The Estate Planner

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Estate Planning Red Flag
You don't have a health care power of attorney

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Life insurance

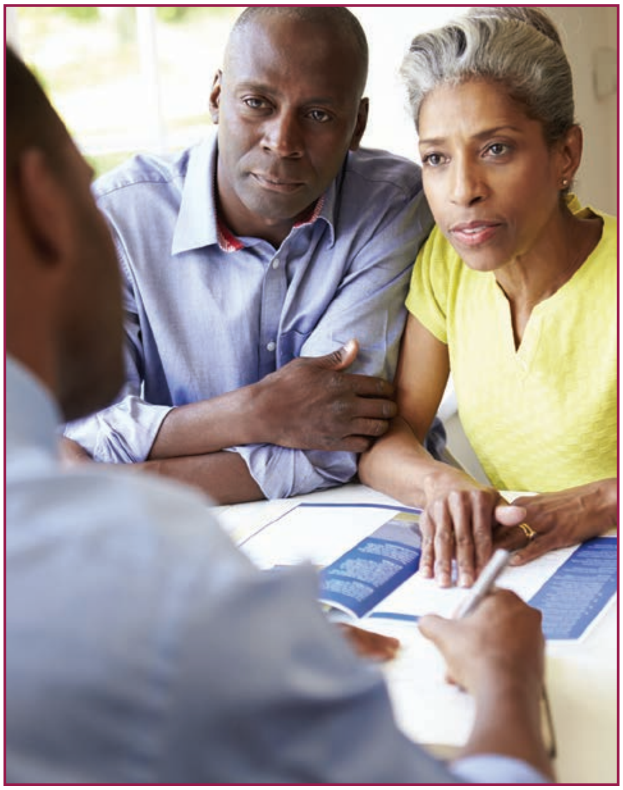
A powerful estate planning tool for nontaxable estates

For years, life insurance has played a critical role in estate planning, providing a source of liquidity to pay estate taxes and other expenses. It's been particularly valuable for business owners, whose families might not have the liquid assets they need to pay estate taxes without selling the business.

Today, the estate tax exemption has climbed above $5 million, so estate taxes are no longer a concern for the vast majority of families. But even for non-taxable estates, life insurance continues to offer significant estate planning benefits.

Replacing income and wealth

If you die unexpectedly, life insurance can protect your family by replacing your lost income. It can also be used to replace wealth in a variety of contexts. For example, suppose you own highly appreciated real estate or other assets and wish to dispose of them without generating current capital gains tax liability. One option is to contribute the assets to a charitable remainder trust (CRT).



If you're philanthropically inclined, life insurance can help you support your favorite charities in a cost-effective manner.

As a tax-exempt entity, the CRT can sell the assets and reinvest the proceeds without triggering capital gains tax. In addition, you and your spouse will enjoy an income stream and charitable income tax deductions. Typically, distributions you receive from the CRT are treated as a combination of ordinary taxable income, capital gains, tax-exempt income and tax-free return of principal.

After you and your spouse die, the remaining trust assets pass to charity, reducing the amount of wealth available to your children or other heirs. But you can use life insurance (a cost-effective second-to-die policy, for example) to replace that lost wealth.

You can also use life insurance to replace wealth that's lost to long term care (LTC) expenses, such as nursing home costs, for you or your spouse. Although LTC insurance is available, it can be expensive, especially if you're already beyond retirement age. For many people, a better option is to use personal savings and investments to fund their LTC needs and to purchase life insurance to replace the money that's spent on such care. One advantage of this approach is that, if neither you nor your spouse needs LTC, your heirs will enjoy a windfall.

Funding charitable gifts

If you're philanthropically inclined, life insurance can help you support your favorite charities in a cost-effective manner. One strategy is to donate life insurance to charity. If you transfer a policy to a charitable organization, so that the organization becomes both owner and beneficiary, you'll enjoy a charitable income tax deduction (subject to certain limitations), plus additional deductions if you continue to pay the premiums. Or, you can simply name a charity as beneficiary. You won't be entitled to any charitable income tax deductions, but you'll retain control over the policy, including the right to tap its cash value or change beneficiaries. When you die, your estate will be entitled to an estate tax charitable deduction.

Another strategy is to use other assets to fund charitable gifts and purchase life insurance to replace the wealth donated to charity. This strategy is particularly valuable if you have a significant amount in traditional IRAs or retirement plans. If you leave these assets to your heirs, they'll be subject to income tax on any distributions they receive. But if you leave the assets to charity and purchase a life insurance policy for your heirs' benefit, both the charity and your heirs will receive the funds tax-free. You can even withdraw funds from an IRA or retirement plan and use the after-tax proceeds to pay the premiums.

Treating your children equally

If much of your wealth is tied up in a family business, treating your children fairly can be a challenge. It makes sense to leave the business to those children who work in it, but what if your remaining assets are insufficient to provide an equal inheritance to children who *don't* work in the business? For many families, the answer is to purchase a life insurance policy to make up the difference.

Why ILITs are still relevant

Historically, the primary purpose of an irrevocable life insurance trust (ILIT) has been to remove an insurance policy — and its proceeds — from your taxable estate. But even in a nontaxable estate, an ILIT offers significant benefits. A properly drafted ILIT can protect the trust assets against creditors of the grantor as well as of the beneficiaries, particularly if it's established in a state with favorable asset protection laws.

In addition, an ILIT will shield your insurance proceeds against estate taxes in the event your estate becomes taxable in the future — either because your wealth grows unexpectedly or because Congress decides to reduce the estate tax exemption.

Protecting your assets

Depending on applicable state law, a life insurance policy's cash surrender value and death benefit may be shielded from creditors' claims. For additional protection, consider setting up an irrevocable life insurance trust (ILIT) to hold your policy. (See "Why ILITs are still relevant" above.)

Finding the right policy

These are just a few examples of the many benefits provided by life insurance. Talk to your estate planning advisor to help determine which type of life insurance policy is right for your situation. ✤

4 WAYS TO TRANSFER A FAMILY BUSINESS

For many people, a family-owned business is their primary source of wealth, so it's critical to plan carefully for the transition of ownership from one generation to the next.

The best approach depends on your particular circumstances. If your net worth is well within the estate tax exemption, for example, you might focus on reducing income taxes. But if you expect your estate to be significantly larger than the exemption amount, estate tax reduction may be a bigger concern.

Here are four estate-tax-wise techniques to transfer a family business:

1. IDGT. An intentionally defective grantor trust (IDGT) is an *income* defective trust. As such, it can be a highly effective tool for transferring business interests to the younger generation at a minimal gift and estate tax cost.

> *An estate defective trust is designed so that beneficiaries are the owners for income tax purposes, while the assets remain in the estate for estate tax purposes.*

An IDGT is designed so that contributions are completed gifts, removing the trust assets and all future appreciation in their value from your taxable estate. At the same time, it's "defective" for income tax purposes; that is, it's treated as a "grantor trust" whose income is taxable to you. This allows trust assets to grow without being eroded by income taxes, thus leaving a greater amount of wealth for your children or other beneficiaries.

The downside of an IDGT is that, when your beneficiaries inherit the business, they'll also inherit *your* tax basis, which may trigger a substantial capital gains tax liability if they sell the business. This result may be acceptable if the estate tax savings outweigh the income tax cost. But what if the value of your business and other assets is less than the current estate tax exemption amount, so that estate taxes aren't an issue? In this case, you might consider an *estate* defective trust.

2. Estate defective trust. Essentially the opposite of an IDGT, an estate defective trust is designed so that beneficiaries are the owners for income tax purposes, while the assets remain in the estate for estate tax purposes. This technique provides two significant income tax benefits. First, assuming your beneficiaries are in a lower tax bracket, this strategy will result in lower "familywide" taxes. Second, because the trust assets remain in your estate, the beneficiaries' basis in the assets is "stepped up" to fair market value, reducing or eliminating their potential capital gains tax liability.

This strategy assumes you'll have little or no estate tax liability. If your estate increases unexpectedly or Congress decides to reduce the exemption, the benefits may be lost.

3. Sale to an IDGT. If you prefer to sell the business to your children, consider an installment sale to an IDGT (with the payments funded by the business's cash flow). Selling to a trust allows you to retain some control over the business while removing it from your taxable estate. And by structuring the transfer as a sale, you'll avoid gift taxes. Also, when you sell assets to a grantor trust you're essentially selling them to yourself, so there are no capital gains taxes on the transaction.

4. BIDIT. One drawback to selling to an IDGT is that, if you die before the sale is complete, the IDGT will be converted to a nongrantor trust and your estate will be hit with a capital gains tax liability (usually based on the present value of all unpaid installments). To avoid this risk, some taxpayers have started using business intentionally defective irrevocable trusts (BIDITs). A BIDIT works like an IDGT, except it's established by the business itself rather than the owner. Because the grantor is an entity rather than a person, this technique eliminates the income tax risk associated with the grantor's death.

Be aware that the BIDIT is relatively new and untested, but its proponents believe that it can provide a variety of estate tax, income tax and asset protection advantages over an IDGT.

If you own a family business, be sure to review your ownership succession plan in light of recent tax developments. Determining the right strategy to implement when transferring ownership of the business to heirs depends on the value of your business and other assets and the relative impact of estate and income taxes. ✤

Changing family makeup requires estate plan review

Today's American families have grown increasingly diverse. A typical nuclear family consisting of a breadwinning husband, homemaker wife and their children no longer represents the dominant configuration. Instead, the family may include unmarried parents of adopted children or married parents with unadopted stepchildren. If your family's demographics have recently changed, it's time to revisit your estate plan. Let's take a closer look at a few specific family makeups.

Family with recently adopted children

Adopted children are placed on an equal footing with biological children in most situations for estate planning purposes. Thus, adopted and biological children are treated the same way under a state's intestate succession laws, which control who inherits property in the absence of a will.

In addition, adopted children generally are treated identically to biological children for purposes of wills or trusts that provide for gifts or distributions to a class of persons, such as "children," "grandchildren" or "lineal descendants" — even if the child was adopted after the will or trust was executed.

Blended family with stepchildren

Stepchildren generally don't have any inheritance rights with respect to their parents' new spouses unless the spouse legally adopts them. If you have stepchildren and want them to share in your estate, either adopt them or amend your estate plan to provide for them expressly.

Of course, estate planning isn't the only reason to adopt stepchildren. Adoption also gives you all of the legal rights of a parent during your life.

Before you adopt stepchildren, however, you and your spouse should consider the potential effect on their ability to inherit from (or through) their other biological parent's relatives. In most states, when a child is adopted by a stepparent, the adoption decree severs the parent-child relationship with the other biological parent and his or her family.

If you wish to *exclude* stepchildren from your estate, in most cases it's sufficient to do nothing. But some states permit stepchildren to inherit through intestate succession under certain circumstances, so be sure to check with your estate planning attorney regarding the laws in your state of residence.

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Family with second-parent adoptions

A growing minority of states now permit second-parent adoptions, in which an unmarried person adopts his or her partner's biological or adopted children without terminating the partner's parental rights.

For unmarried couples who can't obtain a second-parent adoption, or choose not to, estate planning is especially critical — if they want the "nonparent" to have custody of the child should the "parent" die or become incapacitated and if the nonparent wants the child to inherit from him or her.

First, the parent should consider using a power of attorney for parental authority and appointing the nonparent as a guardian to ensure that he or she can act on the child's behalf and has priority over the parent's blood relatives in the event the parent dies or becomes incapacitated.

Second, both partners should amend their wills. The parent's will should name his or her partner as the child's guardian, and the nonparent's will should spell out any property to be inherited by the child.

A change in your family makeup?

If you and your spouse recently have adopted a child or your new spouse has children from a previous marriage whom you haven't legally adopted, it's important to revisit your estate plan — specifically your will or living trust — to ensure those children are treated according to your wishes. Relying solely on your state's intestate laws may result in unwanted circumstances. ✤

Estate Planning Red Flag

You don't have a health care power of attorney

What happens if illness, injury or age-related dementia renders you unable to make decisions or communicate your wishes regarding your health care or financial affairs? Unless your estate plan addresses these situations, your family may be forced to seek a court-appointed guardian.

Health care arrangements are particularly important because your wishes won't necessarily coincide with someone else's judgment about what's "in your best interests." To help ensure that your wishes are carried out, create a health care power of attorney (HCPOA). Sometimes referred to as a "health care proxy" or "durable medical power of attorney," an HCPOA appoints a representative to make medical decisions on your behalf if you're unable to do so.

Who should be your representative? The natural inclination may be to name your spouse or a child, but they may not be the best choices. A close family member may find it difficult to act as a health care proxy, especially if it involves decisions about whether to continue or terminate life-sustaining measures. Designate someone you trust to make the tough decisions in order to carry out your wishes when the time comes.

Your HCPOA should provide guidance on how to make health care decisions. Although it's impossible to anticipate every potential scenario, the document can provide your representative with guiding principles. For example: What are your desired health outcomes? Is your top priority to extend your life? Is artificial nutrition or hydration an option? Under what circumstances should life-sustaining treatment be withheld or terminated?

Other documents to consider include a living will — which communicates your preferences regarding life-sustaining medical treatment in the event you are dying of a terminal condition or an end-stage condition. Also consider a revocable trust and durable power of attorney to provide for a trusted representative to manage your financial affairs in the event you're unable to do so.

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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