

Maximize the Benefits

Leveraging Wealth Transfer Planning

Wealth transfer planning is the process of positioning your assets to pass to your heirs in a tax-efficient manner, either during your lifetime or upon your death. With the assistance of Baird's estate and financial planning professionals, your Financial Advisor can help you transfer significant wealth to the next generation without having your hard-earned assets diminished by gift and estate taxes.

Who can benefit from Wealth Transfer Planning?

At some level, everyone should be concerned with wealth transfer planning. Even individuals with modest estates should have at least a basic will to determine the distribution of assets after debts and expenses have been paid.

Individuals and families with larger estates, however, can benefit most from advanced wealth transfer planning. Various techniques and strategies can be used to increase the amount of wealth transferred to the next generation and decrease the amount of gift and estate taxes paid to state and federal governments.

Federal gift and estate taxes: An overview

Taxes can be imposed on the transfer of property during your life (gift tax) or at death (estate tax). Much of estate and wealth transfer planning is designed to minimize, or even eliminate, transfer taxes.

Estate tax

The federal estate tax is only imposed on estates that exceed a certain exempt amount, also known as the Applicable Exclusion Amount. Currently the amount is set at \$11,400,000 and is indexed for inflation each year. For estates exceeding the exempt amount, the tax rate is 40%.

Property transferred to charitable organizations is completely exempt from federal estate tax, and most transfers made to a surviving spouse qualify for an unlimited marital deduction. For married couples, good estate planning will combine the use of each spouse's estate tax exemption and the unlimited marital deduction to defer all taxes to the death of the surviving spouse.

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Gift tax

To prevent people from avoiding estate taxes by giving away all their assets during their lifetimes, the federal government imposes a gift tax on property transferred prior to death. There are two notable exceptions to this tax:

- Every U.S. citizen or resident alien may give property worth up to the “annual gift tax exclusion” each year to any number of individuals without any gift tax implications. This annual exclusion was increased to \$15,000. A married couple can double this amount and gift up to \$30,000 to individual recipients without incurring gift tax. To be eligible for this annual exclusion, the gift must be a “present interest,” meaning the recipient must have the right to present use or enjoyment of the transferred property. Outright gifts of cash or securities qualify as present interest gifts. Transfers made in trust may not qualify as present interest gifts unless the trust beneficiaries are given a corresponding right to withdraw the transferred amount from the trust for a designated period of time. These withdrawal rights are commonly known as “Crummey powers” after a tax court case of the same name.
- Every U.S. citizen or resident alien may make lifetime gifts above the annual exclusion amount up to a cumulative total of \$11,400,000 without incurring gift tax. This lifetime exemption may be used all at once or incrementally, and the gifted property may be transferred

to one recipient or divided among multiple recipients. Gifts exceeding the \$11.4 million exemption are taxed at the same 40% rate used for estates. Any portion of the \$11.4 million gift exemption used during a person’s lifetime will result in a dollar-for-dollar reduction of the overall federal estate tax exemption.

The importance of gifting in Wealth Transfer Planning

One of the keys to effective wealth transfer planning is utilizing the ability to transfer property equal to the \$15,000 annual gift exclusion, and possibly the \$11.4 million lifetime gift exclusion, to loved ones without incurring gift taxes. When these gifts are used strategically, a tremendous amount of wealth can often be transferred to loved ones without generating gift or estate taxes.

Using life insurance to leverage wealth transfer

Life insurance can be a highly effective tool to transfer wealth to the next generation in ways that minimize transfer taxes. One of the staples of estate planning involves using gift exclusion amounts to purchase life insurance in an Irrevocable Life Insurance Trust, which is not considered part of the insured’s estate for tax purposes.

Irrevocable Life Insurance Trusts

An Irrevocable Life Insurance Trust is created for the primary purpose of owning one or more life insurance policies. As an “irrevocable” trust, it may not be rescinded, amended or altered after it is created unless such changes are authorized by a court.

However, this irrevocable feature also prevents the insurance proceeds from being included as part of the insured’s taxable estate.

Typically, the insured is the person who creates the ILIT. The insured names the trust beneficiaries (usually the insured’s children) and selects someone other than the insured to act as trustee. The insured retains no beneficial interest in the trust. The ILIT’s trustee applies for and purchases new insurance policies, naming the trust as owner and beneficiary of the policies.

The insured makes annual gifts to the ILIT to be used by the trustee to pay the life insurance premiums. In order for these gifts to qualify as “present interest gifts” for purposes of the annual gift tax exclusion, the ILIT trustee must notify the trust beneficiaries that they have the right to withdraw corresponding amounts from the trust. After a designated period (typically 30 days), the trustee is free to make the premium payment on the life insurance policy. Upon the death of the insured, the trustee receives the insurance proceeds and distributes them according to the terms of the trust. Insurance proceeds payable directly to the ILIT will bypass the insured’s estate completely and pass to the beneficiaries without being subject to estate or income tax.

The pages that follow detail how life insurance and ILITs can be used in different ways to maximize the benefits of wealth transfer planning.

Charitable Remainder Trust

Leave a lasting legacy.

A charitable remainder trust (CRT) is a unique irrevocable trust that has both a charitable and a non-charitable beneficiary. In most instances, highly appreciated assets are transferred into the CRT in exchange for the right to receive a stream of payments for a pre-determined period. Tax laws allow the donor to receive a current income tax deduction based upon the estimated value of the remainder interest. Typically the trustee will sell the assets after they have been transferred to the CRT and, because the trust is a tax-exempt entity, no income taxes will be due on the sale. You, or other non-charitable beneficiaries, will receive income from the trust for life or for a specified period (not to exceed 20 years), after which the trust terminates and the remaining balance is distributed to your designated charitable organizations.¹

Benefits

- Immediate income tax deduction for the donor
- CRTs are exempt from taxes on income and capital gains
- Income stream for donor or other non-charitable beneficiaries
- Donated assets not counted as part of taxable estate

Incorporating Life Insurance

The CRT strategy alone will benefit both you and your favorite charity. But because the remaining balance of the CRT will eventually pass to this charity, your heirs may not benefit from this strategy. One solution is to purchase a life insurance policy inside a wealth replacement trust to replace the value of the assets given to the charity. A WRT is an irrevocable trust

designed to hold a life insurance policy outside of your taxable estate. By using some of the income stream and tax savings from the CRT to purchase life insurance in a CRT, you may be able to replace the value of the assets given to the charitable trust. Essentially, your heirs will receive the assets but in the form of an income and estate tax-free death benefit.

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¹A CRT income beneficiary or beneficiaries may have to pay taxes on portions of the income received.

By combining a wealth replacement trust strategy with a CRT, you can:

- Receive tax advantages
- Generate a beneficial income stream
- Donate to your favorite charity
- Provide a tax-free death benefit to your heirs.

Keep in mind that neither Baird nor its Financial Advisors provide legal or tax advice. You should consult your attorney and/or tax advisor regarding your particular situation before considering this strategy. Your Baird Financial Advisor will be happy to coordinate with your other advisors to best meet your needs.

Example (Depicted below)

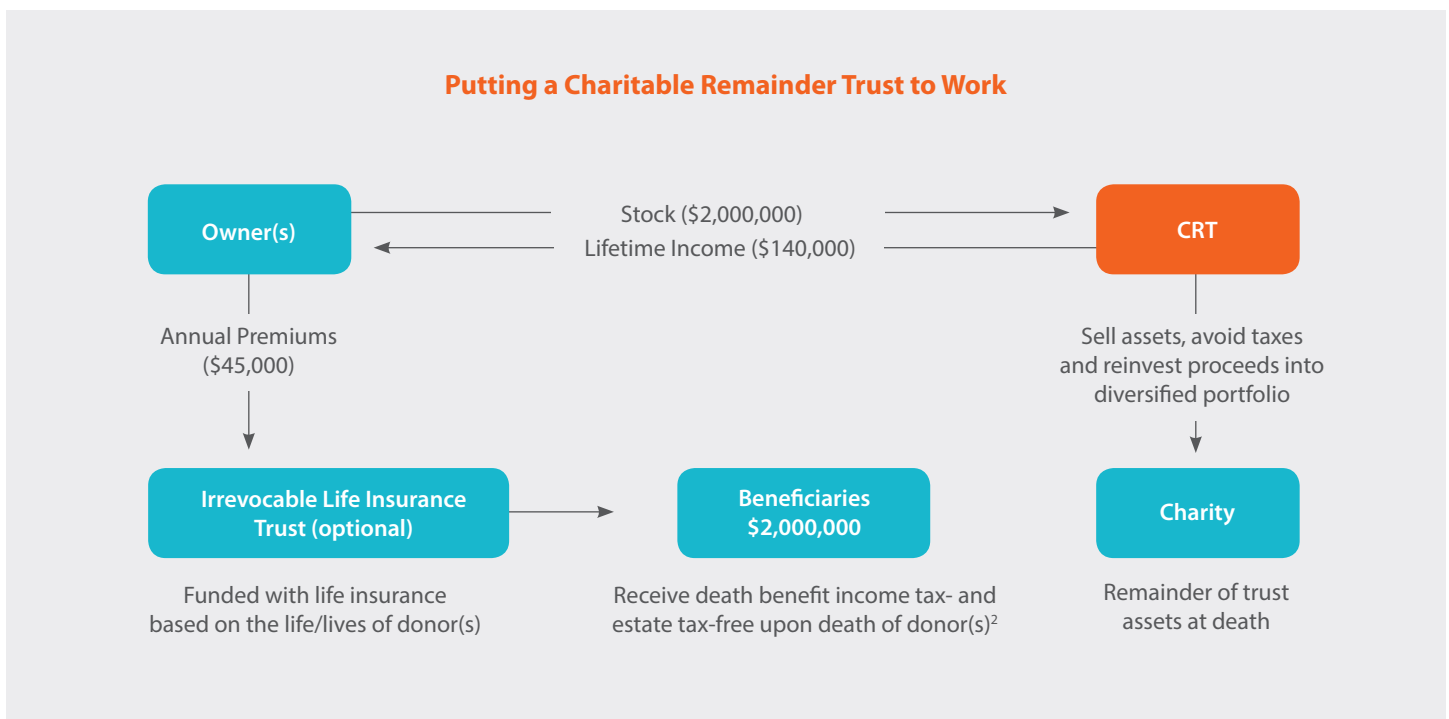
John and Mary Smith have a large estate and own highly appreciated

stock currently worth \$2 million. They are charitably inclined and have been heavily involved with a well-known cancer research organization for the past 12 years. The Smiths have learned that by establishing a CRT that can diversify the assets for them without incurring taxes, they can receive income payments from the trust for the rest of their lives while also benefiting the cancer research organization with the trust balance.

By creating and funding a CRT that will pay them 7% of the initial trust amount, the Smiths can receive \$140,000 annually. Furthermore, they may receive a current charitable income tax deduction of \$612,400, assuming a 5% federal rate used to calculate such gifts. Their adjusted gross income, including income from

the trust, is \$340,000. The maximum deduction they can take, based on current limitations, is \$102,000. However, the unused portion of the charitable income tax deduction may be used over the next five years subject to the same limitations.

The Smiths may also establish a WRT funded with \$2 million of joint life insurance to replace the donated asset for their two children. The annual premiums for this policy would be approximately \$45,000 (payable to the younger insured's age 100) and would guarantee the death benefit for their joint lives (subject to the claims-paying ability of the insurer). The overall strategy will replace the asset, and life insurance proceeds will be paid to the WRT for the benefit of their children free from income and estate taxes.²



²Depends on terms of properly structured Irrevocable Life Insurance Trust.

Asset Maximization Strategy

Preserve and protect your hard-earned assets.

Asset maximization is a commonly used wealth transfer technique designed to maximize the amount of wealth passed to heirs by repositioning assets earmarked for your beneficiaries. Income may be generated from various “live on” assets, such as pensions, non-qualified deferred compensation plans and social security.

You may also have “leave on” assets, such as deferred annuities, certificates of deposit, Individual Retirement Accounts or municipal bonds, which you intend to transfer to your beneficiaries. While many of these “leave on” assets offer tremendous

tax advantages during your lifetime, they may not be the best assets to own at death. The assets you worked so hard to accumulate could be substantially reduced by income and estate taxes, as illustrated in the chart below:

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Summary of Asset Taxation at Death

	Deferred Annuities	Qualified IRAs	Municipal Bonds	CDs	Immediate Annuities	Trust-Owned Life Insurance
Income Tax	Yes	Yes	Yes	No	Some	No
Estate Tax	Yes	Yes	Yes	Yes	No	No



An asset maximization strategy either immediately or systematically repositions an existing “leave on” asset into a more tax-efficient vehicle. Typically it involves taking withdrawals from your existing “leave on” asset or purchasing a single premium immediate annuity to generate a stream of income. The after-tax income stream is then gifted to an irrevocable life insurance trust, which owns and pays the premiums on a life insurance policy. This allows you to manage the tax liability during your lifetime, while the life insurance maximizes the amount you can pass to your heirs free of income and estate taxes.

Benefits

- Reduces or eliminates the tax burden for beneficiaries
- Reduces your taxable estate without sacrificing your income or legacy
- Transfers more to beneficiaries by leveraging the existing asset

Considerations

An asset maximization strategy is not for everyone. It may not be suitable for you if you intend to use the money during your lifetime or if you will be subject to termination fees, charges and expenses or adverse tax implications.

Keep in mind that neither Baird nor its Financial Advisors provide legal or tax advice. You should consult your attorney and/or tax advisor regarding your particular situation before considering this strategy. Your Baird Financial Advisor will be happy to coordinate with your other advisors to best meet your needs.

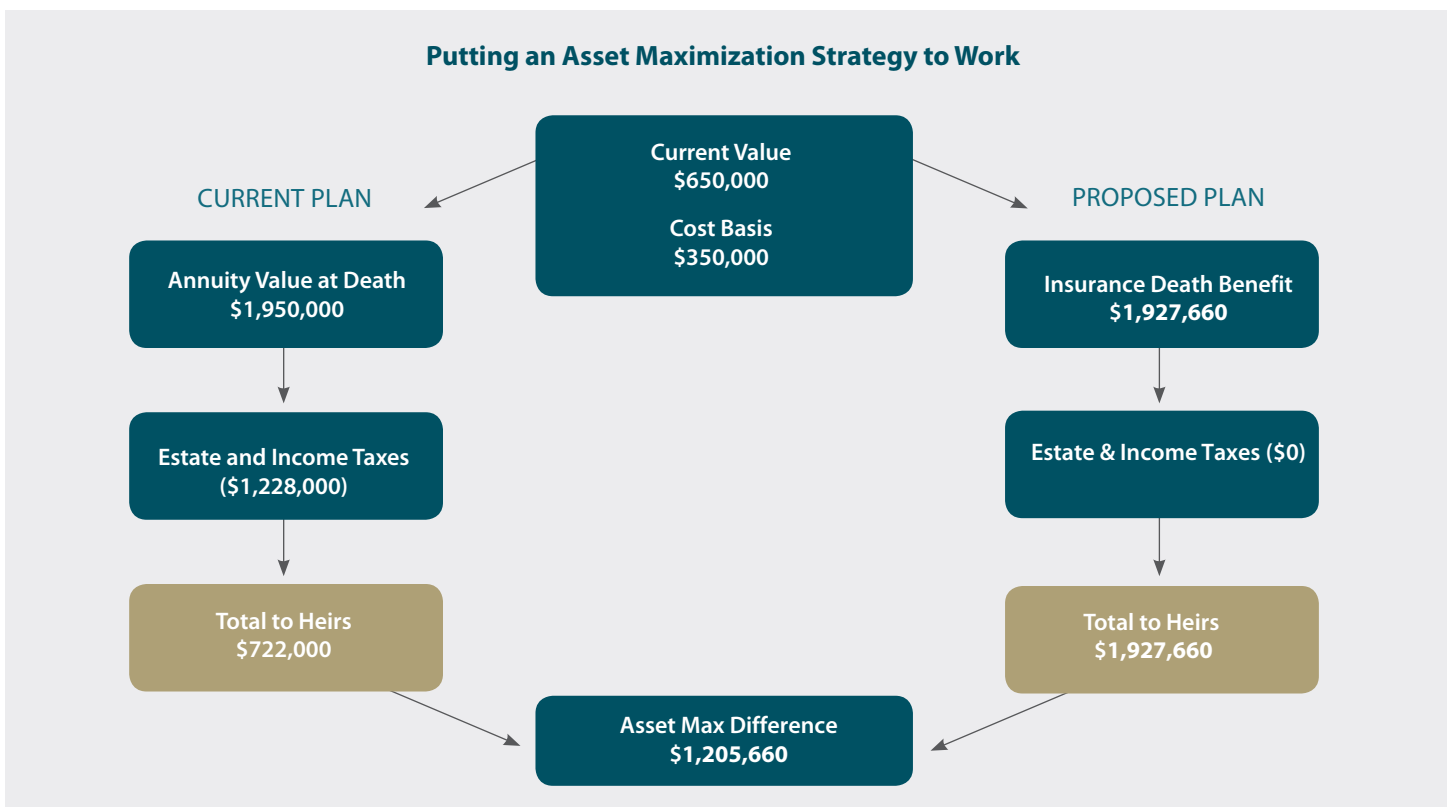
Example (Depicted below)

Bob and Sue Jones (ages 65 and 62, respectively) have a large estate and own a deferred annuity with a current value of \$650,000 growing at 4.5% and a cost basis of \$350,000. They have three children and a strong desire to pass the value of this annuity to them at death. They have no intentions of accessing this annuity, and it has been earmarked as a “leave on” asset. Based on the Jones’ joint life expectancy

(25 years), the value of the annuity is projected to grow to \$1.95 million and appears to be a great asset to pass onto the children. However, because of potential estate and income taxes (\$780,000 and \$448,000 respectively), the value of the annuity could be reduced to \$722,000.

The Joneses decide to complete a tax-free 1035 exchange, moving the value of the deferred annuity into a single premium immediate annuity, resulting in an after tax income stream of \$27,000. This income stream is then gifted to an irrevocable life insurance trust (ILIT) and used to purchase a life insurance policy insuring them for their joint lives.

Based on preferred nonsmoker rates, the Jones’ will be able to purchase \$2.8 million of lifetime guaranteed death benefit protection (subject to the claims-paying ability of the insurer), provided they pay the required annual premiums. Furthermore, because the life insurance is owned by the ILIT, this death benefit will pay out free of income and estate taxes. This strategy will replace the asset they originally intended to pass to their children with a more tax-efficient transfer of wealth.



*Assumes 28% income tax rate and 40% estate tax rate.

Credit Shelter Trust

Provide for the people you care about.

The Credit Shelter Trust (CST) is a unique type of trust used by higher-net-worth married couples to ensure each spouse takes full advantage of the maximum amount that can be sheltered from estate taxes. Currently the amount is set at \$11.4 million and is indexed for inflation each year. There is also an unlimited marital deduction that allows married couples to transfer any amount to each other as a lifetime gift or at death. The dilemma is to ensure that couples do not under-utilize the federal estate tax exemption by over-utilizing the unlimited marital deduction.

The solution is for the couple to provide, by will or trust, that upon the death of either spouse, an amount equal to the federal estate tax exemption is transferred to a CST. The balance of the deceased spouse's estate passes outright to the surviving spouse or to a marital trust that qualifies for the marital deduction.

Benefits

This strategy accomplishes the dual objectives of:

- Reducing combined federal estate taxes by as much as \$2.1 million by fully utilizing both spouses' federal estate tax exemptions

- Providing for the support and maintenance of the surviving spouse by making the trust assets available to the surviving spouse for the remainder of his or her lifetime

Typically, the surviving spouse is given the right to withdraw income and principle from the CST, as needed. However, in some cases the surviving spouse may not need the CST funds because he or she has a sufficient amount of other assets available. If it is clear that the surviving spouse will not need any distributions from the CST, the trust assets may be invested for growth in hope that a greater amount will pass from the trust to the couple's heirs upon the death of the surviving spouse.

Incorporating Life Insurance

In situations where a CST has been funded upon the first spouse's death and the surviving spouse will not need to dip into the trust assets, life insurance can maximize the amount that will pass tax-free to heirs upon the death of the surviving spouse. The trustee of the CST could use a portion of the trust assets to purchase a life insurance policy on the surviving spouse. Upon the death of the surviving spouse, the insurance proceeds will pass to the heirs income and estate tax-free.

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Benefits

- Enables a substantial amount of assets to pass to heirs free of estate taxes
- Purchasing life insurance with a portion of CST assets can further increase the amount of wealth transferred to children and grandchildren.
- Surviving spouse may be able to access the life insurance cash value through the trustee for emergency needs.

Other Considerations

The surviving spouse cannot purchase life insurance with CST assets if he or she is also the trustee. Also, this strategy will work best when the surviving spouse is 85 or younger and free of any major medical illness.

Keep in mind that neither Baird nor its Financial Advisors provide legal or tax advice. You should consult your attorney and/or tax advisor regarding your particular situation before considering this strategy. Your Baird Financial Advisor will be happy to

coordinate with your other advisors to best meet your needs.

Example (Depicted below)

Mary is a 70-year-old widow whose assets include a \$1 million residence and \$2 million in investment assets. When her husband passed away in 2007, a CST was created and funded with \$2 million, which was the federal estate tax exemption at that time, and a marital trust was created and funded with the remaining \$3 million of his estate.

The marital trust is required to pay all income to Mary at least annually, and she can also access the trust principal for health, maintenance and support, if necessary. Together with her own assets, the income she receives from the marital trust is sufficient to comfortably maintain her lifestyle.

Mary is also entitled to receive discretionary income from the CST, but she is concerned that taking income from the CST will only

increase her taxes. Her accountant has advised her that leaving income in the CST may be ill-advised because income is taxed in an irrevocable trust at much higher rates compared to individual income tax rates. Mary would like the CST assets to eventually maximize the legacy she will pass to her children and grandchildren, but she is reluctant to have too much exposure to potential volatility in equity investments.

Mary decides to have the trustee of the CST use a portion of the trust assets to purchase life insurance on her life. The benefits of this strategy may include: minimizing income tax on the CST assets during her lifetime, maximizing the wealth transferred to her heirs upon her death, providing an effective “step-up” in the CST assets because of the tax-free status of life insurance proceeds and providing a guaranteed internal rate of return (subject to the claims-paying ability of the insurer). on the life insurance investment.

