THE ESTATE PLANNER

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AN OVERLOOKED ESTATE PLANNING TOOL

Is private placement life insurance right for you?

A work in progress
An uncertain future requires a flexible estate plan

Estate Planning Red Flag
You're leaving an IRA to someone other than your spouse

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The cost segregation study

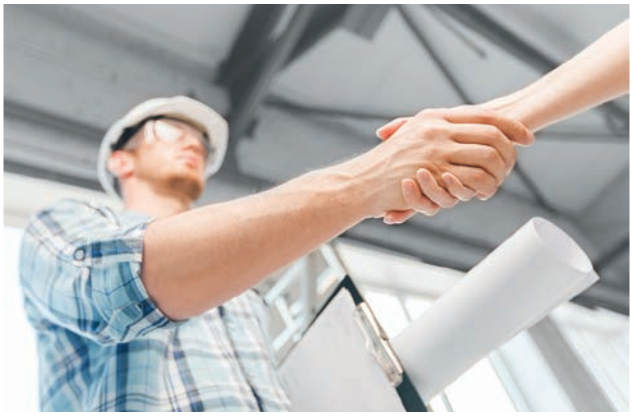
An overlooked estate planning tool

Owners of commercial and rental residential real estate often use cost segregation studies to accelerate depreciation deductions and improve cash flow. But it might surprise you to learn that these studies also offer significant estate planning benefits. Families that inherit real estate can take advantage of these benefits, but they need to act quickly. A cost segregation study can be performed after the owner dies, but it must be completed before the owner's final income tax return is filed or else the benefits will be lost.

What is cost segregation?

A cost segregation study applies engineering and cost-accounting techniques to reclassify certain building components as tangible personal property rather than real property. Ordinarily, commercial buildings are depreciated over 39 years, while rental residential buildings are depreciated over 27½ years. In contrast, personal property — such as equipment, furniture and fixtures, land improvements and certain building components — is generally depreciable over five, seven or 15 years.

By reallocating some of the costs of acquiring, constructing or substantially improving a building to these shorter-lived assets, real estate owners can accelerate depreciation deductions, reduce their tax bills and enhance cash flow. Owners can even use a "look-back" cost segregation study to capture missed depreciation from previous years through a one-time "catch-up" deduction in the current year. (See "Catch up on missed deductions with a look-back study" on page 3.)



What are the estate planning benefits?

Typically, when someone dies, the family's tax-planning efforts focus on the impact of estate and income taxes on the *beneficiaries* who receive the deceased's property. Too often, the family overlooks valuable opportunities to augment the deceased's wealth by reducing his or her final income tax liability.

If the deceased person owns underdepreciated real estate, a cost segregation study can be used to claim missed deductions on the deceased's final income tax return, increasing the amount of wealth available to his or her heirs. The following case study illustrates the potential benefits.

On January 1, 2010, Dan buys a rental residential building for $2.5 million and depreciates the entire cost over 27½ years. He dies in 2016, leaving the building to his children. Dan's executor commissions a cost segregation study, which concludes that $500,000 of the purchase price was properly allocable to five-year property. The executor files Form 3115 with Dan's 2016 income tax return, claiming a one-time deduction for the depreciation he could have taken in previous years.

The amount of the catch-up deduction is, for purposes of the example, $300,000: the difference between the total depreciation Dan claimed from 2010 through 2015 and the amount he could have

Catch up on missed deductions with a look-back study

Cost segregation studies are most effective when they're conducted before, or at the same time as, the acquisition, construction or improvement of the subject real estate. But even if a building was placed in service years ago, that doesn't mean it's too late to enjoy the benefits of a study.

A "look-back" cost segregation study enables owners to claim missed deductions without the need to amend previous years' returns. That's a big advantage, because the statute of limitations for filing an amended return is only three years. By filing Form 3115, *Application for Change in Accounting Method*, with the IRS, owners can claim missed deductions going as far back as 1987 and take a one-time "catch-up" deduction in the current year. Keep in mind, however, that the benefits of a cost segregation study will be eliminated or greatly diminished if the subject property has already been fully or mostly depreciated.

claimed had he treated the five-year property as such from the beginning. The bottom line: Assuming Dan was in the 39.6% tax bracket and had enough income in 2016 to offset the deduction, the cost segregation study reduces his final tax liability by $118,800. Paying less income tax will increase the amount he passes to his heirs. Be aware that, even if he's subject to estate tax, which would erode some of the benefit of the income tax savings, his family is still better off. That is, if he's in the 40% estate tax bracket the extra $118,800 will, after the impact of the estate tax, still net his family more than $71,000.

Leveraging the stepped-up basis

In addition to reducing a deceased person's final tax liability, cost segregation studies conducted for estate planning purposes have a distinct advantage over studies conducted in other contexts. Ordinarily, owners who sell depreciable buildings must pay a 25% "recapture" tax on gains attributable to previous depreciation deductions, in addition to capital gains tax. Because recapture taxes reduce — or, in some cases, eliminate — the benefits of accelerated depreciation, owners are often advised not to conduct a cost segregation study if they plan to sell the building within the next five years or so.

Transferring property at death avoids this issue. The recipient receives a stepped-up basis in the property equal to its date-of-death fair market value. If the recipient then sells the property shortly after the death of the owner, the sale may be for no gain and therefore be income-tax-free.

Act quickly

If you'd like to use accelerated depreciation deductions to reduce a deceased family member's final tax bill, contact your estate planning advisor as early as possible. To take advantage of this strategy, a cost segregation study should be completed well in advance of the filing due date of the deceased's final income tax return, and any missed depreciation deductions must be claimed on that final return. Once the deadline has passed, the opportunity will be lost.

Is private placement life insurance right for you?

The estate planning landscape has changed dramatically during the past decade. The gift and estate tax exemption currently is $5.45 million and adjusted annually for inflation. And the highest marginal income tax rate (43.4%, including the 3.8% net investment income tax) exceeds the top transfer tax rate (40%). For these reasons, many families are shifting their estate planning focus from gift and estate tax reduction to *income* tax reduction.

In recent years, private placement life insurance (PPLI) has emerged as an effective tax-planning tool for investors in hedge funds and other "alternative" investments. These investments offer higher upside potential, but in many cases they're highly tax *inefficient*. For example, hedge funds typically generate short-term capital gains, which are taxed at the same rates as ordinary income. Holding investments through a PPLI policy allows earnings to accumulate tax-free. And while earnings are ultimately taxed as ordinary income upon withdrawal, investors who hold these policies for life can avoid these taxes permanently.

Policy benefits

PPLI is a form of variable universal life insurance that offers more sophisticated investment options than traditional policies. Generally, these policies are designed to maximize cash value growth while minimizing death benefits. Although you might expect PPLI policies to be more expensive, because of the fact that they generally have much lower commission rates, all else being equal they tend to be less expensive than traditional policies.

Like other life insurance products, a PPLI policy's earnings aren't taxed currently, allowing its investments to grow at an accelerated rate. During the life of the policy, you can access its cash value tax-free either by:

- Withdrawing cash value up to your investment in the contract (generally, cumulative premiums paid less any dividends or other nontaxable amounts received under the policy), or
- Borrowing against the policy's cash value. However, that borrowing could lead to negative tax implications if the loan isn't repaid during your life.

From an estate planning perspective, if you hold a PPLI or other life insurance policy for life, your beneficiaries will receive its cash value and death benefit income-tax-free. This makes it possible to permanently eliminate income taxes on investments held in the policy.

PPLI and estate taxes

If estate or generation-skipping transfer taxes are a concern, it's possible to set up an irrevocable life insurance trust (ILIT) to own a PPLI policy. But these arrangements raise issues that don't typically arise in connection with traditional ILITs. For example, unlike traditional policies, PPLI usually involves substantial cash contributions over a relatively short time, making it challenging to fund the ILIT without triggering gift tax liability.

Buying PPLI

Be aware that not just anyone can purchase a PPLI policy. Because PPLI is an unregistered securities product, you can't invest in it unless you're an "accredited investor" *and* a "qualified purchaser" as those terms are defined by the Securities and Exchange Commission (SEC). To be an accredited investor, you must have either:

- A net worth of $1 million or more, alone or together with your spouse (excluding your primary residence), or
- Income of at least $200,000 ($300,000 for married couples) in each of the previous two years.

Generally, to be a qualified purchaser, you must have $5 million or more in net investments.

Do your due diligence

PPLI is a sophisticated insurance product that involves inherently risky investments, so it's important to evaluate your options carefully. It's critical to choose a reputable insurance carrier that understands the complex rules governing life insurance, and knows how to structure a product so that it qualifies as life insurance for federal tax purposes.

While you're permitted to select investments from the insurance carrier's menu of funds, you're prohibited from exercising any control over an investment manager's decisions. So be sure to research each fund's investment philosophy and track record carefully before you invest.

A work in progress

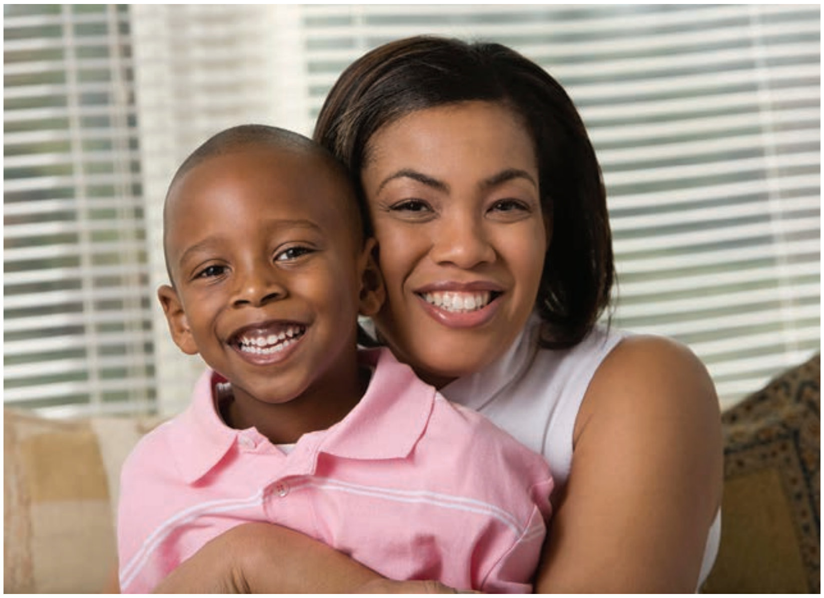
An uncertain future requires a flexible estate plan

Your estate plan shouldn't be a static document. In fact, you should revisit it every few years to account for life-changing events, such as marriage or the birth of a child, or tax law changes.

If your life expectancy is 30 years or more, it may be difficult to plan for the future: Should you make lifetime gifts to reduce estate tax liability? Or should you keep the assets in your estate to try to minimize the potential income tax burden on your loved ones? Adding flexibility to your estate plan is key, and a carefully constructed trust is the proper vehicle.

Estate tax planning vs. income tax planning

When you transfer assets at death, your tax basis is "stepped up" to the assets' current fair market value, allowing your heirs to sell the assets without recognizing capital gains. When you transfer assets via gifts, however, they retain *your* basis, so recipients who sell appreciated assets may face a big tax bill. From an income tax perspective, it's usually



best to keep assets in your estate and transfer them at death.

Estate tax planning, on the other hand, generally favors lifetime gifts. By transferring assets to the younger generation as early as possible — either in trust or outright — you remove those assets from your estate while their values are low, thus minimizing gift taxes. This also shields future appreciation from estate taxes.

The best strategy is the one that will produce the greatest tax savings for your family. But if you wait until you know the answer, it may be too late. Let's look at an example.

Kim, 40, has a net worth of $5 million. In 2016, she transfers $1 million in stock (with a $500,000 tax basis) to an irrevocable trust for the benefit of her son, John. When Kim dies 30 years later, the stock's value has grown to $6.5 million. By giving the stock to John in 2016, Kim avoided estate tax on $5.5 million in appreciation. However, because the stock retains Kim's $500,000 basis, John will incur a $1.2 million capital gains tax (assuming a 20% rate) if he sells it.

Assume that, when Kim dies in 2046, her net worth remains at $5 million and the inflation-adjusted estate tax exemption is $12 million. Even if Kim had kept the stock, her estate would have been exempt from tax. Thus, there was no advantage to giving it away. And, if she had transferred the stock at death, John would have gotten a stepped-up basis, which means that he would have little or no capital gains tax liability if he sold the stock shortly after Kim's death. Under these circumstances, keeping the stock in Kim's estate would have been the better tax strategy.

Suppose, instead, that in 2046 Kim's net worth (apart from the stock) has grown to $10 million. Keeping the stock would increase her estate to $16.5 million, generating a $1.8 million estate tax (assuming a 40% tax rate). Given these facts, the estate tax savings are significantly larger than the potential income tax cost. So the family is better off if Kim removes the stock from her estate in 2016.

> *It's difficult to predict your family's financial situation, and the state of estate and income taxes, decades from now.*

Bear in mind that this example is oversimplified for illustration purposes. To determine the right strategy, you also need to consider state income and estate taxes, as well as your beneficiary's future plans.

Give your trustee power

It's difficult to predict your family's financial situation, and the state of estate and income taxes, decades from now. But with a carefully designed trust, it's possible to hedge your bets, giving the trustee the ability to switch gears when the best course of action reveals itself.

Here’s how it works: You transfer assets to an irrevocable trust for the benefit of your heirs, relinquishing control over the assets and giving the trustee absolute discretion over distributions. The assets are removed from your estate, minimizing gift and estate taxes. If, however, it becomes clear that estate tax *inclusion* is the better tax strategy, the trustee has the power to force the assets back into your estate.

Planning for the future

If you’re in your 20s or 30s, there are many variables to consider when creating or updating your estate plan. Choosing certain strategies today may not be advantageous decades from now. Flexibility is important, but so is using caution; risks are involved. Your estate planning advisor can explain the potential pitfalls before you take action.

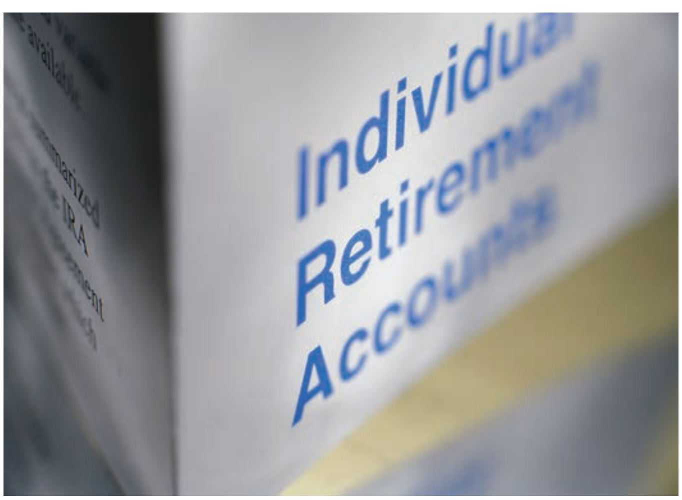
ESTATE PLANNING RED FLAG

You’re leaving an IRA to someone other than your spouse

An IRA can be a powerful wealth-building tool, offering tax-deferred growth (tax-free in the case of a Roth IRA), asset protection and other benefits. But if you leave an IRA to your children — or to someone other than your spouse — these benefits can be lost without careful planning.

Surviving spouses who inherit IRAs are permitted to roll them into their own IRAs, allowing the funds to continue growing tax-deferred or tax-free until they’re withdrawn in retirement or after age 70½. Beneficiaries *other* than your spouse, such as your children, are treated differently. To take advantage of an IRA’s tax benefits, they must transfer the funds directly into an “inherited IRA.” Although they’ll have to begin taking distributions by the end of the following year, they’ll be able to stretch those distributions over their life expectancies, allowing earnings to grow tax-deferred or tax-free as long as possible.

Your children or other nonspousal beneficiaries won’t have this option, however, unless you name them as beneficiaries (or secondary beneficiaries) of your IRA. If you leave an IRA to your estate, your children or other heirs will still receive a share of the IRA as beneficiaries of your estate, but they’ll have to withdraw the funds within five years (or, if you die after age 70½, over what would otherwise be *your* remaining actuarial life expectancy).



If you name multiple nonspousal beneficiaries (several children, for example), they’ll have to establish separate inherited IRA accounts by the end of the year after the year of death in order to take distributions over their own life expectancies. If they miss the deadline, they’ll have to use the *oldest* beneficiary’s life expectancy. Be aware that, unlike other IRAs, inherited IRAs aren’t protected from creditors in bankruptcy.

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Angela G. Carlin is the Co-Chair of Weston Hurd's Estate, Trust and Probate Practice Group. She focuses her practice on estate, trust and probate administration and litigation, and tax matters. Angela is the author of the Merrick-Rippner Probate Law publication which is the recognized authority in Ohio on probate law. She received the Nettie Cronise Lutes Award from the Ohio State Bar Association in 1996 as the Outstanding Woman Lawyer and for many years, she has been named as an *Ohio Super Lawyer* by Thomson Reuters and a *Leading Lawyer* by Inside Business Magazine.

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Carlin Comments

Another Disappointed Illegitimate Heir (Part 2)

By Angela G. Carlin

In lieu of a hearing, all parties including the estate and Appellant Wright stipulated to the facts including: that I.V. Burdette, Jr. died without a will, the estate was opened only to settle the personal injury claim, Wright was not listed as an heir nor did she receive any estate distribution, that Wright was the biological child of the decedent, that Wright's mother and Burdette were never married, that Wright was never adopted by Burdette nor did Burdette acknowledge Wright as his daughter in any statutory proceeding in probate or juvenile court, that Burdette never designated Wright as his heir-at-law, and that Burdette was never determined to be Wright's father in any parentage action and none such action was pending at Burdette's death.

Both parties moved for summary judgement with Wright filing a supporting affidavit where she averred that her father acknowledged her as his daughter, never denied the relationship, and that her father visited her when Wright lived with Burdette's mother – her paternal grandmother. Burdette's brother, Herbert, corroborated Wright's affidavit in his own affidavit. Interestingly, Veronica, one of Burdette's two natural children admitted that Wright was introduced to Veronica as a stepsister, but that Burdette never acknowledged Wright as his daughter. After the matter was submitted for decision without a hearing, the probate court magistrate overruled Wright's motion for summary judgment or relief from judgment concluding that she was not an heir of Burdette. Wright filed objections to such decision arguing that the birth certificate was prima facia evidence of paternity, and that she was denied her rights of equal protection. The probate court overruled Wright's objections and upheld the magistrate's decision, concluding that: 1) the birth certificate was insufficient to prove inheritance rights; 2) the undisputed facts established that a parent-child relationship was not established or acknowledged by a marriage between the biological parents of Wright; 3) there was no provision for Wright in Burdette's Will because he died intestate; 4) there was no formal adoption of Wright by Burdette; and 5) there was no acknowledgment of Wright by Burdette in any statutory proceeding.

Upon appeal of the probate court decision by Wright, the appellate court upheld the trial court decision notwithstanding that pursuant to Ohio Revised Code 3705.23(A)(3) and (B)(1), a certified copy of a birth certificate "shall be prima-facia evidence of the facts stated in it in all courts and places," however "prima facia evidence is not conclusive," since "(t)he term denotes evidence which will support, but not require, a verdict in favor of the party offering the evidence," citing *Krischbaum v. Dillon*, 58 Ohio St. 3d 58, 64, 567 N.E. 2d 1291 (1991). Unless a statute provides otherwise, prima facia evidence creates a rebuttable presumption. Further, it was not enough for Wright to prove that she is, in fact, Burdette's daughter through conclusive DNA testing. Before Wright could claim the status of intestate heir of Burdette, Wright had to prove Burdette acknowledged her as his daughter publicly through paternity proceedings. The law of intestate distribution, Ohio Revised Code 2105.06, establishes a presumption of how a decedent wishes his estate to be distributed in absence of a will. The appellate court determined that once Burdette had acknowledged Wright as his daughter, then Burdette would have known the consequences of his death without a valid will; Burdette could have decided to give Wright more, less, or none of an intestate share by executing a valid will, citing *Byrd v. Trennor*, 157 Ohio App 3d 358, 811 NE 2d 549.