The Estate Planner

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Preserve more wealth for your heirs with asset-protection strategies

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Estate Planning Red Flag

Your estate plan doesn't provide for sufficient liquidity

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Shelter your business assets

Preserve more wealth for your heirs with asset-protection strategies

Estate planning and asset protection go hand in hand. After all, your estate plan will be of little value if you have no assets left to distribute.

Most people concentrate their asset-protection efforts on insulating their personal wealth from frivolous lawsuits or other claims. But if a significant portion of your wealth is invested in a business, it's equally important to protect its assets from unreasonable or excessive creditor claims.

Business asset-protection strategies

Most asset-protection strategies for businesses involve putting up walls between a company and its assets. If the majority of your assets are tied up in a business, consider these strategies:

Distribute the wealth. A simple, yet effective, technique for protecting personal assets is to give them away to your children or other family members. A creditor can't go after assets you don't own. Similarly, your business can protect its assets by distributing accumulated earnings to the owners. So long as you retain a reasonable amount of working capital in the business, this strategy allows you to shield excess funds against business creditors. (This assumes that the business is conducted within an entity that allows one's personal assets to be protected from the business liabilities.)

Divide the pie. One of the best strategies for protecting business assets is to divide the business into separate entities. If certain business activities are riskier than others, consider forming separate entities to conduct these activities. Doing so allows you to limit the liability risk associated with them. Provided the entities are structured and operated properly, you can prevent creditors from going after assets owned by other entities within the group, even if they have common ownership.

Weigh renting vs. buying. Another way to protect valuable business assets is to sell them (usually to another entity created by the company's owners) and then lease them back. If done right, these assets no longer belong to your company, so they're beyond the reach of the company's creditors.

Strip it down. Equity stripping involves pledging company assets as collateral for a loan. The company then loans the funds to its owners, who protect the loan proceeds with their own personal, asset-protection arrangements. This strategy strips the company of equity, leaving less wealth exposed to creditor claims.

Finally, it's important to ensure that the company is left with sufficient funds to meet its future operating needs. If a court finds that the company is grossly undercapitalized, these walls may quickly tumble down.

Complex tax and legal issues

There are a variety of strategies you can use to protect your business assets and preserve your wealth for your heirs. Whichever ones you choose, start planning as early as possible (ideally, at the time the company is formed). You can't transfer assets with the intent to defraud creditors, so it's important to have asset-protection strategies in place well before any claims arise.

Bear in mind that many of these strategies involve complex tax and legal issues, so be sure to consult your advisors before attempting to implement them. ✤

Changing state taxes can affect your estate plan

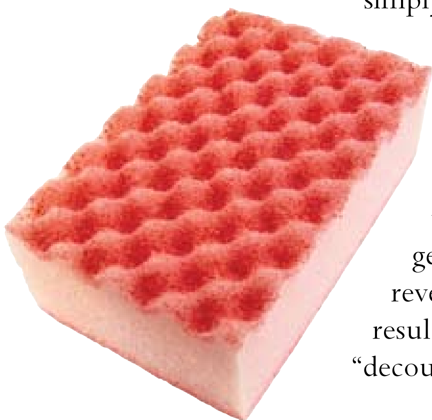
For years, state death taxes had little or no effect on estate planning. That's because the state death tax credit allowed states to grab a piece of an estate's federal tax pie with minimal administrative effort or expense.

Now, however, the credit has been eliminated, prompting revenue-hungry states to rewrite their tax laws. Not only are many states imposing their own estate or inheritance taxes, but some have frozen their exemption amounts at previous levels. As the federal estate tax exemption rises, this creates a gap between federal and state exemptions, resulting in some difficult estate planning challenges.

Historically, the state death tax credit provided estates with a dollar-for-dollar credit — at graduated rates up to 16% of federal tax liability — for estate or inheritance taxes paid to a state.

Sponge tax no longer holds water

Historically, the state death tax credit provided estates with a dollar-for-dollar credit — at graduated rates up to 16% of federal tax liability — for estate or inheritance taxes paid to a state. Rather than impose a separate death tax, many states collected taxes equal to the credit amount. These "pickup" or "sponge" taxes didn't add to an estate's overall tax liability; they simply funneled a portion of the federal estate tax dollars to the respective state.



With no state death tax credit, a sponge tax generates no state tax revenues. To avoid this result, many states have "decoupled" from the federal estate tax and created their own. And to boost revenues, some of these states have fixed their exemption amounts rather than raising them in tandem with the federal exemption.

Falling into the gap

Suppose you live in a state that has decoupled from the federal estate tax and has fixed its death tax exemption at $2 million. Next year, when the federal exemption increases to $3.5 million, there will be a $1.5 million gap between the state and federal exemptions. As the following example illustrates, this gap may throw a monkey wrench into your plans.

Steve and his wife, Debbie, own assets valued at $7 million, all in Steve's name. Steve dies in 2009, when the federal estate tax exemption is $3.5 million, leaving his entire estate to Debbie. There's no federal estate tax, because, under the unlimited marital deduction, transfers between U.S. citizen spouses are tax exempt. But if Debbie dies later in 2009, her $7 million estate will be subject to $1,575,000 in estate taxes. In other words, by transferring

his entire estate to Debbie outright, Steve has wasted his exemption.

Enter the credit shelter trust

A common technique for avoiding this result is to use a credit shelter trust, also known as a bypass trust. Steve's estate plan could have directed $3.5 million into a credit shelter trust that would have provided Debbie with an income interest for life, after which the assets would have gone to their children. The trust would have shielded the assets from estate taxes by taking full advantage of Steve's exemption. And by limiting Debbie's rights to the trust principal, the assets would have bypassed her estate. When Debbie died, her estate would have been worth $3.5 million, which is exempt from estate tax.

What if Steve and Debbie live in a state that imposes its own estate tax with a $2 million exemption and a flat rate of 15% on the taxable estate? When Steve dies, $1.5 million of the $3.5 million transferred to the bypass trust would be subject immediately to $225,000 in state taxes.

Here's the dilemma: Transferring $3.5 million to the bypass trust would eliminate federal estate taxes but would trigger an immediate $225,000 in state taxes plus another $225,000 in state taxes when Debbie dies. Transferring $2 million to the bypass trust would avoid current taxes, but would result in a combined federal and state estate tax bill of $922,500 when Debbie dies, after considering the federal deduction for the amounts paid to the state.

The right strategy boils down to economics: Are Steve and Debbie better off paying $225,000 now and $225,000 later? Or would they be better off paying nothing now and more than $900,000 later? In this case, because Debbie dies later the same year, the first option makes more sense. But if a surviving spouse is expected to live for a long time, deferring the tax may make more sense. The answers may change depending on whether Debbie's estate grows or shrinks and whether federal or state tax laws change.

One way to build some flexibility into your plan is to leave your entire estate to your spouse, with the option to disclaim a portion of the assets into a bypass trust. That way, your spouse and advisors can determine the best strategy when the time comes.

Review your plan

The estate planning landscape has changed dramatically during the last several years, and will likely continue to change in the near future. Review your estate plan regularly to avoid unpleasant tax surprises and to be sure it has the flexibility to adapt to changing circumstances. ✤

What goes down must come up

Estate planning in a low interest rate environment

The financial markets have always been cyclical. When interest rates are low, it's a sure bet that they'll rise again, given time. Key federal rates have dropped this year to their lowest level in several years. So now is a good time to consider wealth-transfer strategies that lock in these low rates, such as family loans, grantor retained annuity trusts (GRATs), charitable lead annuity trusts (CLATs) and sales to grantor trusts.

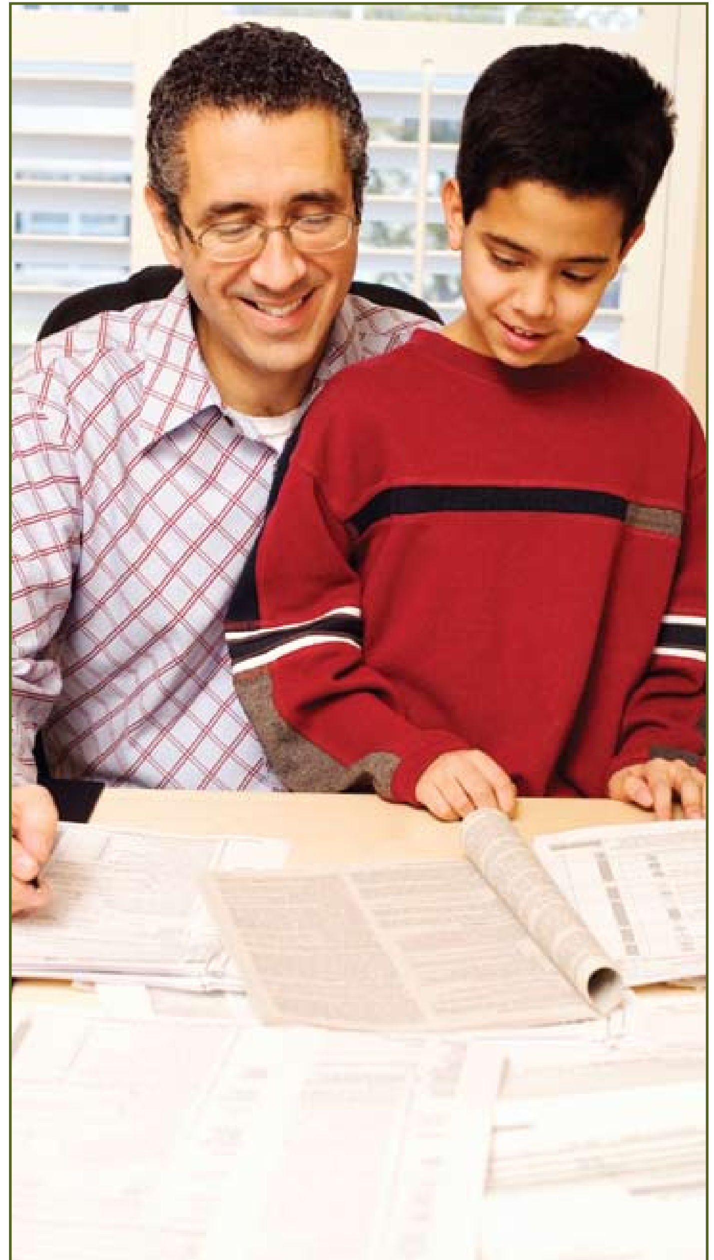
Clearing the hurdles

Many estate planning strategies allow you to transfer substantial amounts of wealth to your children or other beneficiaries free of gift and estate taxes. Their tax-saving potential is based on a simple principle: The value of certain assets for gift tax purposes is based on the assumption that they'll earn a specified rate of return — the applicable federal rate (AFR) — for the month the transfer is made. Any returns above the assumed rate (often referred to as the "hurdle rate") are transferred to your beneficiaries free of transfer taxes.

> *The value of certain assets for gift tax purposes is based on the assumption that they'll earn a specified rate of return for the month the transfer is made.*

Lifetime giving strategies are particularly effective when interest rates are low because the probability of outperforming the hurdle rate — and, therefore, transferring wealth tax free — is high.

Let's say, for example, that you transfer assets to a 10-year GRAT for the benefit of your children during a month when the hurdle rate is 4%. The value of your contribution for gift tax purposes is based on the assumption that the assets will earn a 4% return during the GRAT's term. But history shows that your returns likely will exceed 4% over a 10-year period. These excess returns will escape gift and estate taxes, allowing you to transfer more wealth to your family.



There are many estate planning strategies you can use to take advantage of low interest rates. Here are several examples:

Family loans. This is the simplest technique, but it can be very effective. If you make a low-interest or interest-free loan to your child or another family member, the IRS treats the forgone interest as a taxable gift. You can

An alternative to a family loan

Selling assets to a grantor trust is similar to a family loan, but it allows you to retain greater control over the transferred assets. Thus, it may be an ideal vehicle for transferring an interest in a closely held business.

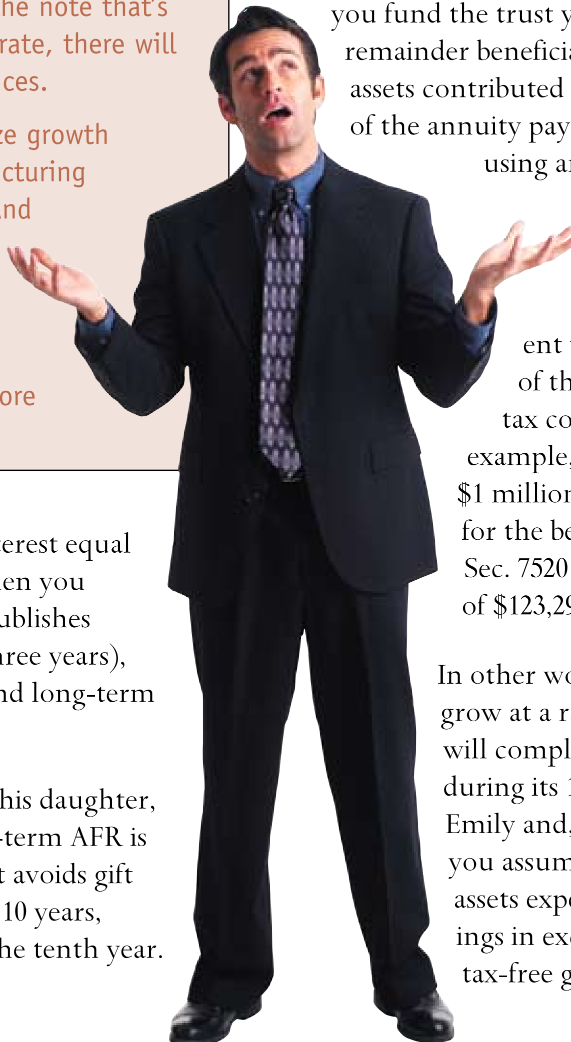
To take advantage of this strategy, have your estate planning professional set up an irrevocable trust that's structured as a grantor trust for income tax purposes. You make a taxable gift of seed money to the trust (usually 10% or more of the purchase price) and then sell your business interest to the trust in exchange for a promissory note.

The business interest, together with all future appreciation in value, is removed from your estate. And, because a grantor trust may be ignored for income tax purposes, you don't recognize any capital gain or loss on the sale, as you are treated as having sold the asset to yourself. In addition, as long as the trust purchases the interest for fair market value and pays interest on the note that's no less than the applicable federal rate, there will be no additional gift tax consequences.

Like a family loan, you can maximize growth and income within the trust by structuring the note with a balloon payment. And unlike a grantor retained annuity trust, there's no mortality risk, though your estate will be subject to income taxes attributable to the unpaid principal should you die before the note is paid off.

avoid gift tax, however, by charging interest equal to or greater than the AFR in effect when you make the loan. Each month, the IRS publishes AFRs for short-term loans (less than three years), mid-term loans (three to nine years) and long-term loans (more than nine years).

For example, Scott lends $1 million to his daughter, Emily, during a month when the long-term AFR is 4.5%. By charging interest at 4.5%, Scott avoids gift tax. The loan calls for interest for only 10 years, with a balloon payment at the end of the tenth year.



Emily invests the money in growth stocks and mutual funds that earn a 6% return. Assuming that she uses the earnings to make the interest payments and reinvests what's left, she will end up with nearly $200,000 gift-tax-free after paying back the loan. And if Emily successfully invests the proceeds and earns, say, an 8% return, she will have amassed more than $500,000. This analysis ignores the income tax consequences of the investments, which of course would have an impact on the results. If, however, Scott and Emily invest the $1 million in the same way, and you further presume that Scott is in a higher income tax bracket than Emily, this will further increase the benefit to them as a family unit.

GRATs and CLATs. These two trust types work in essentially the same way: You contribute assets to an irrevocable trust, which makes annuity payments to a designated beneficiary during the trust term. At the end of the term, any remaining assets are transferred to your children or other beneficiaries free of estate and gift taxes.

The main difference between the two techniques is that a GRAT pays the annuity to you, as grantor, while a CLAT pays the annuity to a charity. In either case, when you fund the trust you make a taxable gift to the remainder beneficiaries equal to the value of the assets contributed to the trust less the present value of the annuity payments. Present value is computed using an assumed rate of return known as the Section 7520 rate.

If you set the annuity payments high enough, their present value will be equal to the value of the trust assets, resulting in no gift tax consequences. From the previous example, let's suppose Scott contributes $1 million to a 10-year GRAT or CLAT for the benefit of Emily. If the applicable Sec. 7520 rate is 4%, an annuity payment of $123,291 will "zero out" the trust.

In other words, assuming the trust assets grow at a rate of 4%, the annuity payments will completely deplete the trust assets during its 10-year term, leaving nothing for Emily and, therefore, no taxable gift. But if you assume that Scott funds the trust with assets expected to grow at a 6% rate, earnings in excess of the hurdle rate result in a tax-free gift to Emily of nearly $166,000.

If your goal is to transfer wealth to your children free of gift and estate taxes while generating an income stream for yourself, a GRAT may be the ideal vehicle. It's also an effective way to transfer an interest in a closely held business at a minimal tax cost. If your objectives are philanthropic, however, a CLAT may be worth a look.

One disadvantage of a GRAT is "mortality risk"; that is, if you die before the end of the trust term, all of the assets will be included in your taxable estate. There is no mortality risk with a CLAT.

Rating your opportunities

Low interest rates create valuable opportunities for tax-free giving. Your estate planning advisor can help you determine which strategies would be most effective for you. ✤

Estate Planning Red Flag

Your estate plan doesn't provide for sufficient liquidity

When planning your estate, providing liquidity to pay taxes and other expenses is every bit as important as developing strategies to minimize estate and gift taxes. There are countless horror stories about families who were forced to sell a family business or other precious assets to raise the necessary funds to pay estate and gift taxes.

But the dangers of neglecting liquidity go well beyond the loss of prized possessions. After you die, your estate must be settled within nine months. If your family is forced to liquidate assets quickly to meet the estate's expenses, it's likely that some assets will receive a price that's significantly less than their fair market value.

To avoid this situation, begin planning for liquidity as early as possible. This is especially critical if most of your wealth is tied up in a closely held business, real estate or other illiquid assets.

Life insurance is generally the most effective liquidity-planning tool. It allows you to build up cash values on a tax-advantaged basis, and the death benefits provide instant liquidity when it's needed most.

If you own a closely held business, you should have a buy-sell agreement — funded by life insurance or other resources — that provides for the company or the other owners to acquire your interest in the business when you die. You might also consider an employee stock ownership plan (ESOP), which creates a market for your shares and allows you to convert some of your stock into more liquid investments.

Another option is to sell business interests to your family or to a trust. Not only does this raise cash to meet your future liquidity needs, but it also removes wealth from your estate, reducing the tax burden.

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Good News from the IRS gives Estate Planners and Clients Piece of Mind

The Internal Revenue Service has issued a revenue ruling that grants estate planners and clients piece of mind and greater flexibility in overall tax and estate planning.

GRANTOR'S NONFIDUCIARY POWER TO SUBSTITUTE TRUST PROPERTY DIDN'T TRIGGER INCLUSION IN ESTATE

A recent IRS revenue ruling concludes that the assets or principal of an *irrevocable* trust that a grantor creates during life is not includible in his gross estate for federal estate tax purposes just because the grantor retained the power, exercisable in a nonfiduciary capacity, to acquire trust property by substituting other property of equivalent value. *Rev Rul 2008-22, 2008-16 IRB 796*. This ruling is good news for anyone who wants to set up a "defective grantor trust." From a tax point of view, this type of trust facilitates numerous tax transactions and this type of trust is intentionally structured so that the grantor, rather than the trust or its beneficiaries, will be taxed on the trust's income without the trust being included in the grantor's estate. Under Code Sec. 675(4), a grantor's power to substitute property causes trust income to be taxed to the grantor and is commonly used to create a defective grantor trust. The new ruling gives this technique a big boost by making it clear that such a power of substitution won't cause inclusion in the grantors' estate. For high net worth clients, this is a clear win-win situation.

But planning (and maybe more importantly, implementation) of this strategy is not without some peril. The IRS noted that, under the facts in the example set forth in the Revenue Ruling, the trust instrument (i) expressly prohibits the grantor from serving as trustee, and (ii) the grantor's power to substitute assets of equivalent value is held in a nonfiduciary capacity. However, the ruling then went on to observe that the assets the grantor transfers into the trust must be equivalent in value to the ones he receives in exchange. This is where it begins to get tricky. The mere reserved power of the grantor to substitute assets is sufficient to create a "defective grantor trust." However all the benefits of such a trust can be lost if there is a swap of property and they are not equivalent value. The trustee has a fiduciary obligation to ensure that the assets exchanged are of equivalent value. As a result, the grantor cannot exercise the power to substitute assets in a manner that will reduce the value of the trust corpus or increase his net worth. Further, in view of trustee's ability to reinvest the assets and his duty of impartiality regarding the trust beneficiaries, the trustee must prevent any shifting of benefits between or among the beneficiaries that could otherwise result from a substitution of property by the grantor. However, if structured (and implemented) properly, the ruling concluded that grantor's retained power will not cause the value of the trust corpus to be included in his gross estate under Code Section 2036 or Code Section 2038.

For more information about this or other estate planning opportunities please call Tom Quilter, Sean Fraser or George Malis at Abbott Nicholson at 313-522-2500.

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