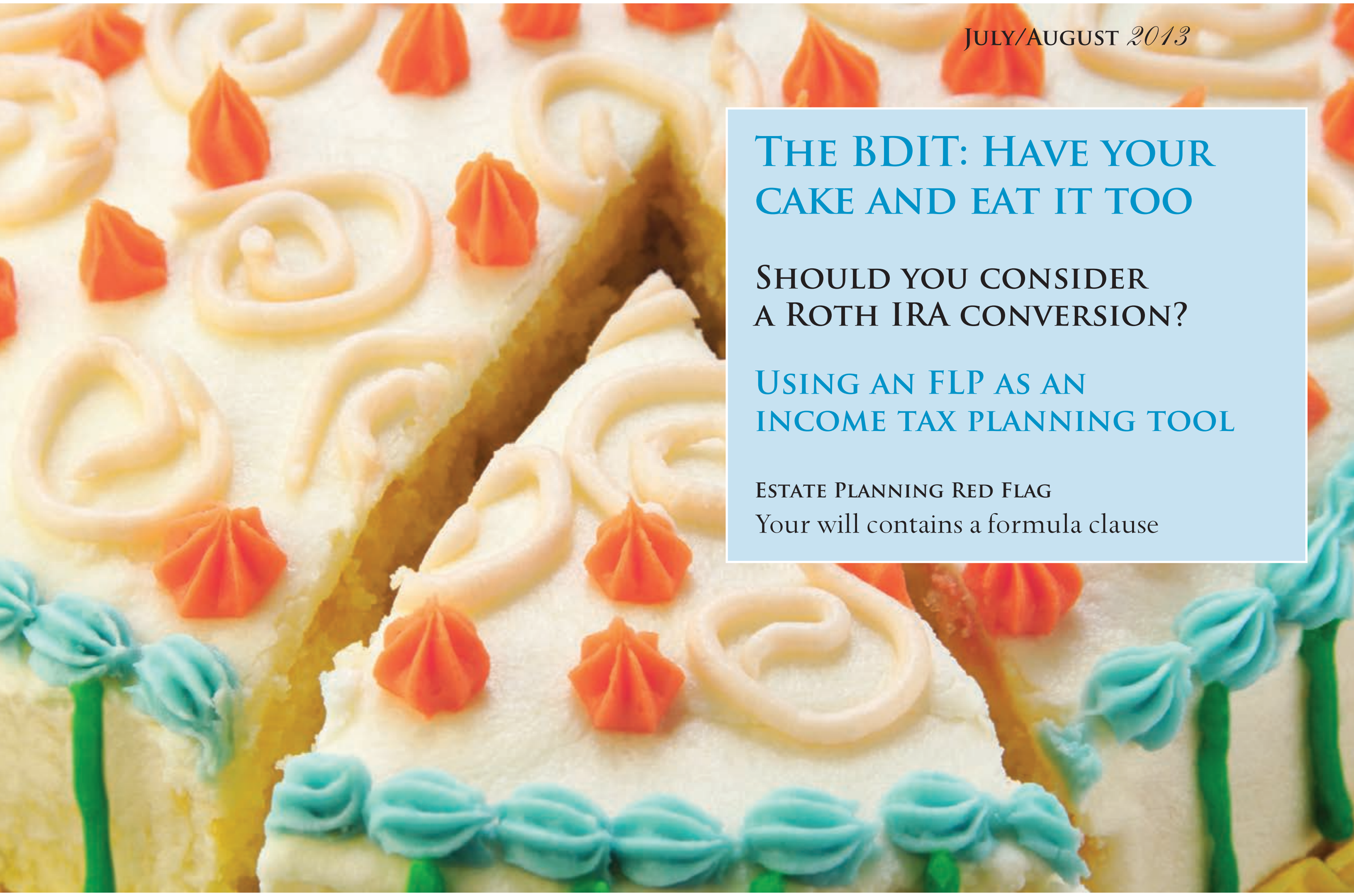
The Estate Planner



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Your will contains a formula clause

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The BDIT: Have your cake and eat it too

Many people are reluctant to consider advanced estate planning strategies because they're not ready to give up control over their property. A beneficiary defective inheritor's trust (BDIT) is a relatively new tool that, when structured properly, allows you to take advantage of sophisticated tax planning and asset protection techniques without losing control or enjoyment of the trust assets.

Setting up a BDIT

The BDIT strategy is based on the principle that, unlike one who *establishes* a trust, a beneficiary can receive substantial rights in a trust without causing the assets to be included in his or her estate.

A BDIT is set up by a third party — typically, a parent or grandparent — who names you as beneficiary and trustee. As trustee, you manage the trust assets and exercise certain other rights over the trust.

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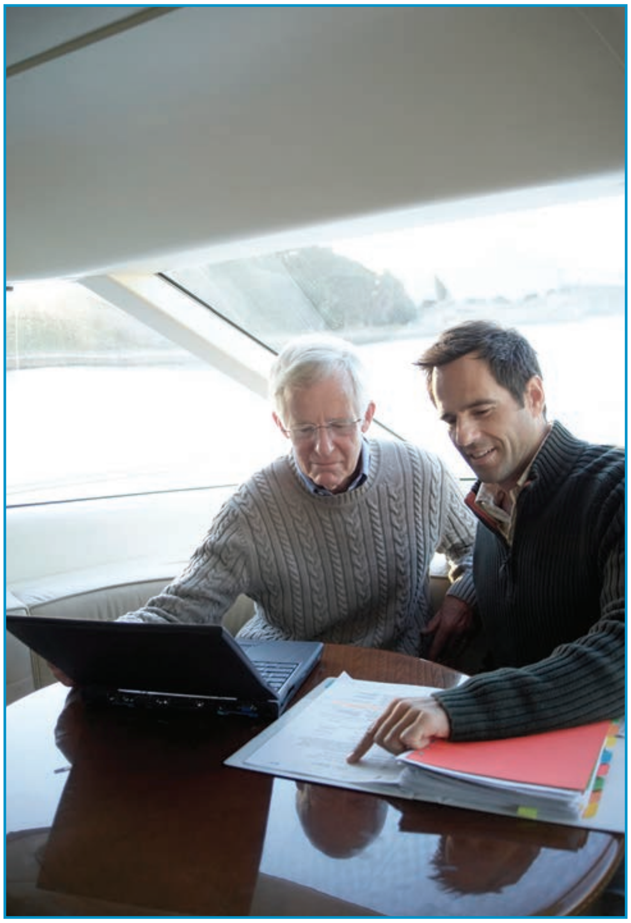
To ensure the desired tax treatment, however, the trust should also name an independent trustee to make decisions regarding discretionary distributions, tax issues and trust-owned insurance on your life. Usually, BDITs are structured as dynasty trusts, so the trust can continue to benefit your children, grandchildren and future generations without triggering gift, estate or generation-skipping transfer tax liability.



For this strategy to work, the BDIT must have "economic substance." So it's critical for the third-party grantor to "seed" the trust with his or her own funds.

If you give the funds to the third party, the IRS likely will treat you as the trust's creator and the BDIT's benefits will be lost. If you sell assets to the BDIT in exchange for a note, an oft-cited rule of thumb says that the seed money should be at least 10% of the purchase price. If the grantor lacks the resources to contribute that much, many experts believe that having a creditworthy third party (such as your spouse) personally guarantee the note is sufficient to lend the transaction economic substance.

Leveraging the benefits

Like other third-party trusts, a properly structured BDIT will shield assets against claims by your creditors. In addition, you can exercise a variety of rights over the trust assets without triggering estate taxes. These include the right to:

- Manage trust assets,
- Receive trust income,
- Withdraw assets from the trust (limited to an ascertainable standard, such as amounts needed for your "health, education, maintenance or support"),
- Receive discretionary distributions, in any amount, as determined by an independent trustee,
- Remove and replace the independent trustee,
- Use trust assets (such as a home) rent-free, and
- "Rewrite" the trust by exercising a special power of appointment to distribute the trust assets to anyone other than yourself, your estate or your creditors.

A BDIT is structured to be "income tax defective." The preferred method of creating the "defect" is to grant you, as beneficiary, carefully designed lapsing Crummey withdrawal powers with respect to trust contributions. This accomplishes two important objectives:

1. It ensures that you're treated as grantor for income tax purposes. By paying the trust's income taxes, you enable the trust to grow tax-free and you reduce the size of your estate.
2. It allows you to enter into tax-free transactions with the trust.

BDIT in action

Tim is the sole owner of a business, organized as a limited liability company (LLC), with a fair market value of $2 million. He wishes to share the business with his four children on a tax-advantaged basis, but he's not ready to give up control. Tim's father, Frank, sets up four BDITs, structured as dynasty trusts, each with Tim as the primary beneficiary and one of his four children as contingent beneficiary. Frank seeds each trust with $35,000 and ensures that Tim is the owner of each trust for income tax purposes by granting him withdrawal powers over the full amount of seed money.

Tim sells a 25% LLC interest to each BDIT in exchange for a note bearing a market rate of interest. The purchase price for each LLC interest is $350,000, which reflects a 30% valuation discount for lack of control and marketability. Because the seed money is 10% of the purchase price, no guarantees are necessary.

The result: Tim removes $2 million from his estate with no gift, estate or income tax consequences. As owner, he pays tax on the trust's income, so the LLC grows tax-free for the benefit of himself, his children and future generations. He accomplishes all of this while retaining control over, and the right to use, the trust assets.

The second item makes it possible to leverage the BDIT to produce significant estate planning benefits. It allows you to sell appreciating, discountable assets to the trust tax-free, thus removing those assets from your estate and allowing you and your heirs to enjoy all future growth transfer-tax-free. (See "BDIT in action" on page 3.)

To ensure the transaction isn't treated as a disguised gift, it's critical to sell the assets for fair market value and to ensure that the interest rate and other terms of the note are comparable to those in arm's-length transactions.

Handle with care

A BDIT is a powerful tool that allows you to enjoy the benefits of sophisticated planning techniques without relinquishing control over your hard-earned wealth. Making this strategy work requires precise planning, however, so be sure to consult your estate planning advisor. ✤

Should you consider a Roth IRA conversion?

A main objective of an estate plan is to preserve wealth for your loved ones. There are many strategies to achieve this. If you have a large amount of funds in a traditional IRA — or in an employer plan that you intend to roll over into a traditional IRA — consider whether you might benefit from converting all or a portion of it to a Roth IRA. A conversion can allow you to turn tax-*deferred* future growth into tax-*free* growth and take advantage of a Roth IRA's estate planning benefits.

Wealth preservation benefits

One of the biggest advantages of a Roth IRA is that it's exempt from minimum distribution requirements, allowing the funds to continue growing tax-free for many years. With a traditional IRA, you're required to start taking distributions on reaching age 70½ — regardless of whether you need the money — and those distributions are taxable at *ordinary* income tax rates, not the lower long-term capital gains rates.

With a Roth IRA, you can preserve more wealth for your family by leaving funds in the IRA for as long as possible. After you die, your heirs will be subject to the same distribution requirements that apply to all IRAs inherited by nonspouses. In most cases, they'll be able to stretch out distributions over their life expectancies and qualified Roth IRA distributions are income-tax-free.

When are withdrawals tax-free?

Distributions of *contributions* to a Roth IRA can be withdrawn at any time tax-free. Distributions of amounts rolled over to a Roth IRA at least five years prior are similarly tax-free.

When a Roth IRA is at least five years old, qualified distributions of earnings — including distributions after age 59½ and for qualified first-time homebuyer expenses — are tax-free. But that doesn't mean all Roth IRA distributions escape taxation altogether.

For instance, distributions of earnings before age 59½ that aren't qualified will be subject to both taxation and an early withdrawal penalty. And distributions that are free of income tax because they're done on or after attaining age 59½ may still be subject to an early withdrawal penalty in certain circumstances.

There are specific ordering rules, so be sure to understand them before taking a distribution.

Timing is a key consideration

Unlike a traditional IRA, which is funded with pretax dollars, a Roth IRA is funded with after-tax dollars. In the case of a conversion, you're subject to income taxes on the amount you convert as if you'd withdrawn the funds from the traditional IRA and reinvested them in a Roth IRA.

The difference is one of timing: With a Roth IRA you pay the taxes now; with a traditional IRA you pay the taxes when you withdraw the funds. So, which type of IRA creates more wealth?

From an income tax perspective, it depends on the relative tax rates. If your future tax rate turns out to be the same when the funds are withdrawn as it is now, it's a wash. If you expect your tax rate to be lower in retirement, a traditional IRA likely will produce a greater after-tax return. If you expect your tax rate to go up in retirement, a Roth IRA is generally preferable.

Roth IRA and your estate plan

From an estate planning perspective, the Roth IRA is the clear winner. Traditional IRAs are poor estate planning vehicles because their full value is included in your taxable estate even though your heirs are saddled with a sizable income tax liability on the distributions they receive.

Roth IRAs are also includible in your taxable estate, but the size of your estate is reduced by the amount of income taxes you pay on the conversion, and qualified distributions to your heirs are tax-free. In other words, by paying income tax now on amounts converted into a Roth IRA, you provide a benefit to your heirs by allowing them to receive future distributions tax-free.

Whether this makes economic sense depends on several factors, including whether you'll have a taxable estate and whether your heirs will take advantage of the ability to defer their distributions over their lifetime.

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Decision time

Before deciding whether to convert your traditional IRA to a Roth IRA, be sure to consider all of the income and estate tax implications — including the tax consequences of the conversion itself. Your estate planning advisor can analyze your current situation and help you decide if converting a traditional IRA to a Roth IRA will be beneficial. ✤

Using an FLP as an income tax planning tool

For many years, family limited partnerships (FLPs) have been a popular vehicle for consolidating and managing family wealth while reducing gift and estate taxes. Now that fewer people are subject to these taxes (thanks to lower estate tax rates and higher exemption amounts), an FLP may have lost some of its appeal as an estate planning tool. But with individual income tax rates at their highest level in years, don't overlook an FLP's potential as an *income* tax planning tool.

Higher income taxes reduce the amount of wealth available to pass on to your heirs, which can have a big impact on your estate plan.

Tax hikes under PPACA and ATRA

The Patient Protection and Affordable Care Act of 2010 (PPACA) and the American Taxpayer Relief Act of 2012 (ATRA) increase individual income taxes in several ways beginning this year. Among other things, the combined acts:

- Increase the top marginal rate to 39.6%,
- Increase the tax rate on capital gains and qualified dividends from 15% to 20% for taxpayers in the 39.6% bracket,
- End the 2% payroll tax holiday that was in effect in 2011 and 2012,

- Impose a 3.8% Medicare tax on net investment income and an additional 0.9% Medicare tax on earned income for certain high-income taxpayers, and
- Restore limits on itemized deductions and personal exemptions for certain high-income taxpayers.

At the same time, ATRA made the $5 million federal gift and estate tax exemption permanent ($5.25 million this year, adjusted for inflation). This takes some of the pressure off families to implement sophisticated estate planning strategies, but the previously listed tax hikes make income tax planning more critical than before.

> *Even if gift and estate tax planning is less of a concern, an FLP may provide an opportunity to take the sting out of higher income tax rates.*

Transfer income with an FLP

Typically, to take advantage of an FLP, one or both parents form and fund a limited partnership and transfer limited partnership interests to their children. The parents receive a general partnership interest, which allows them to retain management control. Because limited partnership interests lack control and are relatively unmarketable, they can be transferred at deeply discounted values for gift and estate tax purposes.

Even if gift and estate tax planning is less of a concern, however, an FLP may provide an opportunity to take the sting out of higher income tax rates. By transferring limited partnership interests to children or other family members in lower tax brackets, you can reduce your family's overall tax liability.

For this strategy to work, you must structure the partnership carefully to ensure that your children receive "real" ownership interests. Generally, under IRS rules, this means that partnership capital must be a "material income-producing factor" and that the children receive legitimate capital interests. If distributions of income to limited partners are disproportionate to their ownership interests, or if their rights with respect to the FLP are unduly restricted, the IRS may view the FLP as a tax avoidance scheme.

Even if an FLP is structured properly, the "kiddie tax" can undo its benefits. Under the kiddie tax, if you transfer an FLP interest or other income-producing property to a child under the age of 19 (24 for certain full-time students) the child's income from such property in excess of $2,000 (in 2013) is taxed at your marginal rate.

Look at the big picture

An FLP can be an attractive tax planning tool, but it's not right for everyone. Be sure to examine the potential benefits in light of your overall business, tax and estate planning goals. ✤

Estate Planning Red Flag

Your will contains a formula clause

Now that the federal estate tax exemption has been set permanently at an inflation-adjusted $5 million (currently, $5.25 million), fewer people are subject to federal estate tax. But that doesn't mean estate planning is any less important. Out-of-date formula clauses, in particular, can create unwelcome surprises.

Consider this example: Dave executed his will in 2007, when the exemption was $2 million. At the time, his estate was worth $2.5 million. His will contained a formula clause providing that an amount up to the current exemption would be placed in a credit shelter trust, with the balance going to his wife, Ann. Had he died in 2007, $2 million of his estate would have gone to the credit shelter trust and Ann would have received $500,000.

Fast-forward six years: Dave dies in 2013, never having amended his will. Let's assume that his estate is now worth $3 million. Because the exemption has climbed to $5.25 million, the formula clause causes his entire estate to go into the credit shelter trust, essentially disinheriting Ann. From a practical perspective, though, if Ann is the income beneficiary of the trust, the technical disinheritance might not have an impact. If, however, Dave's children from his former marriage are the beneficiaries of the trust, Ann will, in fact, have been disinherited.

State estate taxes can create additional headaches. Suppose Dave and Ann live in a state that, instead of adopting the federal exemption, has established its own $2 million exemption and taxes the excess at a 10% rate. Under Dave's will, the amount transferred to the credit shelter trust exceeds the state exemption by $1 million, triggering a $100,000 tax liability.

In light of the many changes to federal and state law over the last several years, it's important to review your estate plan and adjust it, if necessary, to avoid these types of surprises.

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Estate Planning and Divorce

By Jeanne V. Gordon

Estate planning often conjures images of married couples sitting down after the birth of their first child to name guardians, or older couples considering legacies. These images may lead to failure to properly plan during other life challenges.

Estate plan problems often arise in the context of a divorce when the focus of the divorcing couple is as far as possible from estate planning concerns which occur before, during and after a judgment of divorce is entered by the court. The estate plan documents that were executed during the marriage certainly do not represent the wishes of the divorcing couple during and after the divorce.

Prior to and during the divorce process, the couple should consider whether they will be comfortable with each other's spouse acting as an agent in financial and health care matters. If that is no longer prudent for the divorcing couple, then prior to or during the divorce process, each spouse should revise their respective health care power of attorney and financial general durable power of attorney.

Once the divorce is final, new estate plans are critically important for each former spouse. All prior estate plan documents should be revised to remove the former spouse as the beneficiary, executor, guardian and successor trustee. In addition, if a prior trust is revoked or restated, it is necessary to insure that any assets which are transferred to the trust are titled in accordance with statutory requirements.

In formulating a new estate plan, each former spouse must insure that the plan follows the final divorce settlement agreement and judgment. If minor children are involved, selection of a guardian will need to be coordinated with the custody agreement. Also, if one former spouse has sole custody of a child, the noncustodial former spouse will need a health care power of attorney to authorize medical care for the minor child in case of an emergency.

Estate planning should be a part of the divorce process and completed soon after the divorce is adjudicated.

Contact your Weston Hurd attorney with any questions about estate planning and divorce.