

# The ESTATE PLANNER

JANUARY/FEBRUARY 2014

## PLANNING FOR THE NET INVESTMENT INCOME TAX

THE STRETCH IRA:  
A SIMPLE YET POWERFUL  
ESTATE PLANNING TOOL

DO YOU KNOW  
HOW TO ADDRESS IP  
IN YOUR ESTATE PLAN?

ESTATE PLANNING RED FLAG  
You treat trust assets  
as if they're your own

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# PLANNING FOR THE NET INVESTMENT INCOME TAX

You're probably aware that, starting in 2013, high-income taxpayers are subject to a new 3.8% Medicare tax on some or all of their net investment income (NII). But did you know that this NII tax (NIIT) also applies to most nongrantor trusts? The income threshold for trusts is low (only \$11,950 in 2013), so if your estate plan includes a nongrantor trust, it's a good idea to familiarize yourself with the NIIT and consider techniques for reducing it.

## HOW IT WORKS

The NIIT applies to individuals with modified adjusted gross income (MAGI) in excess of \$200,000 (\$250,000 for joint filers, \$125,000 for separate filers). For most taxpayers, MAGI is the same as adjusted gross income (AGI). The tax is 3.8% of your NII or, if less, 3.8% of the amount by which your MAGI exceeds the income threshold.



NII includes taxable interest, dividends, annuities, rents, royalties, passive business income, income from trading in financial instruments or commodities, and certain capital gains (less related expenses). It *doesn't* include income from an *active* trade or business, distributions from IRAs or qualified retirement plans, life insurance proceeds, or Social Security or veterans' benefits.

For trusts (as well as estates) the tax applies to *undistributed* NII to the extent AGI exceeds \$11,950 this year (adjusted for inflation in future years).

## PLANNING OPPORTUNITIES FOR TRUSTS

For individual tax purposes, you have a variety of planning options for reducing or even eliminating the impact of the NIIT. Generally, these strategies involve either reducing your MAGI below the threshold, so the tax doesn't apply to you, or reducing your NII.

For example, you might reduce your MAGI by increasing your contributions to IRAs or qualified retirement plans or by participating in your employer's nonqualified deferred compensation plan. Or, you might reduce your NII by harvesting capital losses to offset capital gains, shifting investments into tax-exempt municipal bonds, or giving investment assets to family members in lower tax brackets (but beware of the "kiddie" tax).

For trusts, your options are more limited. For one thing, the NIIT applies at such low income levels that reducing a trust's AGI below the threshold may be virtually impossible. There are several strategies, however, for reducing a trust's taxable NII, such as:

**Distributing trust income.** Because the NIIT applies only to a trust's *undistributed* NII, if you distribute all of the income to beneficiaries, the tax

is avoided. Of course, this strategy may defeat the purposes of the trust if one of your goals is to preserve the income for future generations or prevent beneficiaries from squandering the funds.

**Changing the trust's investment strategy.** The trustee can reduce or eliminate NII by shifting trust investments into tax-exempt municipal bonds or tax-deferred investments.

**Using a grantor trust.** In some cases, it may be appropriate to establish a grantor trust or convert an existing nongrantor trust into a grantor trust. A grantor trust is the grantor's alter ego for income tax purposes, so the trust itself pays no taxes. Instead, the trust's income is passed through to the grantor.

Be aware, however, that this strategy may increase the *grantor's* NIIT liability, depending on his or her income level. So it's important to weigh the reduction in trust taxes against potential increases in individual income taxes.

**Investing in active businesses.** An important exemption from the NIIT is for trade or business income from a business in which a taxpayer "materially participates." Some trusts may qualify for this exemption, although demonstrating that a trust materially participates in a business in which it invests may be a challenge. (See "Material participation: IRS holds trusts to high standard" below.)

## REVIEW YOUR PLAN

Today's high gift and estate tax exemption amount means that far fewer people will be subject to transfer-related taxes. So it's more important than ever to assess the effect of income-related taxes, including the NIIT, on your estate plan.

In doing so, consider the tax's potential impact on your personal wealth management and retirement plans, as well as on the financial performance of your trusts. As always, keep in mind that taxes are just one of many factors to consider as you shape your estate plan. ❀

## Material participation: IRS holds trusts to high standard

An important exemption to the 3.8% net investment income tax (NIIT) is for income from a trade or business in which a taxpayer materially participates. For an individual, material participation is relatively straightforward: IRS regulations contain a set of quantitative rules that define material participation based on the number of hours a person spends on business activities.

But what about a trust? The IRS generally takes the position that a trust materially participates in a trade or business only if a fiduciary satisfies the material participation requirements. This is a difficult standard for a trust to meet, because it's unusual for a trustee to be directly involved in managing a business in which the trust invests.

In fact, it appears that there's only one court case addressing this issue. In that case — *Mattie K. Carter Trust v. U.S.* — a federal district court ruled that the activities of a trust's agents and employees also counted toward the material participation thresholds.

Unfortunately, the IRS has refused to accept the court's holding in its private rulings. Nevertheless, based on the *Carter* case and a commonsense interpretation of applicable law, it may be reasonable to treat a trust as satisfying material participation requirements if its agents or employees are active in a business. But don't be surprised if this treatment is met with an IRS challenge.

# THE STRETCH IRA: A SIMPLE YET POWERFUL ESTATE PLANNING TOOL

The IRA's value as a retirement planning tool is well known: IRA assets compound on a tax-deferred (or, in the case of a Roth IRA, tax-free) basis, which can help build a more substantial nest egg. But if you don't need an IRA to fund your retirement, you can use it as an estate planning tool to benefit your children or other beneficiaries on a tax-advantaged basis by turning it into a "stretch" IRA.

## STRETCHING OUT THE BENEFITS

Turning an IRA into a stretch IRA is simply a matter of designating a beneficiary who's significantly younger than you. This could be, for example, your spouse (if there's a substantial age difference between the two of you), a child or a grandchild.

If you name your spouse as beneficiary, he or she can elect to roll the funds over into his or her own IRA after you die, enabling the funds to continue growing tax-deferred or tax-free until your spouse chooses to begin withdrawing the funds in retirement or must take required minimum distributions (RMDs) starting at age 70½. (Note that RMDs don't apply to Roth IRAs while the participant is alive.)

If you name someone other than your spouse as beneficiary, he or she generally will have several options:

- ◆ Take a lump-sum distribution of the IRA's balance,
- ◆ Withdraw the funds by the end of the year of the fifth anniversary of your death (if you die *before* beginning to take RMDs),

- ◆ Withdraw the funds over your "remaining" life expectancy, calculated under the applicable IRS table as of the year of death (if you die *after* beginning to take RMDs), or
- ◆ Hold the funds in an "inherited IRA," which allows the beneficiary to spread RMDs over his or her own life expectancy.



Usually the inherited IRA is the best choice because it maximizes the benefits of tax-deferred or tax-free growth. Suppose, for example, that you have an IRA with a balance of \$1.5 million on Dec. 31, 2013, and that you've been required to take RMDs for several years. To calculate the RMD amount, you divide \$1.5 million by your remaining life expectancy according to the applicable IRS table. Assuming your life expectancy is 22 years, you're required to withdraw \$68,182 for 2014.

Now, let's assume that the beneficiary of your IRA is your grandson, and that at the time of your death you've already taken your RMD for 2014. Your grandson won't have an RMD for 2014. For 2015, however, he'll start taking his



RMD based on his own life expectancy. If, for instance, the balance at the end of this year is also \$1.5 million, and your grandson turns 13 next year, his 2015 RMD will be \$21,459.

*Turning an IRA into a stretch IRA is simply a matter of designating a beneficiary who's significantly younger than you.*

### NAMING A TRUST AS BENEFICIARY

A disadvantage of naming your child or grandchild as beneficiary of your IRA is that there's nothing to prevent him or her from taking a lump-sum distribution, erasing any potential stretch IRA benefits.

To ensure that this doesn't happen, you can name a trust as beneficiary. In order for a trust to qualify

for stretch treatment, it will need to meet certain requirements, such as distributing RMDs received from the IRA to the trust beneficiaries.

### KEEP AN EYE ON CONGRESS

In recent years, lawmakers have proposed eliminating the benefits of nonspousal stretch IRAs. It's not certain whether such a law will be enacted, but it's a good idea to monitor legislative activity and revise your plan if necessary.

In the meantime, naming a younger spouse as beneficiary of your IRA remains a good strategy, and there's nothing to lose by naming a child or grandchild as a primary or contingent beneficiary. ❀

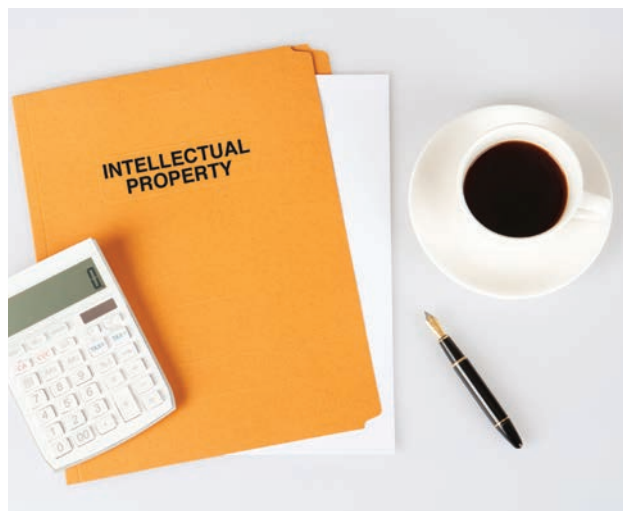


## DO YOU KNOW HOW TO ADDRESS IP IN YOUR ESTATE PLAN?

Over your lifetime, you may have accumulated a wide variety of tangible assets, including automobiles, works of art and property, that you've accounted for in your estate plan. But *intangible* assets can easily be overlooked. Consider intellectual property, such as patents and copyrights. These assets can have great value, so, if you have them, it's important to properly address them in your estate plan.

### 2 COMMON FORMS OF IP

IP generally falls into one of these categories: patents, copyrights, trademarks or trade secrets. Here



we'll focus on patents and copyrights, creatures of federal law intended to promote scientific and creative endeavors by providing inventors and artists with exclusive rights to exploit the economic benefits of their work for a predetermined time period:

**1. Patents.** Patents protect inventions. There are several types of patents; the two most common are utility and design patents. A utility patent may be granted to someone who “invents or discovers any new and useful process, machine, article of manufacture, or compositions of matters, or any new useful improvement thereof.” A design patent is available for a “new, original and ornamental design for an article of manufacture.” To obtain patent protection, inventions must be novel, “non-obvious” and useful.

Under current law, utility patents protect an invention for 20 years from the patent *application filing* date. Design patents last 14 years from the patent *issue* date. There's a difference between the filing date and issue date. For utility patents, it takes at least a year and a half from date of filing to date of issue.

**2. Copyrights.** Copyrights protect the *original* expression of ideas



that are fixed in a “tangible medium of expression,” typically in the form of written works, music, paintings, sculptures, photographs, sound recordings, films, computer software, architectural works and other creations. Unlike patents, which must be approved by the U.S. Patent and Trademark Office, copyright protection kicks in as soon as a work is fixed in a tangible medium.

*Valuing intellectual property is a complex process, so obtain an appraisal from a professional with experience valuing IP.*

For works created in 1978 and later, an author-owned copyright lasts for the author's lifetime plus 70 years.

## ESTATE PLANNING FOR IP

For estate planning purposes, a key question is: What's it worth? Valuing IP is a complex process. So it's best to obtain an appraisal from a professional with experience valuing IP.

After you know the IP's value, it's time to decide whether to transfer the IP to family members, colleagues, charities or others through lifetime gifts or through bequests after your death. The gift and estate tax consequences will affect your decision, but also consider your income needs, as well as who is in the best position to monitor your IP rights and take advantage of their benefits.

If you'll continue to depend on the IP for your livelihood, for example, hold on to it at least until you're ready to retire or you no longer need the income. You also might want to retain ownership of the IP if you feel that your children or other transferees lack the desire or wherewithal to exploit its economic potential and monitor and protect it against infringers.

Whichever strategy you choose, it's important to plan the transaction carefully to ensure that your objectives are achieved. There's a common misconception that, when you transfer ownership of the tangible medium on which IP is recorded, you also transfer the IP rights. But IP rights are separate from the work itself and are retained by the creator — even if the work is sold or given away.

## DON'T TRY THIS AT HOME!

Before you begin to address IP in your estate plan, discuss your options with your estate planning advisor.

IP law can be complex, so properly documenting your IP wishes is essential to ensure they'll be carried out after your death. ❀

### ESTATE PLANNING RED FLAG

## You treat trust assets as if they're your own



Irrevocable trusts can provide a variety of benefits, including gift and estate tax savings, creditor protection, and the ability to control how assets are distributed. To preserve these benefits, however, it's critical to respect all trust formalities.

Consider *U.S. v. Tingey*. In that case, a taxpayer set up an irrevocable trust for the benefit of his wife and children, naming someone else as trustee. Around the same time, the taxpayer and his wife purchased a ski cabin, the title to which was transferred to the trust. Later, the couple got into financial trouble and ended up owing more than \$2 million in federal taxes. The government successfully foreclosed several tax liens on the ski cabin.

The couple argued that the government couldn't enforce the liens against the ski cabin, because title was held by the trust. But the 10th U.S. Circuit Court of Appeals disagreed. The court explained that a tax lien may be satisfied by property if it's held by the taxpayer's "nominee" — in other words, "the taxpayer has engaged in a legal fiction by placing legal title . . . in the hands of a third party while actually retaining some or all of the benefits of true ownership."

Several factors indicated that the couple had done just that. Among other things, they maintained the ski cabin, paid the utility bills and insurance premiums (on a policy issued in the taxpayer's name), used the cabin without the trustee's permission or supervision, and rented the cabin to friends without the trustee's knowledge. Additionally, note payments in connection with the purchase of the cabin came from a variety of sources, including rents, payments directly from the couple, and payments from the taxpayer's business.

As this case illustrates, if you continue to treat assets as your own after transferring them to an irrevocable trust, they may be at risk.

# EXPERIENCE. RESPONSIVENESS. VALUE.

At Shumaker, we understand that when selecting a law firm for estate planning and related services, most clients are looking for:

- A high level of quality, sophistication, and experience.
- A creative and imaginative approach that focuses on finding solutions, not problems.
- Accessible attorneys who give clients priority treatment and extraordinary service.
- Effectiveness at a fair price.

Since 1925, Shumaker has met the expectations of clients that require this level of service. Our firm offers a comprehensive package of quality, experience, value and responsiveness with an uncompromising commitment to servicing the legal needs of every client. That's been our tradition and remains our constant goal. This is what sets us apart.

Estate planning is a complex task that often involves related areas of law, as well as various types of financial services. Our clients frequently face complicated real estate, tax, corporate and pension planning issues that significantly impact their estate plans. So our attorneys work with accountants, financial planners and other advisors to develop and implement strategies that help achieve our clients' diverse goals.

Shumaker has extensive experience in estate planning and related areas, such as business succession, insurance, asset protection and charitable giving planning. The skills of our estate planners and their ability to draw upon the expertise of specialists in other departments — as well as other professionals — ensure that each of our clients has a comprehensive, effective estate plan tailored to his or her particular needs and wishes.

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*We welcome the opportunity to discuss your situation and provide the services required to help you achieve your estate planning goals. Please call us today and let us know how we can be of assistance.*

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