

ARE YOU GETTING
"MILLION DOLLAR" ADVICE?



A Guide for Estate Planning

WELL



The Premier Association
of Financial Professionals

INTRODUCTION.....2

STEP ONE:
GET ORGANIZED3

STEP TWO:
TOOLS TO HELP BUILD YOUR ESTATE PLAN.....5

STEP THREE:
UNDERSTAND THE “BUILDING” ENVIRONMENT 11

STEP FOUR:
REVIEW YOUR PLAN REGULARLY..... 15

SUMMARY 16

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Make sure your advisor is a member of the Million Dollar Round Table (MDRT), the premier association of financial professionals. Members serve their clients with exemplary performance and the highest standard of ethics and professional knowledge. MDRT members are on the cutting edge of industry trends, as the organization is the premier forum for the exchange of sales ideas and techniques among industry professionals. Members are exposed to an international network of more than 25,000 professionals.

Founded in 1927, the Million Dollar Round Table sets the standard for professionalism. The organization’s commitment to excellence motivates members to reach their full potentials and assures you the service that you and your family deserve.

ESTATE PLANNING

In the 16th century, the explorer Ferdinand Magellan set sail from Spain on an unprecedented voyage around the world. Halfway there, he died on an island of the Philippines. Three years after setting sail, one of his five ships returned, completing the first circumnavigation of the globe. His mission survived his death, and with a sound estate plan, yours may too.

Like Magellan's sailing charts, your estate plan can serve as a navigational tool—a guide for you during your lifetime, and for others after your death. Whether your assets are large or small, whether you are married or single, or whether you are with or without children, having an estate plan can help you:

- Transfer assets to the beneficiaries of your choice
- Minimize estate taxes and court costs
- Make provisions for the appointment of a guardian for your minor children

Certain essential tools, such as **wills** and **trusts**, can help you develop an estate plan that takes into consideration your current financial situation and future possibilities, as well as your wishes regarding the treatment of your assets and property after your death. Dying “intestate” (without a will or trust that provides guidelines for the distributions of your assets) could subject your estate to certain taxes, legal fees, and court costs that may erode the value of your estate, as well as hamper your heirs from inheriting assets or property according to your wishes.

While an estate plan will ultimately facilitate the administration of your affairs after your death, it can also help establish guidelines for managing assets and property during your lifetime. Planning can never start too early, particularly when you are in your prime earning years, with a family dependent on you for support and income. Estate planning can be simple, or it can be complex, based on your goals and objectives, as well as the size of your estate.

Estate planning can be a challenging solo voyage. Choose a specialized crew, who can help you design the best possible strategies to achieve your goals and objectives. Your estate planning team can include your attorney, financial professional, tax professional, and insurance agent. You may also wish to include your accountant or banker. The number of individuals participating in your estate plan is not as important as the competence and expertise they bring on board.

There are a number of tasks that will need to be accomplished, but a few of the early tasks will likely include an analysis of your current estate and your family's future needs, as well as your goals and objectives.

ASSESS YOUR ESTATE

There is no mystery involved in figuring out what belongs in your estate. The U.S. Treasury regulations relating to the taxation of property owned at death contain a catch-all definition stating that the

“gross estate of a decedent who was a citizen or resident of the United States at the time of his death includes the value of all property—whether real or personal, tangible or intangible, and wherever situated—beneficially owned by the decedent at the time of his death.”

The first step in understanding the potential implications of the federal estate tax is to review the major items that may comprise your estate:

- **Personal assets.** Your personal property, savings, real estate, retirement plans, and the proceeds of any life insurance policies that you own are included in your estate.
- **Rights to future income.** Your rights to *future* income, such as rights to payments under a **deferred compensation** agreement or **partnership income continuation plan**, may be includable in your estate. These rights are commonly referred to as “income in respect of a decedent” and may be includable at their present commuted value.
- **Business interests.** Interests in any business you own at death, whether as a proprietor, a partner, or a corporate shareholder, may be includable in your gross estate.

GET ORGANIZED

GATHER INFORMATION

Now that you've identified what assets belong in your estate, it's a good idea to collect the appropriate documentation involving current and/or future income, property ownership, insurance, and any legal arrangements already in place. This will include records of:

- Current income from employment and all investments
- Any expected deferred compensation
- All retirement benefits, including **Individual Retirement Accounts (IRAs)**, **pension plans**, **profit-sharing plans**, and **Social Security** (including **survivor benefits**)
- Investment documents, certificates, passbooks, etc.
- Insurance policies
- Deeds to primary and vacation residences
- Your will
- Trust agreements
- A list of all personal property
- Current and expected debts and obligations, including mortgage and loan balances, real estate liens, taxes payable, consumer debts, and estimates of funeral costs and estate settlement expenses.

Once this information is assembled, a complete analysis can begin, thereby providing the basis for a solid estate plan. In the future, this data will serve as a “map” for your executor and/or heirs, as they go about the business of settling your estate.

TOOLS TO HELP BUILD YOUR ESTATE PLAN

STEP TWO

Magellan, while sailing through what is now known as the Straits of Magellan, left letters along his course, directing ships due to follow. A **will** functions similarly. A will is a formal legal document instructing your survivors in the settlement of your estate. It is crucial to the success of an estate plan that your will be properly written by a qualified, experienced, legal professional and witnessed simultaneously by two parties. Your estate planning team can also help you determine the use of three other important tools: **living trusts**, **advanced directives**, and **life insurance**.

WILLS

If you die without a will (intestate), you automatically forfeit the chance to direct the dealings of your estate. This may result in needless legal disputes, damage to personal relationships and, sometimes, financial tragedy. Even in cases where tax planning may not really benefit the estate because the size of the estate falls under the **applicable exclusion amount** (the value of assets an individual is allowed to transfer to beneficiaries, other than a spouse, free of gift or estate taxes), a will should be drawn up for non-tax purposes. The reason is simple: A will is an opportunity for you to designate your own executor, guardians for minor children, and other fiduciaries, rather than rely on the probate court to appoint them for you. Trustees for minor children or other beneficiaries of your estate can be designated in a will, and their powers can be tailored to the anticipated needs of those beneficiaries.

For those who have neither spouse nor children, and who would have their estate go to personal friends or charity, a will or a trust is the primary means of fulfilling these wishes. The courts will not award portions of an estate to charities or to those who are not relatives when blood relations (no matter how distant) can be found. Wills are also important to those who have made personal and emotional commitments to each other without a marriage contract. In addition, there is no guarantee that the designated heir(s) will survive, making a will the primary means to designate *secondary* beneficiaries.

RESTRICTIONS ON DISTRIBUTION OF ESTATES

Although you are generally free to dispose of your assets as you wish, you may be surprised to learn that there are some restrictions, which can vary from state to state, that may apply:

- **Spousal Rights.** If you are married, your spouse is generally entitled to receive a minimum share of your estate. If your spouse does *not* receive the amount mandated by law, almost every state allows him or her to take an election against your will.

TOOLS TO HELP BUILD YOUR ESTATE PLAN

- **Children's Rights.** If you have children, unless you intentionally disinherit them, some states allow them to receive *at least* the share they would have been legally entitled to if you had died intestate (without a will). Also, if you adopt a child or have a biological child *after* your will is executed, unless you have provided for that child in your will—or he or she has received a share of your estate through lifetime gifts—some states entitle the child to receive the share he or she would have received if there had been no will.
- **Gifts to Friends.** Perhaps you would like to leave your estate to a cherished friend. Your will may not be immune to challenges from biological relatives, who may have benefited if you had died intestate.
- **Charitable Gifts.** If you plan to bequeath a portion of your wealth to charity, bear in mind that some states limit the amount you may leave to charitable organizations at the expense of close family members.

CHOOSING AN EXECUTOR

The role of executor is critically important to the successful execution of a carefully designed will. The executor you name must combine the tact of a diplomat with the administrative skills of a professional executive. The person should be close enough to you and your family to do as you would wish and yet be able to act without the sway of emotions caused by conflicts among family members.

The executor's primary job is to wrap up your financial affairs, but can extend further. The duties of the executor include:

- **Determining what the individual owns**—Some assets may need to be valued. The executor may hire appraisers to assess the value of an art collection, real estate property, furniture, or household goods.
- **Paying any bills and claims against the estate, including funeral costs**—All bills should be paid *before* any distribution of assets. The executor must keep accurate records of joint property, even if it escapes probate by passing directly to the other owner, because property affects estate tax bills.
- **Paying all estate and inheritance taxes**—Taxes on the estate are generally due nine months following an individual's death.
- **Collecting any money due on the estate**—All debts owed the decedent must be collected prior to the settlement of the estate. This can include any personal or business loans the decedent may have made, deferred compensation amounts from an employer, lump-sum benefits from retirement plans, etc.

- **Handling other estate assets such as insurance or trusts—** Trusts are used frequently in estate planning, and the assets within the trust may not be included in the decedent's gross estate. Insurance policies, with the estate or a trust as beneficiary, may also be utilized to provide necessary cash to pay immediate expenses, or provide funding for estate taxes.
- **Overseeing the investment of assets in the estate—**Until such time as the estate can be paid out, it is the responsibility of the executor to prudently manage and invest the funds.
- **Distributing assets and property according to the will—**The will sets forth the decedent's wishes as to the distribution of assets. It is the duty of the executor to distribute the estate in accordance with the will.
- **Settling the estate with the probate court—**Careful records must be kept of all estate assets and expenses. Most probate courts will demand a detailed account of all money received, spent, or held by the estate.

THE PROBATE PROCESS

Probate is a judicial process designed to determine that a will is valid and to administer the estate, ensuring the faithful execution of all instructions found within the will. Although most states have exemptions for smaller estates, the assets in your will ultimately fall under the jurisdiction of the probate court.

Probate's disadvantages typically outweigh its advantages. It may be possible for an estate plan to be arranged so assets will circumvent the probate process. However, it is important to analyze probate to determine what effect it may have on your estate plan.

Some advantages to the probate process are:

1. **Protection from creditors upon asset distribution.** Once an estate has been probated and its assets distributed, no creditor of the decedent can make a claim on any of the probatable assets.
2. **Fair analysis of estate value.** If heirs believe property has been overvalued in probate, thus increasing the potential estate tax, the lawyer or executor can bring in an independent appraiser and attempt to get estate valuation reduced.
3. **Protection from some taxation.** An estate is a separate taxable entity and may provide opportunities to reduce taxes by shifting income to an heir, or—if the estate's tax bracket is lower than the heir's—keeping it in the estate longer.

TOOLS TO HELP BUILD YOUR ESTATE PLAN

4. **Lower cost of legal counsel while living.** It may cost more for legal counsel to draft a **living trust** than to draft a will.

SOME DISADVANTAGES TO THE PROBATE PROCESS

1. **Higher costs to the estate.** Probate can be costly; fees are set by law, but they are for ordinary services. If the attorney does extraordinary work, the fees may be much greater. The executor may also charge fees. All fees are based on gross, not net, values.

2. **Delay in transfer of assets.** Estate settlement in probate often takes between one and two years. It often takes a month or more to receive court permission to sell an asset, which means an executor may be unable to respond to a sudden change in market conditions. Also, executors tend to be very conservative during probate because of their financial liability if they are judged to be less than prudent.

3. **Public knowledge of the estate.** Probate is a public process; it gives unknown creditors an opportunity to make claims against the estate. For the probate process to work, the will must be a matter of public record.

As you and your crew discuss the best course of action for you, it is important to have a thorough understanding of probate and the role it may play in your estate plan.

LIVING TRUSTS

Like many, you may have heard about using a living trust in place of a will as a method to avoid probate. While it is true that a properly managed living trust provides many unique benefits, it generally should not completely replace a will. A living trust is created during your lifetime. If you have established a **revocable** living trust, you retain control of the management and distributions of your assets, and can alter the terms of the trust at anytime. Furthermore, upon your death, assets distributed from a trust *do* avoid probate.

However, there are some assets you may not wish to place in a trust. For example, it may be impractical to transfer tangible personal property such as automobiles, furniture, and jewelry to a trust. Consequently, some of your assets will remain outside your trust, making a will necessary to specify your intended beneficiaries.

Trusts are complex legal documents and highly varied. While they generally cannot substitute for wills, they may help you achieve certain short- and long-term planning goals. A qualified legal professional can help you determine where trusts may fit into your overall plan.

ADVANCE DIRECTIVES

Another important aspect of estate planning concerns arrangements that address your financial affairs and health decisions in the event of catastrophic illness or incapacity. Advance directives can provide instructions for dealing with certain lifetime contingencies, such as a serious accident or a deteriorating medical condition.

One mechanism that can provide for *financial decision-making* is a **durable power of attorney**. This agreement grants authority to another person to make legal decisions on one's behalf in the event of mental incapacity. The powers granted can be broad or limited in scope and can include such areas as business transactions, insurance transactions, estate transactions, investment decisions, government benefits, and retirement plan decisions.

A **living will** is a set of instructions for a health care provider that stipulates the extent to which measures should be taken (consistent with state statutes) to maintain the patient's life should the person be unable to express his or her wishes. In some states, the patient's condition must be considered "terminal" under the state statutes before the living will becomes effective. A **health care proxy** appoints an agent to make those health care decisions and, unlike a living will, is not limited to decisions regarding artificial life-support. A health care proxy comes into play *only* when a person is unable to make his or her own health care decisions.

Advance arrangements by living will or health care proxy are generally inexpensive, easy to implement, and should be considered *essential* estate planning tools for all individuals, regardless of age. In the absence of such documents, court intervention (with the accompanying time and expense and possible stress a family may endure) may be necessary to carry out one's financial and health care desires at precisely the moment when facility and timeliness are paramount.

LIFE INSURANCE

Without a doubt, it is important to have enough life insurance coverage to handle the financial contingencies that may affect your family in the event of your death. However, determining the necessary amount of life insurance is not that simple. One rule of thumb was that you should have enough life insurance to equal five times your annual salary. But more frequently, having the "right" amount of life insurance coverage requires a careful "Needs Analysis" rather than use of an arbitrary formula.

The Needs Analysis approach incorporates an evaluation of what may be defined as a family's most important financial obligations and goals. This

TOOLS TO HELP BUILD YOUR ESTATE PLAN

includes insurance coverage for mortgage debt, college expenses, future family income, and creating liquidity for meeting future estate tax liabilities.

Mortgage Debt. The first point needing consideration is whether your life insurance proceeds are sufficient to help pay the remaining mortgage on your home. If you are carrying a large mortgage, you may need a sizable amount. If you own a second home, the mortgage on that home also needs to be factored into the formula.

College Expenses. Many people want life insurance proceeds large enough to help cover their children's college expenses and possibly graduate school. The amount needed can be roughly calculated by matching the ages of your children, and the anticipated return from life insurance proceeds during pre-college years, against projected college costs adjusted for inflation. This calculation should be revised periodically as your children get closer to college age.

Continuing Income for Your Family. The amount of income you will need to help provide for your surviving spouse and dependents will vary greatly according to your other assets, retirement plan benefits, Social Security benefits, age, health, and your spouse's earning power. Many surviving spouses may already be employed or will find employment, but their incomes may be insufficient to cover the monthly expenses of their families' current lifestyle. Providing a supplemental income fund through the use of life insurance will help your family maintain its standard of living.

Estate Taxes. Life insurance has long been recognized as an effective method for creating liquidity at death so estate taxes can be paid and asset transfers to future generations can be maximized. However, this use of life insurance requires qualified legal expertise to ensure the proper result.

Existing Resources. If your current assets and retirement plan death benefits are sufficient to cover your financial needs and obligations, you may not need additional life insurance for these purposes. If, however, they are not, the difference between your total assets and your total needs may be funded with life insurance.

An insurance professional can be of great assistance in determining an amount of coverage that is consistent with your estate's needs.

UNDERSTAND THE “BUILDING” ENVIRONMENT

TAXING ISSUES

Magellan embarked on his voyage thinking the world was much smaller than it turned out to be. It took him four months to sail across the Pacific—a journey he thought he could complete in less than a week. Taxes can similarly take people by surprise, and you may be unaware of the potential negative effect estate taxes could have on the value of your estate.

One of the main functions of estate planning is to help minimize the effect of taxes on an estate, and the myriad of tax laws makes this a challenging and difficult task. The laws pertaining to taxes and estates are continually evolving and changing. In particular, the **Economic Growth and Tax Relief Reconciliation Act of 2001 (the Tax Relief Act)** contains several statutory revisions related to estate taxes that are fairly complex, are phased in or phased out over various schedules during the ten-year life of the legislation, and are ultimately subject to a budgetary “sunset” provision.

Unless Congress takes legislative action, it appears the infamous “death tax” is going to die a slow death. . . and then be resurrected. Specifically, the estate tax has been repealed for precisely one year—2010—only to be revived in 2011 due to the sunset provision that applies to all aspects of the bill. In the interim, the maximum estate tax rate will be reduced gradually, while the lifetime exemption amount per person that can avoid any estate taxation will be increased gradually (see chart).

YEAR	TOP RATE	EXEMPTION AMOUNT
2002	50%	\$1.0 million
2003	49%	\$1.0 million
2004	48%	\$1.5 million
2005	47%	\$1.5 million
2006	46%	\$2.0 million
2007	45%	\$2.0 million
2008	45%	\$2.0 million
2009	45%	\$3.5 million
2010	repealed	N/A
2011	55%	\$1.0 million

There are additional transfer taxes that should be considered. They include:

Generation-Skipping Transfer Taxes—The generation-skipping transfer (GST) tax, imposed on assets transferred to heirs two or more generations removed from the grantor is, like the estate tax, also scheduled for repeal in 2010. During phase-out, rates will be pegged to the top estate tax rate throughout the ten-year repeal period. The **per person lifetime exemption** amount that can be transferred without triggering generation-skipping transfer taxes is \$1.12 million in 2003. (*Note:* In 2004 and 2005, the GST exemption increases to \$1.5 million.)

Gift Taxes—The lifetime exemption amount for gift tax purposes is \$1 million in 2003 and is not scheduled to increase. The top gift tax rate mirrors the top estate tax rate during the phase-out period, and is

UNDERSTAND THE “BUILDING” ENVIRONMENT

pegged to the top marginal income tax rate (35%) beginning in 2010 and thereafter.

TAX STRATEGIES

Magellan didn't just jump on a passing boat. He developed a plan, years in the making, involving five ships and 270 men. Mitigating taxes can feel just as elaborate, but it is, arguably, one of the most critical aspects to estate planning. There are a number of proven strategies that can help minimize the effect of federal taxes on an estate.

Transferring assets to a spouse—sometimes referred to as the marital deduction—is a strategy that involves transferring property and assets to the surviving spouse. Federal law generally allows the transfer of an unlimited amount of assets to a spouse without incurring any gift or estate taxes. Although this may sound like a perfect solution, for couples with assets valued in excess of the **applicable exclusion amount**, there are drawbacks to this strategy. This may cause an increase in federal estate tax liability for the estate of the “second to die” spouse. Take the hypothetical example of Bob Williams and his wife Sara. Bob's estate is worth \$1 million, and Sara's estate is worth \$1 million. If Bob transfers \$1 million to Sara via the **unlimited marital deduction**, there will likely be no federal tax due on Bob's estate (assuming Bob dies in 2003). Sara's estate will rise to the amount of \$2,000,000. At the time of Sara's death, the amount of her estate subject to taxation will be \$2,000,000 minus her applicable exclusion amount of \$1 million (in 2003). This scenario will greatly reduce the amount of money that Sara will be able to bequeath to her children and grandchildren—by approximately half, depending on the year of Sara's death. There are, of course, strategies to use in order to avoid this, including setting up a **bypass trust**.

Bypass trusts, or **credit shelter trusts**, can give Bob and Sara Williams the advantages of the marital deduction while utilizing both of their individual applicable exclusion amounts. Using a bypass trust, Bob can bequeath the \$1 million that is shielded by his exclusion amount, to the trust. The trust can be used to provide Sara with income for life. When Sara dies, the trust assets will be distributed to the beneficiaries. In this scenario, Bob has fully utilized the \$1 million applicable exclusion amount and, if properly designed, the assets in the trust will not be included as part of Sara's gross estate. Using her own applicable exclusion amount, Sara will also be able to transfer her remaining \$1 million estate to her beneficiaries, without the estate being subject to federal taxes. However, it is important to note that even if an estate is exempt from federal tax, state and local tax may apply.

GIFTING STRATEGIES

One way to help reduce the size of one's taxable estate is to give assets away. The **annual gift tax exclusion** allows a donor to give away up to \$11,000, adjusted for inflation, per calendar year, per donee, without incurring a gift tax liability. If the donor is married and his or her spouse consents to "splitting" the gift, the annual gift tax exclusion is increased to \$22,000, adjusted for inflation, although only one spouse actually makes the entire gift. Benefits to gifting as an estate planning tool include:

- Making gifts during one's lifetime shifts future appreciation of gifted property to the donee.
- In addition, taxable income may be shifted from the high tax bracket of a donor to the lower tax bracket of a donee, age 14 or older.
- No gift tax is paid out-of-pocket until taxable gifts exceed the current exemption amount of \$1 million.

WHAT ABOUT LIFE INSURANCE GIFTS?

For many individuals, life insurance can be the single largest asset in their gross estates. If this is true in your case, you may wish to consider how to shield the death benefit proceeds from federal estate tax liability. If, at your death, you own a life insurance policy, the death benefit proceeds will be included in your gross estate and could be subject to federal estate taxes (depending on the size of your estate).

An **irrevocable life insurance trust (ILIT)** can be set up to be the owner and beneficiary of the policy. When properly drafted, an ILIT can eliminate the death benefit proceeds not only from your gross estate, but also from the gross estate of the trust's beneficiary.

ILITs can be designed to keep the proceeds of a life insurance policy out of your estate and give your estate the liquidity it needs. Generally, you can fund a life insurance trust either by transferring an existing life insurance policy or by having the trust purchase a new policy. (*Note:* If you plan to use an existing policy, you (the transferor) must live for more than three years following the transfer to the ILIT—otherwise, the policy proceeds will be included in your taxable estate. Additionally, if the transferred policy has a cash value exceeding the annual exclusion amount, federal gift tax may apply.)

UNDERSTAND THE “BUILDING” ENVIRONMENT

To avoid inclusion in your estate, such trusts must be irrevocable—meaning that you cannot dissolve the trust or change the terms of the trust if you change your mind later. With proper planning, the proceeds from life insurance held by the trust may pass to trust beneficiaries without income or estate taxes. This gives them cash that may be used to help pay estate taxes or other expenses, such as debts or funeral costs.

CHARITABLE GIVING

Your gifting strategy may also include gifts to charity. Charitable gifts are not taxed as long as the contribution is made to an organization that operates for religious, charitable, or educational purposes. You, or your estate may be entitled to a tax deduction for contributions to a qualifying charity.

A more complex estate planning strategy is the **charitable remainder trust (CRT)**. The CRT can allow you to: defer capital gains taxes on highly appreciated assets; receive an income stream based on the full, fair market value of those assets; receive an immediate charitable deduction; and ultimately benefit the charity(ies) of your choice.

Because a CRT is tax exempt, the trustee can sell highly appreciated assets on a tax-free basis and reinvest the full proceeds in other assets more likely to meet the growth and income objectives of the trust. Although no gain is recognized upon transfer, capital gains retain their character upon sale by the CRT and are recognized by the income stream recipient upon distribution. Assets donated to the trust are removed from the donor's taxable estate, potentially avoiding significant future estate taxation and likely reducing future probate costs. Donated assets are also protected from the claims of creditors. This feature may be particularly attractive to business owners concerned about their personal liability or to those who are sensitive about issues related to the division of assets in a divorce.

REVIEW YOUR PLAN REGULARLY

STEP FOUR

When possible, Magellan hugged the coast, navigating his course using mapped territories. Similarly, it is wise to stay in touch with the details of your estate plan. Continued consultation with trusted legal, tax, financial, and insurance professionals can prove invaluable. It is important to regularly review your estate plan, particularly in light of changing tax laws, as well as changes in your own assets and life circumstances. The following life events may signify the need to take another look at your estate plan and make sure it accurately reflects your goals and objectives:

- Change in tax laws
- Change in marital status
- Addition of children and/or grandchildren to the family
- Significant change in your net worth
- Change in your domicile (tax laws differ by state, as well as outside the U.S.)
- Special circumstances that require additional planning, such as a disabled child or spouse, or perhaps a parent that requires custodial care

SEEK PROFESSIONAL ADVICE

Estate planning is a complex process, requiring the knowledge of experienced professionals—often, the work of a team consisting of legal, financial, insurance, and tax professionals. Proactive, comprehensive planning will help ensure that you are protecting your heirs for many years to come.

In order to initially secure funding for his journey, Magellan, Portuguese by birth, had to seek support from Spain's King Charles after being refused funds by the King of Portugal. Magellan's perseverance paid off, and he sailed under the Spanish flag, carefully avoiding Portuguese territory. More likely than not, your estate planning process will prove to be less difficult. The four step plan outlined in this *Guide for Estate Planning* can help you chart your course: 1) get organized; 2) consider useful estate planning tools; 3) understand the "building" environment and; 4) review your plan regularly. One of the hardest things to do is start. After that, an experienced crew of qualified professionals can help you at every "port" along the way.

SAMPLE

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