INSIGHT ON ESTATE PLANNING

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Understanding how one affects the other can benefit your estate plan

ESTATE PLANNING PITFALL
You haven't taken state estate taxes into account

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When interest rates are low, it's high time for estate planning

Interest rates remain at record lows, and while many experts believe they'll begin to rise soon, it's likely they'll rise slowly. So it's an ideal time to implement estate planning strategies that are most effective in a low-interest-rate environment.

Make family loans

Lending money to a family member is a simple but highly effective estate planning strategy. Although the IRS often scrutinizes these transactions to be sure they're not disguised gifts, careful planning will help you avoid an IRS challenge. It's important to treat the loan just like an arm's-length transaction between unrelated parties. That means charging interest at or higher than the applicable federal rate (AFR), executing a written promissory note and taking steps to collect the payments.

The key to using a family loan to minimize transfer taxes is for the borrower to invest the funds in assets that outperform the AFR, which is more likely to happen when interest rates are low. Consider this example: Paul lends $1 million to his daughter, Mary, at a time when the AFR for long-term loans (more than nine years) is 3%. The transaction calls for Mary to make interest-only payments (at 3%) for 10 years, followed by a balloon payment at the end of year 10. Mary invests the funds in a business that earns a return of 7% per year. After paying back the loan, Mary ends up with a windfall of nearly $553,000. In a sense, therefore, the loan allows Paul to make a tax-free gift.

Consider a GRAT

A grantor retained annuity trust (GRAT) is an irrevocable trust that pays you (the grantor) an annuity for a term of years, after which it distributes its remaining assets to your children or other beneficiaries. When you contribute assets to a GRAT, you're deemed to have made a taxable gift to the beneficiaries equal to the projected value of their remainder interests. That value is calculated

by taking the value of your contributions and subtracting the present value of your annuity payments. The higher the annuity payments and the longer the trust term, the lower the present value and, therefore, the lower the gift-tax value.

Present value is based on the Section 7520 rate, a conservative, assumed rate of return published monthly by the IRS. To the extent that the trust's investment returns outperform the Sec. 7520 rate (and provided you survive the trust's term), your beneficiaries receive a tax-free windfall. And considering the fact that the Sec. 7520 rate has been in the neighborhood of 2% in recent months, that's a relatively easy target to beat.

Strategies for the charitably inclined

If philanthropy is one of your estate planning goals, certain charitable giving strategies are most effective in a low-interest-rate environment. For example, a charitable lead annuity trust (CLAT) works best when interest rates are low. A CLAT works in essentially the same way as a grantor retained annuity trust (GRAT): You contribute assets to an irrevocable trust that transfers any remaining assets to your children or other beneficiaries at the end of the trust term. But while a GRAT pays an annuity to you as grantor, a CLAT pays an annuity to the charity, or charities, of your choice.

Like a GRAT, a CLAT generates a tax-free gift to your beneficiaries, so long as the trust assets outperform the Section 7520 rate. In addition, contributions to a CLAT that are structured as a grantor trust are eligible for charitable income-tax deductions. However, keep in mind that, if a CLAT is a grantor trust, you pay taxes on the trust's income. If a CLAT is designed as a *non*grantor trust, you lose the upfront charitable income tax deduction, but the trust pays tax on its income and enjoys a charitable deduction for amounts paid out to charity.

Make an installment sale to an IDGT

An intentionally defective grantor trust (IDGT) is an irrevocable trust designed so that contributions are considered completed gifts for gift tax purposes even though the trust is deemed to be a "grantor trust" for income tax purposes. An installment sale of assets to an IDGT is a particularly attractive strategy for transferring a family business to your children or other heirs because it enables you to minimize gift and estate taxes while retaining control over the business during the trust term.

By structuring the transaction as an installment sale for fair market value, you avoid gift taxes on the transfer. And designing the IDGT as a grantor trust ensures that *you* pay income taxes on the trust's earnings, in effect making an additional tax-free gift to the beneficiaries. In addition, as grantor, any payments you receive from the trust are tax-free as well.

Typically, the grantor makes a taxable gift of "seed money" to the IDGT — usually 10% of the sale price. This ensures that the trust has sufficient economic substance to make the purchase. The success of a sale to an IDGT depends on the business generating enough income to make the note payments, which is easier to do when interest rates are low.

Lock in low rates

The strategies described above can also be effective when interest rates are high, but they're most powerful when rates are low. If you're considering one of these techniques, act quickly to lock in the lowest rate possible. •

Asset protection: Back to basics

Asset protection trusts — both offshore and domestic — can be highly effective vehicles for protecting your wealth in today's litigious society. But these trusts can be complex and expensive, so they're not right for everyone. For those seeking simpler asset protection strategies, there are several basic, yet effective, tools to consider.

Some of these strategies involve transferring assets to another person or entity, or changing the way property is titled. Here are a few common asset protection strategies:

Insurance. For many people, insurance is the first line of defense against liability claims that expose their assets to risk. It includes personal or homeowner's liability insurance, as well as professional liability insurance for doctors, lawyers and other professionals who are common targets for lawsuits.

Lifetime gifts. The most effective asset protection strategy may also be the simplest: giving your assets away to your children or other loved ones. After all, a creditor can't come after assets you don't own. The disadvantage of this approach, of course, is that you must relinquish control over the assets. But if you're comfortable parting with assets during your lifetime, gifts are a great way to place them beyond the reach of your creditors.

Tenancy by the entirety. Many states permit married couples to hold their home or other real estate as "tenants by the entirety." This form of ownership protects assets against claims by either spouse's separate creditors. So, for example, it can be effective when one spouse is exposed to professional liability risks. It doesn't, however, protect couples against claims by their joint creditors. Tenancy

by the entirety, if available, is a good option for people who aren't comfortable transferring title to their spouses.

Retirement accounts. Qualified retirement plans — such as 401(k), 403(b), and 457 plans, as well as certain pension and profit-sharing plans — are excellent asset protection vehicles. IRAs offer more limited protection. Assets held in most qualified plans enjoy unlimited protection from creditors' claims — both in bankruptcy and outside of bankruptcy — under the Employee Retirement Income Security Act.

IRAs are exempt from creditors' claims in bankruptcy up to a specified threshold (currently, $1,245,475, although it's slated to be adjusted in April of this year). This limit doesn't apply, however, to amounts rolled over from a qualified plan to an IRA or to future earnings on those amounts within the IRA.

Outside the bankruptcy context, the level of asset protection for IRAs varies depending on applicable state law.

Family limited partnerships (FLPs) and family limited liability companies (FLLCs). Transferring assets to an FLP or FLLC

can be an effective asset protection strategy, especially if you wish to retain control over a business or other assets. To take advantage of this strategy, you simply set up an FLP or FLLC, transfer assets to the entity, and either give or sell ownership interests to your children or other family members.

You can maintain control over the assets by retaining a small (for example, 1%) general partnership interest in an FLP or acting as manager of an FLLC. Limited partners in FLPs — as well as managers and members of FLLCs — aren't (except in very limited circumstances typically involving some personal wrongdoing) personally liable for the entity's debts. And their personal creditors cannot reach the entity's assets. Instead, these creditors are limited to obtaining rights to any distributions received by the limited partner or LLC member.

Assess your risk

Keep in mind that, for these strategies to work, you must implement them at a time when there are no pending or threatened claims against you. Otherwise, you may run afoul of fraudulent conveyance laws.

Before you weigh your asset protection options, it's a good idea to conduct a risk assessment to evaluate your level of exposure. Armed with this information, you can determine which asset protection tools are right for you. •

Trusts and taxes

Understanding how one affects the other can benefit your estate plan

Trusts typically are a main component of an estate plan. But do you know how higher taxes can impact a trust's overall effectiveness? Because the income thresholds for trusts are low, it's worth your time to understand how the current tax environment affects your trust planning.

2016 rates

For 2016, the top marginal individual income tax rate is 39.6%. And the capital gains rate for taxpayers in the highest bracket is 20%. High earners are also subject to a 3.8% tax on net investment income — including interest, dividends, annuities, rents, royalties, net capital gains and certain passive business income. The income levels at which these tax increases apply may vary.

This year, trusts are subject to the 39.6% ordinary income rate and the 20% capital gains rate to the extent their taxable income exceeds $12,400. And the 3.8% investment tax applies to *undistributed* net investment income to the extent that a trust's adjusted gross income exceeds $12,400.

Implementing the proper strategies

Thankfully, there are estate planning techniques that can help you offset the bite of higher taxes on trust income. For example, an intentionally

defective grantor trust (IDGT) is designed so that you, the grantor, are treated as the trust's owner for income tax purposes — even though your contributions to the trust are considered "completed gifts" for gift and estate tax purposes.

IDGTs offer significant advantages. The trust's income is taxed to you, so the trust itself avoids taxation. This allows trust assets to grow tax-free, leaving more for your beneficiaries. And, by virtue of paying the tax on the trust's income, you're able to reduce the size of your estate. Further, as the owner, you can sell assets to the trust or engage in other transactions without tax consequences.

Keep in mind that, if your personal income exceeds the applicable thresholds, using an IDGT won't avoid the tax increases described above. Still, the other benefits of these trusts make them very attractive.

Another option is to change your investment strategy. Despite the advantages of grantor trusts, *non*grantor trusts are sometimes desirable or necessary. At some point, for example, you may decide to convert a grantor trust to a nongrantor trust to relieve yourself of

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the burden of paying the trust's taxes. Also, grantor trusts become nongrantor trusts after the grantor's death. One strategy for easing the tax burden on nongrantor trusts is for the trustee to shift investments into tax-exempt or tax-deferred investments.

Finally, you can distribute your income. Generally, nongrantor trusts are subject to tax only to the extent they accumulate taxable income. When a trust makes distributions to a beneficiary, it passes along ordinary income (and, in some cases, capital gains), which are taxed at the *beneficiary's* marginal rate.

Thus, one strategy for avoiding income, capital gains and investment taxes is to distribute trust income to beneficiaries in lower tax brackets. The trustee might also consider distributing appreciated assets, rather than cash, and letting the beneficiary sell the asset personally if he or she is able to take advantage of a lower capital gains rate on the sale.

Of course, this strategy may conflict with a trust's purposes, such as providing incentives to beneficiaries, preserving assets for future generations and shielding assets from beneficiaries' creditors.

Taking the next steps to reduce taxes

Even though your estate plan likely contains a variety of trust types, it can be easy to overlook the impact of taxes on them. A primary goal of your estate plan is to ease the tax burden on your family as much as possible after your death, so talk to your estate planning advisor to learn how to reduce the effects of high taxes on your trusts. •

ESTATE PLANNING PITFALL

You haven't taken state estate taxes into account

A generous gift and estate tax exemption (currently $5.45 million) means only a small percentage of families are subject to federal estate taxes. But it's important to consider state estate taxes as well. Although many states tie their exemption amounts to the federal exemption, several states have exemptions that are significantly lower — in some cases $1 million or less.

One way to avoid this tax burden is to retire in a state that imposes low or no estate taxes. But moving to a tax-friendly state doesn't necessarily mean you've escaped taxation by the state you left. Unless you've cut all ties with your former state, there's a risk that the state will claim you're still a resident and are subject to its estate tax.

Even if you've successfully established residency in a new state, you may be subject to estate taxes on real estate or tangible personal property located in the old state (depending on that state's tax laws). And don't assume that your estate won't be taxed on this property merely because its value is less than the exemption amount. In some states, estate taxes are triggered when the value of your *worldwide* assets exceeds the exemption amount.

If you're relocating to a state with low or no estate taxes, consult your estate planning advisor about steps you can take to terminate residency in the old state and establish residency in the new one. Examples include acquiring a residence in the new state, obtaining a driver's license and registering to vote there, receiving important documents at your new address, opening bank accounts in the new state and closing the old ones, and moving cherished personal possessions to the new state.

If you own real estate in the old state, consider transferring it to a limited liability company or other entity. In some states, interests in these entities may be treated as nontaxable intangible property. •

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