Insight on Estate Planning

August/September 2014

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Unintended consequences

After divorce, review your estate plan to avoid surprises

If you're recently divorced, you've likely had your fill of legal documents and proceedings. But it's important to review your estate plan as soon as possible to ensure you're protected against unintended consequences. Consider the following questions after your divorce.

How can I keep control of my assets?

Generally, a divorce judgment automatically extinguishes your spouse's rights under your will or any trusts. So there's little danger that your ex-spouse will inherit your property, even if you haven't yet amended your estate planning documents. If you have minor children, however, your plan may inadvertently give your ex-spouse control over your wealth.

Property inherited by minors generally must be held in a conservatorship until they reach the age of majority (usually 18). And in most cases a court will appoint their surviving parent (your ex-spouse) as conservator. Even though the conservatorship will be under court supervision, your ex-spouse will have a great deal of discretion in determining how your assets are invested and spent while the children are minors.

The best way to avoid this result is to create one or more trusts for the benefit of your children. A trust allows you to choose a trustee who'll be responsible for managing assets and making distributions to your children. It also allows you to determine when and under what circumstances the children will receive your property. For example, you may want to delay distributions until your children are beyond the age of majority or have reached certain milestones (such as finishing college or finding a job).

Also, a trust can protect your children's inheritance from claims of their ex-spouses. (See "Divorce protection for your children" on page 3.)

What if I decide to remarry?

Estate planning is particularly important if you remarry. Suppose, for example, that you have children from a previous marriage. If you haven't updated your will or trusts, a substantial portion of your estate may go to them (under your ex-spouse's control, if they're minors). This may not be the best result, particularly if your new spouse and any children of the second marriage need more financial support than children from the previous marriage.

It's also important to consider estate taxes, although they aren't as big a concern as they once were. Today, the federal estate tax exclusion is more than $5 million ($5.34 million in 2014), so relatively few families are subject to the tax. But if

your estate is very large, there may be opportunities to reduce or defer estate taxes. Here's an example:

Frank dies with a $15 million estate. He leaves $5 million to his second wife, Marie, and $10 million to his children (Ray and Debra) from his first marriage. The $5 million he leaves to Marie is shielded from tax by the marital deduction, but the $10 million he leaves to Ray and Debra triggers a $1,864,000 estate tax liability (assuming a 40% tax rate). Had Frank left his entire estate to Marie, estate taxes would have been deferred until her death.

The problem with this approach is that, by leaving everything to Marie, Frank puts his children's inheritance at risk. What if Marie spends it all? What if she remarries and leaves everything to her new husband and children?

Here are two strategies Frank can use to provide for Ray and Debra while still taking advantage of the marital deduction:

1. QTIP trust. Generally, to receive the benefits of a marital deduction, you must leave property to your spouse outright. The qualified terminable interest property (QTIP) trust is an exception to this rule. A QTIP trust is an irrevocable trust that pays out all of its current income to the surviving spouse at least annually and meets certain other requirements. In the example, had Frank transferred assets to a QTIP trust, he could have taken advantage of the marital deduction while preserving the trust principal for Ray and Debra.

Historically, there was a disadvantage to leaving your entire estate to your spouse, either outright or in a QTIP trust: The marital deduction *defers*, but doesn't *eliminate*, estate taxes, so the assets were eventually subject to estate tax as part of the surviving spouse's estate, wasting the first spouse's estate tax exemption. With the advent of portability, however — which allows a surviving spouse to take advantage of a deceased spouse's unused exemption amount — this disadvantage has been eliminated in most cases, or at least minimized.

2. ILIT. Another option for Frank is to establish an irrevocable life insurance trust (ILIT) for the benefit of Ray and Debra. He can leave his entire estate to Marie, taking full advantage of the marital deduction, while also providing a generous inheritance for his children. If the ILIT is designed properly, the insurance proceeds will pass to Ray and Debra outside of Frank's estate and be free of estate taxes.

Keep what's yours

In the event of a divorce, ask your advisor to review your estate plan as soon as possible. The last thing you want is for your hard-earned wealth to end up in the hands of an ex-spouse or your child's ex-spouse. Several strategies are available to make sure that won't happen.

Divorce protection for your children

When people plan their estates, they often overlook the possibility that their children may get divorced. If that happens, there's a risk that your child's ex-spouse will end up with some of your property in a divorce settlement.

The most effective way to avoid this result is to establish a trust for your child's benefit. But simply setting up a trust isn't enough. You must design the trust carefully to ensure that your child's ex-spouse has no claim to the trust assets. If the child has too much control over the trust, a court may view the trust assets as marital property subject to division in divorce.

It's also advisable to avoid giving the child a remainder interest in the trust or providing for mandatory distributions, which may be considered property rights in some states. Ideally, to ensure that your child's ex-spouse can't reach the trust assets, give the trustee full discretionary authority over whether to make or withhold distributions.

Protecting your real estate assets

Estate planning and asset protection go hand in hand. After all, planning for the distribution of wealth is useless if you have no wealth to distribute.

But, asset protection for real estate is particularly challenging, because it's the only asset that can't be moved. Many asset protection strategies involve relocating assets to domestic or foreign jurisdictions that offer greater creditor protection. But unlike other assets — such as cash, bank and brokerage accounts, stocks and bonds, cars, boats, jewelry, art and other collectibles — real estate can't be removed from the jurisdiction in which it's located. Let's take a closer look at several strategies for protecting your real estate assets.

Giving gifts

One of the most effective ways to protect real estate from creditors is to give it to your children or other family members, either outright or via a trust. Doing so places the real estate beyond the reach of your creditors and may also reduce your estate tax liability. The disadvantage of this strategy, however, is that you'll lose all economic interest in and control over the real estate.

Further, although transferring assets may protect you from your creditors, the assets would now be subject to the claims against the person or entity to whom the assets were transferred. Keep in mind that gifting real estate — as well as the other asset protection strategies discussed later — won't protect you from your *existing* creditors if a transfer constitutes a "fraudulent conveyance." A fraudulent conveyance is a transfer of property made with the intent to hinder, delay or defraud creditors. The best way to avoid a fraudulent conveyance claim is to transfer property as early as possible, *before* any creditor claims arise.

Protecting your home

There are three strategies that can protect your home against creditors:

Tenancy by the entirety. About half the states allow married couples to hold title to their principal residence as tenants by the entirety. Similar to joint tenancy, tenancy by the entirety also protects the residence during the marriage against claims by a creditor of *one* of the spouses. It doesn't protect the residence against a couple's joint liabilities.

One of the most effective ways to protect real estate from creditors is to give it to your children or other family members, either outright or via a trust.

Homestead exemptions. A few states offer unlimited homestead exemptions, which protect a principal residence from creditors regardless of whether it's owned by a couple or a single person.

Qualified personal residence trust (QPRT). A QPRT allows you to transfer a principal residence or vacation home to an irrevocable trust — thereby placing it beyond the reach of creditors. Unlike an outright gift or transfer to a regular trust, however, you retain the right to live in the home during the trust term. At the end of the term, the property is transferred to your children or other beneficiaries. QPRTs can also be used to reduce gift and estate taxes.

Protecting other real estate

For business and investment real estate, an effective asset protection strategy is to transfer title to a limited liability company (LLC) or limited partnership (LP). So long as the transfer isn't a fraudulent conveyance and the LLC or LP is structured and operated properly, the entity shields the real estate from creditors' claims.

A creditor with a judgment against an individual owner (a member or limited partner) can't satisfy that judgment against the entity's assets. Generally (but not in all cases), the creditor's only remedy is to seek a "charging order," which permits the creditor to intercept any distributions made by the LLC or LP to the debtor. So long as the entity doesn't distribute the real estate or other assets to the debtor, the creditor's efforts to collect are frustrated.

Plan early

If you're exposed to significant liability risks — either personally or professionally — it's a good idea to have an asset protection plan. And the earlier you implement your plan, the more likely it is to succeed. ▮

How will the GST tax affect your estate plan?

If you've recently become a grandparent, you may be considering making a gift to the newest member of the family. However, before taking action, it's important to understand how the generation-skipping transfer (GST) tax may affect your estate plan.

GST tax in action

Like the gift and estate tax exemption, the GST tax exemption stands at an inflation-adjusted $5.34 million for 2014. In addition, the GST tax is a flat tax — applied at the highest marginal estate tax rate, currently 40% — on transfers that skip a generation.

GST tax applies to transfers to "skip persons" — that is, grandchildren or other relatives more than one generation below you or nonrelatives more than 37½ years younger than you. (There's an exception, however, if your child predeceases you. In that case, your grandchildren by that child are no longer considered skip persons.)

> *The GST tax applies only to transfers that are subject to gift or estate tax.*

The tax applies — *in addition to* gift and estate taxes — to:

Direct skips. These are an outright gift or bequest to a grandchild or another skip person, or transfers to a trust whose beneficial interests are held only by skip persons.

Taxable trust terminations. An example of a taxable trust termination is when a child with a life interest in a trust dies, causing the trust assets to pass outright to a skip person.

Taxable trust distributions. This type of distribution occurs when a transfer of funds emanates from a trust (other than a direct skip or trust termination) to a skip person.

The GST tax applies only to transfers that are subject to gift or estate tax. So, if you make an outright gift to a grandchild that's within the annual gift tax exclusion (currently $14,000 per recipient) or a direct payment of qualifying tuition or medical expenses on a grandchild's behalf, there's no GST tax.

Leveraging your exemption amount

If your generation-skipping gifts won't exceed the $5.34 million exemption amount, allocation isn't an issue. But if you don't have enough exemption to go around, allocate it in a way that maximizes the tax savings.

A powerful tool for leveraging the exemption is an irrevocable trust. Allocating only enough of your exemption to cover your contributions to the trust will allow any future growth to be shielded from GST taxes — thus creating a "dynasty."

Considering the automatic allocation

As you plan your estate, pay careful attention to the automatic allocation rules, which automatically allocate your GST tax exemption to direct skips and certain trust contributions. The rules are designed to prevent you from inadvertently losing the benefits of the exemption. But in some cases, it makes sense to opt out.

Say you're making several outright gifts to your grandchildren but you're also planning to set up a $5 million trust for their benefit. To save your exemption for the trust (where it will generate the greatest tax savings), you might want to opt out of automatic allocation for the outright gifts.

Playing by the GST tax rules

If you plan to make gifts to your grandchildren or later generations, talk to your estate planning advisor about the GST tax rules. The rules regarding allocation of the GST tax exemption are complex, and mistakes can be costly. Your advisor can also inform you of the ins and outs of the automatic allocation. ■

Estate Planning Pitfall
You own property outside your revocable trust

The primary purpose of a revocable trust — also known as a "living trust" or "inter vivos trust" — is to avoid probate. But if you're not diligent about transferring assets to the trust, that purpose may be defeated.

Probate is a court proceeding held to authenticate your will, assess the value of your estate, resolve creditor claims, pay taxes and other expenses, and distribute assets to your beneficiaries. Avoiding probate may be desirable for several reasons, including:

Cost reduction. Executor and attorneys' fees, court costs and other charges can make probate expensive.

Time savings. The probate process can be time consuming, delaying distribution of assets to beneficiaries pending weeks or even months of court hearings.

Privacy. Probate proceedings are a matter of public record, exposing details about your financial affairs to anyone who cares to look.

A revocable trust avoids probate and also allows your representatives (rather than a court) to maintain control over your financial affairs in the event you become incapacitated.

It's critical to transfer title to your assets to the trust. If you leave assets out of the trust, they may have to go through probate and they won't be under the trustee's control if you become incapacitated.

Keep in mind that, depending on your circumstances, it may be desirable to transfer certain assets to your loved ones outside the revocable trust, using other methods that also avoid probate. For example, you can transfer retirement accounts to family members simply by naming them as beneficiaries of your IRAs or retirement plan. Similarly, you can name beneficiaries for life insurance policies. In fact, with life insurance policies there are other strategies, such as using an irrevocable life insurance trust, which in addition to allowing you to avoid probate will also provide a way to avoid estate taxes on the proceeds.

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