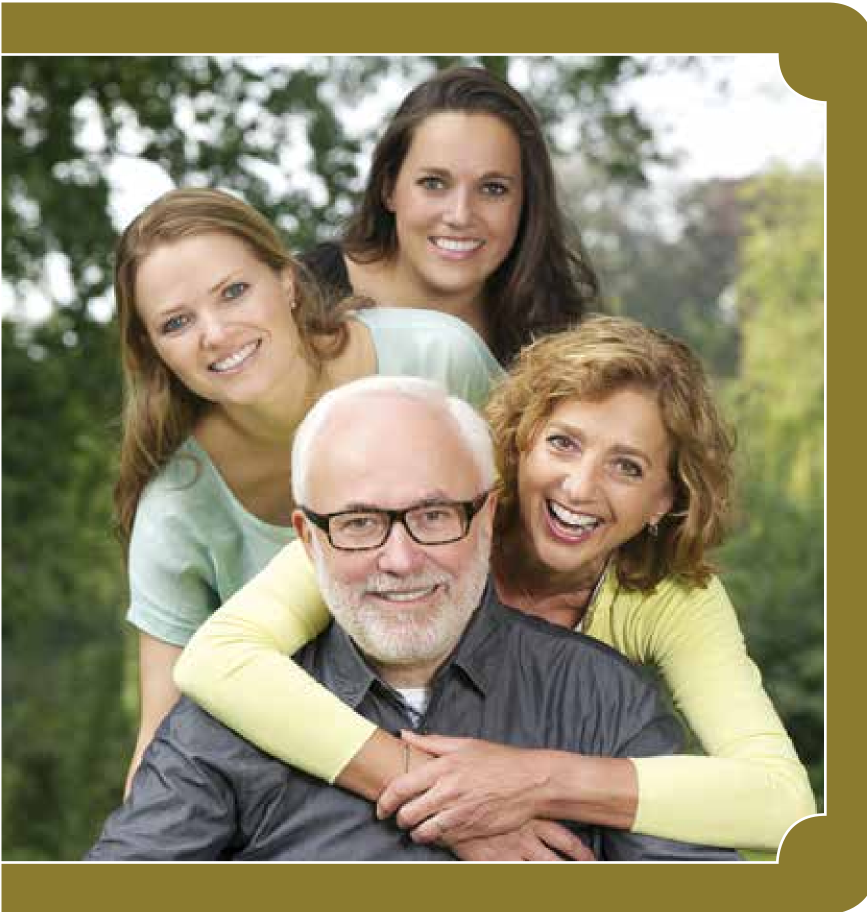
Insight on Estate Planning

February/March 2014



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A trust with a twist

The beneficiary defective inheritor's trust (BDIT) is a powerful estate planning tool that allows you to enjoy the benefits of a traditional trust without giving up control over your property. You can continue managing and using the BDIT assets without compromising the trust's ability to reduce transfer taxes and shield assets from your creditors.

BDITs can hold a variety of assets, but they're particularly effective for assets that have significant appreciation potential or that are entitled to substantial valuation discounts, such as interests in family limited partnerships and limited liability companies (LLCs). And by designing a BDIT as a "dynasty" trust, you can provide benefits for future generations without triggering transfer taxes or exposing the trust assets to creditors' claims.

When to use one

Popular estate planning tools such as grantor retained annuity trusts and intentionally defective grantor trusts offer many benefits. They enable you to leverage valuation discounts to reduce gift, estate and generation-skipping transfer taxes. And they allow you to "freeze" asset values at their date-of-contribution levels, protecting all future appreciation from transfer taxes.

These tools also take advantage of the grantor trust rules to generate additional estate planning benefits. The trust's income is taxed to you, as grantor, allowing the assets to grow tax-free and preserving more of your wealth for future generations. Essentially, your tax payments are additional, tax-free gifts to your children or other beneficiaries. And, because a grantor trust is your alter ego, you can sell it appreciated assets — removing them from your estate — with no income tax consequences.

Despite these benefits, most traditional trusts suffer from a significant disadvantage: You must relinquish the right to control, use or direct the ultimate disposition of the trust assets. If you wish to take advantage of trust-based estate planning techniques but you're not ready to let go of your wealth, a BDIT may be the answer.

Why it works

The BDIT's benefits are made possible by one critical principle: Assets transferred by a third party (such as a parent) to a properly structured trust for your benefit enjoy transfer-tax savings and creditor protection, even if you obtain control over those assets.

Planting the seeds for a BDIT

To ensure that a beneficiary defective inheritor's trust (BDIT) will withstand an IRS challenge, it's critical for the sale of assets to the trust to have "economic substance." Generally, that means that the third party establishing the trust must "seed" the trust with a meaningful contribution of his or her own funds. If you give the third party the seed money, the IRS will likely view the transaction as a sham.

According to a common rule of thumb, seed money should be at least 10% of the asset purchase price. This may not be feasible, however, if you plan to transfer millions of dollars in assets to a BDIT. If the third party lacks the means to contribute sufficient seed money, you may be able to make up the difference by obtaining a personal guarantee from a financially sound and creditworthy party (such as your spouse).

IRS rules prohibit you from transferring assets to beneficiaries on a tax-advantaged basis if you retain the right to use or control the assets. But those rules don't apply to assets you *receive* from others in a beneficiary-controlled trust. The challenge in taking advantage of a BDIT is to place assets you currently own into a third-party trust.

How it works

The classic BDIT strategy works like this: Let's say Molly owns her home and several other pieces of real estate in an LLC. She'd like to share these properties with her two children on a tax-advantaged basis by transferring LLC interests to trusts for their benefit, but she's not yet ready to relinquish control. Instead, she arranges for her father to establish two BDITs, each naming Molly as primary beneficiary and trustee and one of Molly's children as contingent beneficiaries.

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To ensure that the BDITs have the economic substance necessary to avoid an IRS challenge, Molly's father "seeds" the trusts with cash. (See "Planting the seeds for a BDIT" on page 2.) He also appoints an independent trustee to make decisions that Molly can't make without jeopardizing the strategy, including decisions regarding discretionary distributions and certain tax and insurance matters.

In addition, in order for each trust to be "beneficiary defective," the trust documents grant Molly carefully structured lapsing powers to withdraw funds from the trust. This "defect" ensures that

Molly is treated as the grantor of each trust for income tax purposes.

After the BDITs are set up, Molly sells a one-third LLC interest to each trust at fair market value (which reflects minority interest valuation discounts) in exchange for a promissory note with a market interest rate. When the dust settles, Molly has removed the LLC interests from her taxable estate at a minimal tax cost, placed them in trusts for the benefit of herself and her heirs, and provided some creditor protection for the trust assets.

Unlike a traditional trust strategy, however, this strategy allows Molly to retain the right to manage and use the trust assets, to receive trust income and to withdraw trust principal in an amount needed for her "health, education, maintenance or support." She also has the right to receive additional distributions, at the independent trustee's discretion, in any amount.

In addition, Molly has the right to remove and replace the independent trustee and to use a special power of appointment to distribute trust assets as she sees fit (so long as she doesn't direct distributions to herself, her estate or her creditors).

The best of both worlds

Traditional estate planning techniques often involve a trade-off between tax and asset protection benefits on one hand and control over your wealth on the other. A properly structured BDIT can provide the best of both worlds. Talk with your advisor to determine if a BDIT makes sense as part of your estate plan. ■

Thanks, Grandma and Grandpa!

3 estate-planning-friendly strategies to pay for a grandchild's college education

It's no secret that the cost of a college education continues to soar. Jack and Debbie would like to help pay for their grandson's higher education. They asked their estate planning advisor about strategies for funding their grandson's education while saving gift and estate taxes. The couple's advisor suggested three options:

1. Make direct tuition payments. A simple but effective technique is to make tuition payments on behalf of your grandchild. So long as you make the payments *directly* to the college, they avoid gift and generation-skipping transfer (GST) tax without using up any of your gift or GST tax exclusions or exemptions.

But this technique is available only for tuition, not for other expenses, such as room and board, fees, books and equipment. So it may be desirable to combine it with other techniques.

A disadvantage of direct payments is that, if you wait until the student has tuition bills to pay, there's a risk that you'll die before the funds are removed from your estate. Other techniques allow you to set aside funds for future college expenses, shielding those funds from estate taxes.

If your grandchild is planning to apply for financial aid, also be aware that most schools treat direct tuition payments as a "resource" that reduces financial aid awards on a dollar-for-dollar basis.

2. Create grantor and Crummey trusts. These trusts offer several important benefits. For example, they can be established for one grandchild or for multiple beneficiaries, and assets contributed to the trust, together with future appreciation, are removed from your taxable estate. In addition, the funds can be used for college expenses or for other purposes.

On the downside, for financial aid purposes a trust is considered the child's asset, potentially reducing or eliminating the amount of aid available to him or her. So keep this in mind if your grandchild is hoping to qualify for financial aid.

Another potential downside is that trust contributions are considered taxable gifts. But you can reduce or eliminate gift taxes by using your annual exclusion ($14,000 per recipient; $28,000 per recipient for gifts by married couples) or your lifetime exemption ($5.34 million in 2014) to fund the trust. To qualify for the annual exclusion, the beneficiary must receive a *present*

interest. Gifts in trust are generally considered *future* interests, but you can convert these gifts to present interests by structuring the trust as a Crummey trust.

With a Crummey trust, each time you contribute assets, you must give the beneficiaries a brief window (typically 30 to 60 days) during which they may withdraw the contribution. Curiously, the law doesn't require that you notify beneficiaries of their withdrawal rights. Notification, however, is typically recommended.

A disadvantage of direct tuition payments is that, if you wait until the student has tuition bills to pay, there's a risk that you'll die before the funds are removed from your estate.

If a Crummey trust is established for a single beneficiary, annual exclusion gifts to the trust are also GST-tax-free.

3. Consider a Section 2503(c) minor's trust. Contributions to a Sec. 2503(c) minor's trust qualify as annual exclusion gifts, even though they're gifts of future interests, provided the trust meets these requirements:

- Assets and income may be paid to or on behalf of the minor before age 21,
- Undistributed assets and income will be paid to the minor at age 21, and
- If the minor dies before reaching age 21, the trust assets will be included in his or her estate.

When the beneficiary turns 21, it's possible to extend the trust by giving the minor the opportunity to withdraw the funds for a limited time (30 days, for example). After that, contributions to the trust no longer qualify for the annual exclusion, unless you've designed it to convert to a Crummey trust. Then, so long as you comply with the applicable rules, gifts to the trust will qualify for the annual exclusion. ■

Power of attorney abuse: What can you do about it?

A financial power of attorney — sometimes called a "power of attorney for property" or a "general power of attorney" — can be a valuable planning tool. The most common type is the durable power of attorney, which allows an agent to act on the behalf of a person (the "principal") even if the person becomes mentally incompetent or otherwise incapacitated. It authorizes the agent to manage the principal's investments, pay bills, file tax returns and handle other financial matters if the principal is unable to do so as a result of illness, injury, advancing age or other circumstances.

The main disadvantage of a power of attorney is that it's susceptible to abuse by scam artists, dishonest caretakers or greedy relatives. A broadly written power of attorney gives an agent unfettered access to the principal's bank and brokerage accounts, real estate, and other assets. So if you

have elderly parents or other family members who've signed powers of attorney, keep an eye on their agents' activities. And if you or a loved one is about to sign a power of attorney, make sure it includes safeguards to help prevent abuse.

Watch out for your loved ones

Many people believe that, once an agent has been given a power of attorney, there's little that can be done to stop the agent from misappropriating money or property. Fortunately, that's not the case.

Many people mistakenly believe that, once an agent has been given a power of attorney, there's little that can be done to stop the agent from misappropriating money or property.

If you suspect that an elderly family member is a victim of financial abuse by the holder of a power of attorney, contact an attorney as soon as possible. An agent has a fiduciary duty to the principal, requiring him or her to act with the utmost good faith and loyalty when acting on the principal's behalf. So your relative may be able to sue the agent for breach of fiduciary duty and obtain injunctive relief, damages (including punitive damages) and attorneys' fees.

Your relative also may be able to sue for "conversion." Conversion involves an agent's use of the principal's property for his or her own benefit or otherwise in a manner inconsistent with the principal's ownership rights. In most states, to establish an agent's liability for conversion, you must show that the principal demanded the return of the property (preferably in writing) and that the agent refused to do so.

Take steps to prevent abuse

If you or a family member plans to execute a power of attorney, there are steps you can take to minimize the risk of abuse:

- Make sure the agent is someone you know and trust.
- Consider using a "springing" power of attorney, which doesn't take effect until certain conditions are met, such as a physician's certification that the principal has become incapacitated.
- Use a "special" or "limited" power of attorney that details the agent's specific powers. (The drawback of this approach is that it limits the agent's ability to deal with unanticipated circumstances.)
- Appoint a "monitor" or other third party to review transactions executed by the agent, and require the monitor's approval of transactions over a certain dollar amount.

- Provide that the appointment of a guardian automatically revokes the power of attorney.

Some state laws contain special requirements, such as a separate rider, to authorize an agent to make large gifts or conduct other major transactions.

Act now

When dealing with powers of attorney, the sooner you act, the better. If you're pursuing legal remedies against an agent, the sooner you proceed, the greater your chances of recovery. And if you wish to execute or revoke a power of attorney for yourself, you need to do so while you're mentally competent.

Estate Planning Pitfall
You've chosen your executor hastily

Choosing the right executor — sometimes known as a "personal representative" — is critical to the smooth administration of an estate. Yet many people treat this decision as an afterthought. Given an executor's many responsibilities and complex tasks, it pays to put some thought into the selection.

An executor's duties may include:

- Collecting, protecting and taking inventory of the estate's assets,
- Filing the estate's tax returns and paying its taxes,
- Handling creditors' claims and the estate's claims against others,
- Making investment decisions,
- Distributing property to beneficiaries, and
- Liquidating assets if necessary.

You don't necessarily have to choose a professional executor or someone with legal or financial expertise. Often, lay people can handle the job, hiring professionals as needed (at the estate's expense) to handle matters beyond their expertise.

Many people choose a family member or close friend for the job, but this can be a mistake for two reasons. First, a person who's close to you may be too grief-stricken to function effectively. Second, if your executor stands to gain from the will, he or she may have a conflict of interest — real or perceived — which can lead to will contests or other disputes by disgruntled family members.

If either of these issues is a concern, consider choosing an independent outsider as executor. Some people appoint co-executors — one trusted friend who knows the family and understands its dynamics, and one independent executor with business, financial or legal expertise.

Regardless of whom you choose, be sure to designate at least one backup executor to serve in the event that your first choice dies or becomes incapacitated before it's time to settle your estate — or turns down the job.

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