distributed under old wills and revocable trusts far different from what clients imagined. Although there was extensive discussion of this issue after the 2010 tax act, many clients have still done nothing to update their documents. Illustrating the unintended results may help clients understand the need for more regular reviews and flexible drafting.

Insurance Generally. Although many of these clients had purchased life insurance in the past to cover estate taxes, that driver may be forever gone. So for this largest category of client, even if insurance to fund federal estate taxes will no longer be relevant, that same insurance may be recast to fund state estate taxes, serve investment and retirement needs, minimize current income taxes, and for other purposes. The coverage might ultimately be purchased (or retained), but the product and ownership decision path to that result may be quite different.

Trust-Owned Life Insurance (TOLI). If a moderate wealth client has owned life insurance for the purpose of paying an estate tax his/her estate may never face, caution the client not to merely cancel the policy before having it evaluated. A good policy might make sense to retain as a ballast against other investments the client holds, or to secure other benefits. If that policy is held in an irrevocable life insurance trust (ILIT), after the client has the policy itself reviewed, practitioners should then review the trust itself. Sometimes, even with a less than optimal old trust, there may be sufficient flexibility to facilitate your remaking a plan that was intended to pay estate tax into a new and more robust planning tool. There may be options the trustee or a trust protector can exercise, the possibility of decanting (pouring the old trust into a newer and better trust), and more.

Pension-Owned Life Insurance. If your client held life insurance inside a pension plan, you may have counseled the client to remove the policy because of the adverse estate tax consequences. However, if the client's estate is safely below the new estate tax exemption, it may no longer matter. In fact, it might become de rigueur to use this approach to planning, especially for moderate wealth married couples with a $10 million or more portable exemption. The higher income tax rates will further accelerate this type of planning. This is yet another example of how the advice given only a few months ago has changed 180 degrees for a moderate wealth client.

Irrevocable Trusts Generally. Clients should be encouraged to evaluate any existing irrevocable trusts. If your client has an old trust—for example, to hold annual gifts—for children or grandchildren with the possible permanency of the $5 million plus exemption, these may no longer be needed for estate tax purposes. The client might choose to forgo annual gifts inasmuch as there may no longer be an estate tax benefit; in fact, there may be an income tax detriment from the loss in basis step-up on future gifts. These clients might well wish to simply cancel the trust and distribute the funds to the current beneficiaries.

Counsel such clients to consider the impact of an outright distribution if their heirs/beneficiaries divorce or are not financially mature and responsible. If you are representing the trustee, caution against the potential claims of beneficiaries if the trust is simply closed in violation of the terms of the governing instrument.

The bottom line is that all irrevocable trusts should be reviewed in light of the new estate tax paradigm. Determine how they can be modified, or even eliminated, to provide appropriate clients with the simplest, least costly and best results consistent with their current wishes. Some irrevocable trusts may permit an independent trustee to distribute "so much, or all of, the principal…." This type of clause may suffice to distribute the trust to current beneficiaries and terminate the trust.

Caution, however, is still in order. What of contingent or other beneficiaries? Will terminating a trust that is no longer needed to address estate tax issues simply put those assets in harm's way in the event of a recipient beneficiary's being sued? There may be other options, such as decanting, to clean up an old trust and revitalize it. These old trusts, however, may now provide valuable income tax flexibility if income can be sprinkled out to beneficiaries in lower income tax brackets and not subject to the 3.8% Medicare tax on passive income. If this is not the case, the compressed income tax rates trusts face (they are taxed at the maximum bracket and the new 3.8% Medicare tax on slightly less than $12,000 of income) may suggest eliminating the trust as quickly as possible.

Amend Durable Powers. For the moderate wealth client, the standard planning technique was to make annual gifts. With the gift exemption growing to $14,000 per donee per year, for many moderate-sized estates that may be just what the tax doctor ordered. However, many durable powers are long outdated, some with smaller caps, rather than inflation-adjusting references to the annual gift exclusion. Many clients have put off planning for years (many for more than a decade) waiting for certainty. When those plans and documents are updated, the gift provisions should also be updated. Also consider the discussion below for potentially high net worth clients using SLATs ("Spousal Lifetime Access Trusts") to make state estate taxes an optional cost. Gifts up to the maximum remaining federal exemption to an existing trust (like a SLAT) might warrant including in the power of attorney.

Potentially High Net Worth Clients and Clients in Decoupled States

For clients that are not in the snare of the estate tax, but who might be, or who face a state estate tax in a decoupled state, planning may not take the form of planning pre-ATRA.

With the reduced fear of the estate tax, even these clients will likely demand greater simplicity. Efficiency and creativity may be a prerequisite to getting these clients to move forward on "modified planning." Clients have never been comfortable with the costs, and perhaps even more so, the complexity, of estate tax planning. Practitioners will be challenged to implement planning that remains palatable to these clients, achieves client planning goals, and yet remains profitable to the practitioners.

Life Insurance May Lead the Way. These clients may find that life insurance planning, which may be viewed as less costly and complex than some of the other planning techniques (GRATs, note sale transactions, QPRTs, etc.), may be more appealing. This may be enhanced by the income tax benefits of permanent life insurance in light of the new higher income taxes, capital gains rates and Medicare tax on passive income. Potentially high net worth clients, who are no longer in great fear of the estate tax, may well appreciate and be able to dollarize the potential income tax savings of the cash free buildup inside a quality life insurance policy.

Bypass Trusts. These trusts have been at the foundation of planning for many clients. Although practitioners across the board may explain the benefits of using a bypass trust in lieu of relying on portability, it will be a much harder sell. Assume a married couple living in a decoupled state with a $1 million exemption. The combined estate is $8 million. One option that many would recommend is to fund a $1 million state exemption level bypass trust, with the balance into a QTIP trust to which GST exemption should be allocated. But for a variety of reasons, this may no longer be optimal.

Are Testamentary Bypass Trusts Passé? Using bypass trust planning has been nearly ubiquitous in estate planning. But that might just change. Although every practitioner knows the benefits of using a bypass trust over relying on portability, under the new paradigm, that may be the wrong discussion. The client may well view that as not worth the cost of the "hassle" involved in establishing and maintaining a testamentary bypass trust. And for all the effort and cost, it will only save state estate tax on $1 million. Hardly an optimal investment. More importantly, with a permanent $5 million gift exemption, a gift to an inter vivos SLAT may provide potentially much greater state estate tax savings by applying a similar planning concept.

In the end, the testamentary bypass trust will require the funding of a trust at death, a point in time when the spouse may prefer that the surviving spouse not be forced to deal with new complexities, an income tax return will have to be filed for the bypass trust, and new accounts opened. All to save state estate tax on $1 million? Creating that structure today in the form of a SLAT prevents the newly widowed spouse from having to deal with complexity at the emotional nadir of his or her life. More significant, the use of a SLAT has the potential to make far more meaningful inroads in reducing the state estate tax, and it provides the added benefit of asset protection during lifetime. Clients will need that non-estate-tax benefit to bite at the SLAT planning apple. Finally, if the client understood and was agreeable to establishing a life insurance trust, a modified version of the traditional insurance trust can serve all these purposes.

Ultra-High Net Worth Clients

For wealthier taxpayers, a very different education process is in order than for moderate wealth clients. Many may believe that they've finished any planning they needed in 2012. If they don't think that today, they might well think that when they receive all the professional bills for their late 2012 planning extravaganza.

High net worth taxpayers need to be educated to the fact that there are more "fiscal cliffs" coming up, and Congress will have to deal with other aspects of deficit reduction. Any of these options could further impact estate planning for the ultra-wealthy. It would take little to enact restrictions on GRATs, discounts, GST allocations and other planning benefits. But the planning impact on very wealthy clients would be dramatic.

The ultra-wealthy client needs to be educated that ATRA has given him or her a bit of breathing room, a sort of grace period, on planning, but they should not squander it.

Planning Steps for Ultra-High Net Worth Taxpayers. The $5 million plus exemption is positive news. But a 40% rate can still decimate the estate of a real estate developer or undermine wealth accumulation goals. In short, what most taxpayers herald as a taxpayer's estate tax bonanza for ATRA, remains a significant worry for the ultra-high net worth client. The perspective for the different level of estate owners is totally opposite. For the moderate wealth client, the permanence of the inflation-adjusted exemption amount may be interpreted as the end of estate tax worries. For the ultra-high net worth client, that same permanent system may really cement the idea that the hopes for estate tax *repeal* are gone. For these clients ATRA may cement their fear of the estate tax. Action is in order.

Loophole Closing May Continue. With Congress facing more fiscal cliffs in coming rounds of deficit reduction negotiations, those with ultra-high net worth should be cautioned to think more carefully and to act quickly. Restrictions on grantor retained annuity trusts (GRATs), valuation discounts, GST exemption allocations, and perhaps even on excluding grantor trusts from the grantor's estate, may all be up for grabs in future legislation. The fact that these matters appear not to have been addressed in the current legislation may only be due to time constraints. These could all show revenue additions to the federal budget as part of future deficit reduction activities. Given that the estate tax exemption is now an inflation-indexed $5 million, doubled for married couples because of portability, there may be little resistance to these changes as they will only affect a tiny fraction of the wealthiest Americans.

Complete Planning. Consider adding to gifts to GST-exempt grantor trusts that your client started in 2012 (or prior years). Many of these trust plans fell short of the $5 million gift goal because time was too limited to complete all desired transfers, or gifted assets appraised at values less than the $5,120,000 exemption. Use the recent legislation as a reprieve to help clients complete the transfers of as much as they can to their trusts.

Exercise Swap Rights Now. Some clients, in order to complete planning, funded 2012 trusts with assets that may have already been appraised or liquid assets that did not require an appraisal. The thought was "fund the trust in 2012 in case the exemption dropped and other changes were legislated and swap those assets out for the intended hard-to-value assets the client wanted held in the trust."

These swaps should be done as quickly as possible. Although no one can predict what coming rounds of fiscal cliff legislation may bring, what if restrictions are made on grantor trusts established in the future? Depending on the wording of future restrictions, such changes, if enacted, might subject existing trusts to new more restrictive estate inclusion rules—particularly if the valuations are incorrect. On the other hand, if the swap is completed before any restrictions are enacted on grantor trusts (if there are, in fact, any so enacted), it may be safer.

Plan Before the Next Adverse Tax Change. Take advantage of this current window of opportunity to consummate note sale transactions and other steps to shift greater future values into protective trusts, and freeze the value of the client's remaining estate while it is still feasible. The 40% marginal estate tax rate is very high, and if your client's estate is, or will be, well in excess of the $5 million inflation-adjusted exemption, you should encourage the client to take maximum advantage of sophisticated estate freeze techniques before Washington deficit cutters attack them.

If a client completed sophisticated trust planning in 2012, the estate planning infrastructure may already be in place to complete more planning with relatively modest cost and effort. If an irrevocable trust was created in 2012 as a grantor trust in one of the states with favorable trust laws, that may be just what is needed to complete a note sale transaction, or perhaps an additional sales transaction if a sale transaction were completed in 2012. If the client contracted for appraisals in 2012, and if the client consummates additional transfers of the same assets (e.g., selling interests in a business that was appraised in 2012 for purposes of making a $5 million gift in 2012), the client might be able to use the same appraisal report to support a large note sale transaction if done early enough in 2013. (*See*, Shenkman, "Role of Guarantees and Seed Gifts in Family Installment Sales," *Estate Planning Magazine*, November 2010, page 3.)

Bypass Trusts and Title to Assets. As noted above, practitioners reflexively tell clients to divide assets to facilitate the funding of bypass trusts. But for the first time, large numbers of wealthy clients have used up most or all of their exemptions. So this mainstay of the initial consultation discussion may not always be correct.

Now a more thoughtful discussion of who should own assets and how they should be titled for purposes other than funding bypass trusts might be relevant. Although many clients might just opt to leave remaining assets in one spouse's name (e.g., the spouse who has not used his or her exemption if the other one has), that may not be ideal given the growing issue of identity theft. So splitting assets into each spouse's name might still be good advice, but the explanation and rationale may differ for many. Even the use of bypass trusts in wills might require a somewhat different discussion. Although practitioners might be loath to eliminate bypass trusts because of the indexing of the exemption amount and the desire for flexibility, perhaps a different drafting approach might be warranted for some clients who have exhausted existing exemptions in their 2012 planning or for clients in decoupled states whose bypass trusts are capped at a much lower amount, e.g., $1 million.

Perhaps the language in wills and revocable trusts should be revised for clients who have used much of their exemptions to give great latitude to the trustee of the bypass trust to simply distribute the funds outright to the beneficiaries of the trust and not fund the trust. Perhaps disclaimer bypass trusts would make more sense for these clients than bypass trusts that are automatically funded. That way the inflation adjustment that will grow in future years can be flexibly planned for after death.

GRATs. The focus in 2012 was using exemptions that might have been lost and locking in long- term GST allocations and grantor trust status before these planning gems were legislated away. For most clients, unless these benefits were secured, GRATs really were suboptimal. Now, however, for clients who have maximized these benefits in their 2012 planning, it might be quite advantageous to revisit the idea of GRATs so as to lock in additional gift transfers before future "cliff legislation" brings back the frequently talked about 10-year GRAT and other limitations.

Annual Gift Planning Post-ATRA. The old model of annual gift planning was to make annual gifts using the $13,000 (in 2013, $14,000) annual gift tax exclusion. For high net worth clients, annual gifting will take on a new meaning, and possibly a new complexity.

With the inflation indexing of the $5 million exemption amount, even a modest inflation increase will result in a potentially meaningful dollar increase in the gift exemption. In 2013 the gift exemption increases by $130,000 to $5,250,000. So each year advisors to the high net worth client may choose to gift to a GST-exempt trust this incremental amount so as to compound growth outside of the client's estate.

For dollar figures in this range, however, appraising interests in hard-to-value assets won't be practical. So the high net worth client might make a gift of cash or marketable securities to avoid the costs and complexities of appraisals. If the cash accumulates to a sufficient level inside the trust, then a swap for hard-to-value assets, perhaps every five years, might be worthwhile.

CONCLUSION

The post-ATRA estate planning environment appears to be dramatically different from any estate tax regime that has existed in the last dozen years. For the first time, there is a permanent, very high, inflation-adjusted and portable exemption amount that excludes all but the ultra-high net worth from gift, estate and GST tax. Even more significant is that fear of the estate tax for the vast majority of clients is simply gone. Although clients still require all the valuable non-federal estate tax minimization planning professionals can provide, educating clients that the simplest and lowest-cost solution is not preferable may be the greatest challenge many practitioners face.

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