Insight on Estate Planning

August/September 2015

Premarital planning

Protecting your assets *without* a prenup

The ABLE account: A good alternative to a special needs trust?

Make net gifts to reduce your gift tax rate

Estate Planning Pitfall

Your powers of attorney are more than a few years old

Florida Office
100 - 2nd Avenue South, Suite 200N • St. Petersburg, Florida 33701
T: 727.471.5868 F: 727.498.5696

Arizona Office
15849 North 71st Street, Suite 120 • Scottsdale, Arizona 85254
T: 480.999.0237 F: 727.498.5696

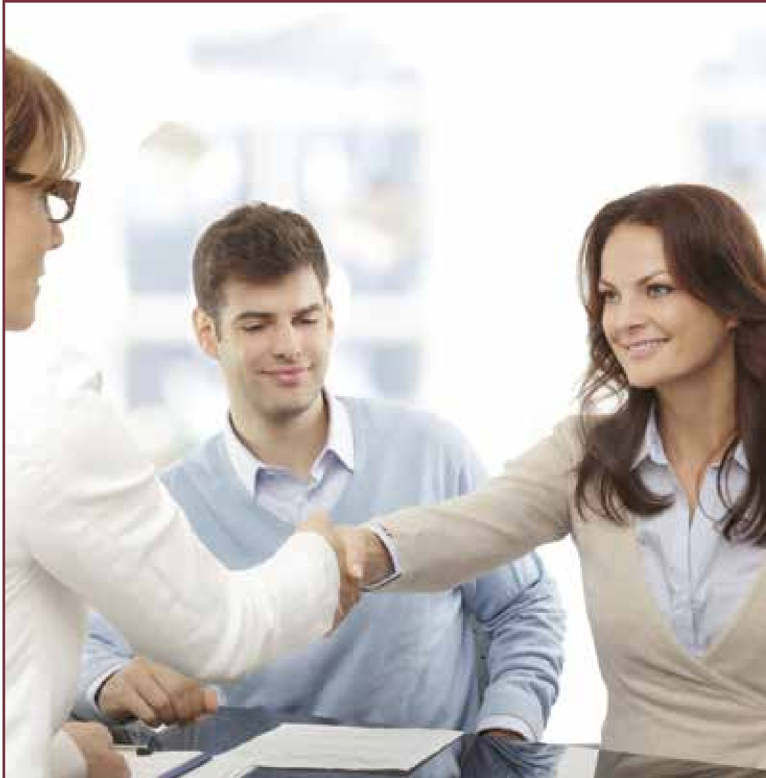
www.LegacyProtectionLawyers.com

Protecting your assets *without* a prenup

If you or one of your children is getting married, you may be concerned about protecting your family's assets in the event of a divorce. This is a particularly significant issue for family business owners, who typically want to avoid sharing ownership with their ex-spouses or their children's ex-spouses.

A prenuptial agreement can be an effective tool for overriding marital property rights and keeping assets in the family. But these agreements have some important disadvantages. For example, in the event of divorce, prenups are vulnerable to challenge on several grounds.

For many families, a more palatable alternative is an asset protection trust. Such a trust can protect assets against ex-spouses as well as other creditors, and it can be set up without the consent, or even knowledge, of the future spouse.



Why assets need protection

The laws regarding division of property in divorce are complex and vary dramatically from state to state. In general, however, spouses retain their "separate property," which includes property they owned before marriage as well as property received by gift or inheritance during marriage.

Marital property, which is subject to division in divorce, generally includes all property acquired during marriage, regardless of how it's titled. Depending on applicable state law, marital property may even include the appreciation in value of separate property (including the other spouse's business) during marriage.

Also, separate property may lose that status if it's commingled with marital property. For example, if you deposit an inheritance in your joint bank account, it will likely be deemed marital property.

In light of these risks, it may be advisable to take additional steps to protect separate property from potential loss in the event of divorce.

Prenup drawbacks

Of course, the emotional issues involved can make putting a prenup in place difficult. In addition, the requirements for an enforceable prenup make it vulnerable to attack in connection with a divorce.

For example, a prenup may be unenforceable if one spouse can show that:

- The agreement was signed under duress,
- He or she didn't have independent legal counsel,
- The agreement was unconscionable when signed, or
- The other spouse didn't provide full financial disclosure.

Even if you dot all the i's and cross all the t's, there's a risk that the other spouse will challenge the agreement, which can be costly and time consuming.

Benefits of an asset protection trust

A domestic asset protection trust (DAPT) can solve many of the problems associated with a prenup. It eliminates the emotional component, because there's no need to obtain the consent of, or even inform, the future spouse. In some cases, a foreign asset protection trust (FAPT) may be appropriate. (See "Should you go offshore?" at the right.)

A DAPT is an irrevocable, spendthrift trust established in one of the 15 or so states that authorize them. What distinguishes DAPTs from other types of trusts is that, in addition to offering gift and estate tax benefits, they provide creditor protection even if the grantor is a discretionary beneficiary.

DAPT protection varies from state to state, so it's important to shop around. Ideally, you should look for a jurisdiction that provides grantors with the greatest degree of control over trust investments and protects trust assets from a broad range of creditors, including divorcing spouses.

To take advantage of this strategy, it's critical to transfer assets to the DAPT well in advance of marriage. Otherwise, the transfer may be deemed fraudulent. Provided the trust holds legal title to the assets — and an independent trustee has discretionary control over distributions — it will be difficult for a divorcing spouse to reach those assets.

DAPTs have one potential disadvantage: Even though they've been around for years, the law surrounding them remains uncertain. Most experts believe that a properly designed DAPT will be effective when set up by a resident of the state whose law authorizes it. But it's less clear whether these trusts will be recognized when set up by nonresidents.

An attractive alternative

Asset protection trusts provide an attractive alternative in situations where prenups are unavailable or undesirable. If you're considering this strategy, talk to your estate planning attorney about the options available in your state, in other states or offshore.

Should you go offshore?

Domestic asset protection trusts (DAPTs) can protect assets from divorcing spouses and other creditors, but uncertainty over their enforceability means they're a less-than-perfect solution. For families that desire a higher level of protection, and have the resources, a foreign asset protection trust (FAPT) may be a good option.

A FAPT is generally more expensive and less convenient than a DAPT, but it can be more effective in placing assets beyond the reach of creditors. These trusts are established in foreign jurisdictions that won't enforce U.S. judgments and offer more favorable trust, asset protection and privacy laws.

Keep in mind that a FAPT won't shelter income from U.S. taxes. Also, in addition to having the expense of setting up and maintaining a foreign trust, you'll be required to comply with the IRS's burdensome and costly rules for reporting foreign assets.

The ABLE account: A good alternative to a special needs trust?

Late last year, Congress passed, and the President signed, the Achieving a Better Life Experience (ABLE) Act. The act authorizes a new, tax-advantaged savings account, modeled after the Section 529 college savings account, for people who are blind or have severe disabilities. While these accounts provide many benefits, it's important to understand their limitations. Other planning tools, such as a special needs trust (SNT), continue to offer significant advantages.

Saving for disability expenses

Like Sec. 529 accounts, state-sponsored ABLE accounts allow parents and other family and friends to make substantial cash contributions. Contributions aren't tax deductible, but accounts can grow tax-free, and earnings may be withdrawn free of federal income tax if they're used to pay qualified expenses. Both types of accounts enjoy some bankruptcy protection, although it appears that ABLE accounts offer no protection against the *beneficiary's* bankruptcy.

In the case of a Sec. 529 account, qualified expenses include college tuition, room and board, and certain other higher education expenses. For ABLE accounts, "qualified disability expenses" include a broad range of costs, such as health care, education, housing, transportation, employment training, assistive technology, personal support services, financial management, legal expenses, and funeral and burial expenses.

An ABLE account generally won't jeopardize the beneficiary's eligibility for means-tested government benefits, such as Medicaid or Supplemental Security Income (SSI). To qualify for these benefits, a person's resources must be limited to no more than $2,000 in "countable assets." Assets in an ABLE account aren't counted, with two exceptions: 1) Distributions used for housing expenses count, and 2) if the account balance exceeds $100,000, the beneficiary's eligibility for SSI is suspended so long as the excess amount remains in the account.

Limited benefits

ABLE accounts offer some attractive benefits, but they're far less generous than those offered by Sec. 529 accounts. Maximum contributions to college savings accounts vary from state to state, but they often reach as high as $350,000 or more. The same maximum contribution limits apply to ABLE accounts, but practically speaking they're limited to $100,000, given the impact on SSI benefits discussed above.

ABLE accounts also impose an annual limit on contributions equal to the annual gift tax exclusion (currently $14,000). There's no annual limit on contributions to Sec. 529 accounts. Plus, although Sec. 529 contributions are taxable gifts, you can bunch five years' worth of annual gift tax exclusions into one year. That means you can make gift-tax-free contributions up to $70,000 ($140,000 for married couples) to a 529 plan in one year.

Other ABLE account limitations and disadvantages include the following:

- The beneficiary must have become blind or disabled before age 26.
- Unlike a Sec. 529 account, you may open an ABLE account only through your home state's program (if any) or through a program established by another state with which your home state contracts, and you're limited to one account per beneficiary.

- Also unlike Sec. 529 accounts, an ABLE account's beneficiary is the owner of the account. That means contributions are irrevocable and the account's funders may not make withdrawals or change beneficiaries.
- An ABLE account beneficiary is permitted to direct the investment of contributions twice a year. If the beneficiary is a minor or otherwise incapable of making investment decisions, a court-appointed guardian may be required.

Finally, be aware that, when an ABLE account beneficiary dies, the state may claim reimbursement of its net Medicaid expenditures from any remaining balance.

An alternative option

ABLE accounts may be a good option for some families, but in many cases an SNT is the better choice. A properly designed SNT is a flexible tool that, like an ABLE account, allows you to enhance a disabled family member's quality of life without jeopardizing his or her eligibility for means-tested government benefits.

Given the limitations of ABLE accounts, an SNT is preferable if you wish to make larger contributions, contribute assets other than cash, achieve stronger asset protection, or provide assistance to a family member who became blind or disabled at age 26 or later. It's also a good option if your home state hasn't established an ABLE program or contracted with another state to provide ABLE accounts to its residents.

Evaluate your options

If you're caring for a disabled family member, it's worth your time to look into the benefits of an ABLE account. Your advisor can help you determine whether it's a good fit for your family, or if you're better off using an SNT.

Make net gifts to reduce your gift tax rate

Lifetime giving is a smart strategy to reduce your taxable estate, but the gift tax rate of 40% is steep. If you've used up your $5.43 million gift and estate tax exemption and you'd like to potentially reduce your effective gift tax rate to 28.6%, consider making net gifts. This technique requires the recipient to agree to pay the gift tax as a condition of receiving the gift, thus reducing the gift's value for gift tax purposes.

A net gift in action

Here's an example that illustrates the net gift's tax-saving power. Bob plans to make a $1 million gift to his daughter, Elizabeth. He's already used

up his gift and estate tax exemption and wants to minimize the tax. At the current top gift tax rate of 40%, an outright gift would result in a $400,000 tax bill.

> *You can enhance the benefits of a net gift by having the recipient assume the potential estate tax liability that might arise under Internal Revenue Code Section 2035(b).*

If Elizabeth agrees to pay the gift tax, the value of the gift — and, therefore, the gift tax liability — is reduced. There's a simple formula to calculate the tax on a net gift: gift tax = tentative tax / (tax rate + 1). The tentative tax is the amount that would have been due if the gift hadn't been structured as a net gift (in this case $400,000). Applying this formula to the example, the gift tax would be $400,000 / 1.4, or $285,714 (for an effective rate of about 28.6%).

To ensure that Elizabeth receives the full $1 million gift, Bob uses a "financed net gift." He makes her a $285,714 loan to cover her tax obligation, bearing interest at the applicable federal rate (AFR) and documented by a written promissory note. Lately, AFRs have been low.

One caveat: The gift tax liability assumed by the recipient constitutes consideration in exchange for the gift. If the gift consists of appreciated property, a net gift or financed net gift can result in capital gains tax liability for the person making the gift.

Suppose, in the previous example, that instead of cash Bob gives Elizabeth real estate with a fair market value of $1 million and a cost basis of $200,000. If Elizabeth pays $285,714 in gift tax, the excess of that amount over Bob's basis ($85,714) is a taxable capital gain to Bob. One way to avoid capital gains tax is to enter into a financed net gift transaction with a grantor trust rather than the ultimate beneficiary.

Tax Court approves enhanced strategy

You can enhance the benefits of a net gift by having the recipient assume the potential estate tax liability that might arise under Internal Revenue Code Section 2035(b). This section provides that a gross estate is increased by the amount of gift tax paid on any gifts made during the three-year period ending on the date of death. It's designed to prevent people from using deathbed gifts to reduce transfer taxes.

Historically, the Tax Court has rejected this strategy, finding that the estate tax

liability, which may or may not arise, is speculative. But in a recent case — *Steinberg v. Comm'r* — the court reversed its position, permitting taxpayers to reduce the value of gifts by the actuarially determined value of the recipient's contingent obligation to pay any tax liability that might arise under Sec. 2035(b).

Put pen to paper

When making net gifts, the recipient (or, in the case of a gift in trust, the trustee) must sign a written agreement when the gift is made that he or she will assume liability for gift and estate taxes. In addition, the recipients should seek separate estate planning attorneys before signing the agreement.

Estate Planning Pitfall

Your powers of attorney are more than a few years old

Health care and financial powers of attorney are critical components of an effective estate plan. Health care powers of attorney, which sometimes go by other names, appoint a trusted person to make medical decisions on your behalf in the event an illness or injury renders you unconscious or otherwise incapacitated. Financial powers of attorney appoint someone to make financial decisions or execute transactions on your behalf under certain circumstances. For example, a power of attorney might authorize your agent to handle your affairs while you're out of the country or, in the case of a "durable" power of attorney, incapacitated.

After you've executed powers of attorney, it's important to review them periodically — at least every five years and preferably more frequently — and consider executing new ones. There are several reasons to do this:

- Your wishes may have changed.
- The agent you designated to act on your behalf may have died or otherwise become unavailable. Or you may no longer trust the person you chose.
- If you designated your spouse as your agent and later divorced, you probably want to designate someone else.
- If you've since moved to another state, your powers of attorney may no longer work the way you intended. Certain terms have different meanings in different states, and states don't all have the same procedural requirements. Some states, for example, require *durable* powers of attorney to be filed with the local county recorder or some other government agency.

Even if nothing has changed since you signed your powers of attorney, it's a good idea to sign new documents every few years. Because of liability concerns, some financial institutions and health care providers may be reluctant to honor powers of attorney that are more than a few years old.

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2015 IEPas15

PRESERVING YOUR LEGACY…
LET MCQUEEN & SIDDALL, LLP GUIDE & COUNSEL YOU!

You Have Only One Chance to Get It Right…
Your personal estate or family business, whether large or small, is something you've worked hard to build. Why not seek out a trusted legal advisor to preserve Your Legacy.

When Choices Matter,
You Must Choose Wisely…
You can retain attorneys with advanced legal degrees in Estate Planning. They have the skills and education of big law firm attorneys…but when planning and preserving your Legacy, our Partners personally guide and serve You.

Your Best Choice… Our attorneys are accessible and responsive, exploit technology to deliver quality legal work efficiently, render practical and effective solutions, communicate clearly, and protect You with integrity.

(PHOTO OF David Siddall and Bill McQueen)

McQueen & Siddall, LLP is a successful and highly regarded ***Personal and Business Legacy*** boutique law firm. The reasons you benefit are just this simple. Our partners know what they are doing. Our partners love what they are doing. And our partners believe in what they are doing. Our partners do things differently. For your benefit, our partners work smarter, make the complex simple, and initiate the uncomfortable but necessary conversations. Our partners' entrepreneurial spirits drive them to exceed your expectations. Fascinated by innovation our partners strive to redefine the way they practice law everyday.

Our partners welcome the opportunity to serve as your personal legal counselor as you commence on this important journey of your lifetime.

WHAT MAKES US UNIQUE? ***OUR NON-NEGOTIABLES!*** COMMITMENTS TO YOU UNLIKE ANY OTHER LAW FIRM…

- **Focused Practice** – We focus on fewer areas of the law, so you receive the highest level of sophistication for a reasonable fee.
- **Intentional Listening** – You will talk…we will listen, so we can understand your issues…and then provide an affordable and easy-to-implement solution.
- **Effective Communication** – You will understand your solutions, know your schedule, and be kept informed – no need to guess what is going on….
- **Location of Your Choice** – You always can't meet at our law offices during weekday business hours. We can come to you – your office, home or other location…even on weekends or evenings.
- **Fixed Fees** –Because of our intentional listening, you can receive a "fixed fee" proposal for your legal services. Relax… you will experience "peace of mind" from the first day of our engagement.
- **Unmatched Integrity** –Our integrity is priceless to us. You benefit by knowing we will do the right thing for you…even if doing the right thing cost money out of our own pockets.
- **Simple Sophistication** –You desire a "cutting edge" solution for your estate plans. Having invested our money and time in obtaining advanced law degrees in Estate Planning, you will receive the same highly sophisticated legal planning offered at large law firms, but with a personal touch!
- **Current Innovations** – Technology changes rapidly. Our boutique law firm invests in the latest and best technology to better serve you. Technology leverages our resources, including staff, between our two offices.

We welcome the opportunity to serve as your Guide, Counselor and Advocate as you commence on this important journey of your lifetime!

This material is intended for educational purposes only and is not legal advice. You should consult with an attorney for advice concerning your particular situation.

While the material in This Guide is based on information believed to be reliable, no warranty is given as to its accuracy or completeness.

Concepts are current as of the publication date and are subject to change without notice.

IRS Circular 230 Notice: We are required to advise you no person or entity may use any tax advice in this communication or any attachment to (i) avoid any penalty under federal tax law or (ii) promote, market or recommend any purchase, investment or other action.