Insight on Estate Planning

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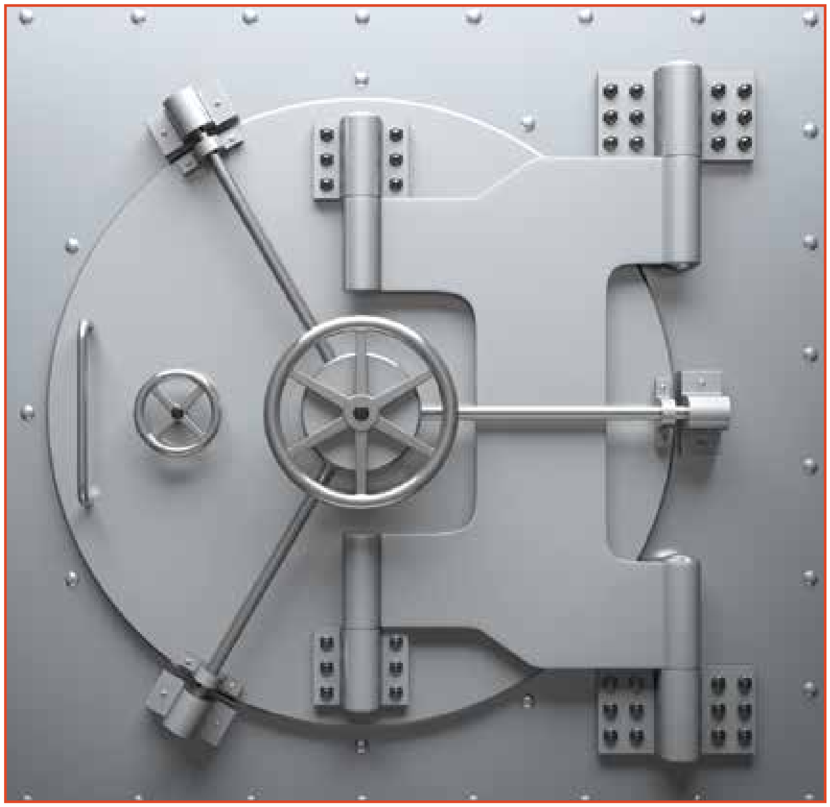
To preserve your wealth, consider a DAPT

No matter how much effort you put into designing your estate plan, it won't do you much good if you have no assets to share with the next generation. That's why estate planning and asset protection planning often go hand-in-hand.



The most effective way to protect your assets is to transfer them to your children or other family members, either outright or in trust, with no strings attached. So long as the transfer isn't a fraudulent conveyance — that is, a transfer intended to delay or defraud known creditors — creditors won't be able to reach the assets. But if you wish to retain some control over your wealth, consider an asset protection trust.

For affluent families with significant liability concerns, foreign asset protection trusts (FAPTs) probably offer the greatest protection against creditors' claims. But if you prefer to avoid the complexity and expense of an FAPT, consider a domestic asset protection trust (DAPT) instead.

What's a DAPT?

A DAPT is an irrevocable, spendthrift trust established in one of the 15 states that currently authorize this trust type (Alaska, Colorado, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia and Wyoming). Unlike trusts in other jurisdictions, a DAPT offers creditor protection even if you're a discretionary beneficiary of the trust.

To take advantage of a DAPT, you don't necessarily have to live in one of the previously listed states. But, as a general rule, to set up a trust in another state you'll need to locate some or all of the trust assets there and engage a bank or trust company in the state to administer the trust.

DAPT protection varies from state to state, so it's important to shop around. For example, different jurisdictions have different statute of limitations periods, which determine how long you'll have to wait until full asset protection kicks in. (During the limitations period, creditors can challenge transfers to the trust.) Also, most of the DAPT laws contain exceptions for certain types of creditors, such as divorcing spouses, child support creditors and pre-existing tort creditors.

Typically, DAPTs are incomplete gift trusts, which give you some flexibility to change beneficiaries or otherwise control the disposition of the assets. But it's also possible to structure a DAPT as a completed gift trust, thereby removing the assets (and any future appreciation of those assets) from your taxable estate.

What are the disadvantages?

The main disadvantage of a DAPT is the uncertainty over whether it will withstand a court challenge. Although they've been around since 1997, DAPTs rarely have been tested in the courts.

Most experts agree that, if you live in one of the states with a DAPT statute, a properly designed and funded DAPT will be effective. But there's some doubt regarding trusts established by nonresidents. It's uncertain whether courts in non-DAPT states will recognize other states' DAPT statutes or whether the U.S. Constitution's Full Faith and Credit Clause requires courts in DAPT states to enforce out-of-state judgments against a DAPT.

Recently, two cases raised concerns about DAPTs. In one, a federal bankruptcy court applied federal rather than Alaska law to invalidate a transfer to an Alaska DAPT. And in the other, the Illinois Supreme Court permitted creditors to seize Illinois property that had been transferred to a FAPT. The court found that under Illinois law a FAPT (and, arguably, a DAPT) is fraudulent *per se*.

A potentially safer option is the "hybrid DAPT," which starts out as a third-party trust but gives the trustee the option of adding you as a discretionary beneficiary at a later date.

Worth the risk

If you're looking for a relatively simple asset protection tool, a DAPT is worth the risk. Despite the uncertainty, a DAPT creates a strong deterrent to creditors and improves the odds that your assets will remain intact. ▮

Estate planning for same-sex spouses

What the Supreme Court's DOMA ruling means

In June, the U.S. Supreme Court struck down as unconstitutional Section 3 of the Defense of Marriage Act (DOMA). Under that section, for purposes of federal law, "marriage" means a legal union between a man and a woman as husband and wife, and "spouse" is limited to a husband or wife of the opposite sex.

The ruling has wide-ranging implications for same-sex couples who are legally married in one of the jurisdictions that permit such unions (as of this writing, 12 states plus the District of Columbia). These married couples are now eligible for approximately 1,100 federal benefits previously enjoyed only by heterosexual spouses, including a variety of federal tax advantages, Social Security benefits and preferred immigration status. One area where the decision will have a big impact is estate planning.

Advantages for married couples

Federal gift and estate tax laws provide married couples several important advantages, including:

Marital deduction. The unlimited marital deduction allows one spouse to transfer any amount of property to the other, either through lifetime

taxes. They can also take advantage of sophisticated estate planning techniques, such as qualified terminable interest trusts (QTIPs) that rely on the marital deduction.

Portability. The tax law concept of "portability" was introduced in 2010 and made permanent this year. When one spouse dies, portability allows the surviving spouse to "inherit" the deceased spouse's unused exemption. To take advantage of this benefit, the deceased spouse's executor must elect portability on a timely filed estate tax return (even if there's no estate tax liability).

Gift splitting. The annual gift tax exclusion allows you to give up to $14,000 per year (adjusted annually for inflation) to any number of recipients, without triggering gift tax or using up any of your lifetime exemption. Spouses that "split" their gifts (by making an election on their gift tax returns) can combine their annual exclusions. This allows them to give up to $28,000 per recipient, regardless of whose assets they use to make the gift. Married couples can also use gift splitting to combine their lifetime exemptions

gifts or bequests at death, free of federal gift or estate tax (so long as the recipient is a U.S. citizen). Before the Supreme Court's decision, same-sex married couples were subject to tax to the extent that total gifts or inheritances exceeded the $5.25 million federal gift and estate tax exemption amount.

Now, same-sex spouses can transfer unlimited assets to each other without triggering federal

Unanswered questions

The Supreme Court's ruling on the Defense of Marriage Act (DOMA) is good news for same-sex married couples, but there are some important issues the Court didn't address. For example, what happens if a same-sex couple is married in one state but resides in or moves to a state that doesn't permit same-sex marriages? Arguably, it follows from the court's decision that a legally married couple should be treated as such for federal tax purposes regardless of which state they live in. But a definitive answer may require further guidance from the IRS.

Also, the court didn't decide the constitutionality of DOMA Section 2, which provides that states aren't required to recognize same-sex marriages performed in other states. Until this issue is resolved, married same-sex couples living in states that don't recognize their marriages may not be eligible for state-law benefits available to heterosexual couples.

and give up to $10.5 million tax-free, even if most or all of the gift comes from one spouse's separate assets.

Retirement benefits. Married couples have a big advantage when it comes to inherited retirement accounts. If you name someone other than your spouse as beneficiary of an employer-sponsored plan or IRA, he or she will generally have to take required minimum distributions (RMDs), which are taxable, beginning the year after you die. If you name your spouse as beneficiary, however, he or she can roll the funds into his or her own IRA and defer RMDs to age 70½. Now, same-sex married couples can also take advantage of spousal rollovers.

Next steps

Legally married same-sex couples should consult their advisors to discuss the impact of the Supreme Court's decision on their estate plans. Also, be sure to consider state taxes in your planning. The DOMA ruling left several questions unanswered, including the treatment of same-sex couples who legally marry in one state but reside in a state that doesn't permit same-sex marriages. (See "Unanswered questions" on page 4.)

For those who've already paid federal gift or estate taxes, there may be an opportunity to amend their returns and claim a refund. Generally, the limitations period for amending a return is three years from the filing date or due date, whichever is later. But keep an eye out for guidance in this area. ▮

Using an FLP or LLC?

Beware the step transaction doctrine

Do you know how to transfer a significant amount of wealth to the next generation at a discounted value for gift tax purposes? The answer is to form either a family limited partnership (FLP) or a limited liability company (LLC). Before doing so, however, be aware of the step transaction doctrine. If the IRS invokes the doctrine on your FLP or LLC, the tax outcome may be different from what you intended.

Using FLPs or LLCs

If you follow a typical arrangement, you 1) establish an FLP or LLC, retaining all of the partnership or membership units, 2) contribute assets to the entity, such as cash, real estate, marketable securities or business interests, and 3) give (or sell) minority interests in the entity to family members or to trusts for their benefit.

This technique allows you to retain control over assets while shifting most of the ownership interests to your family at a minimal tax cost. That's because, for gift tax purposes, minority FLP and LLC interests generally are entitled to substantial valuation discounts (possibly as much as 40% to 50%) for lack of marketability and control.

To ensure the desired tax treatment, the FLP or LLC should have a legitimate nontax business purpose, such as maintaining control over a family business, consolidating management of an investment portfolio or protecting family assets from creditors. Also, you must treat the entity as a legitimate, independent business, observing all business formalities and documentation requirements.

Even with legitimate nontax reasons for forming an FLP or LLC, families frequently get

sequence, the IRS may challenge the arrangement as an indirect gift under the step transaction doctrine.

Defining the doctrine

Under the step transaction doctrine, separate steps may be collapsed into a single transaction if the parties, at the time of the first step, had a *binding commitment* to undertake the later steps; the steps were prearranged parts of a single transaction designed to produce a particular *end result*; or the steps are *mutually interdependent* — that is, so closely intertwined that they're meaningless on their own.

Binding commitments are uncommon, but it's not unusual for the IRS or a court to invoke "end result" or "mutual interdependence" tests. Under these tests, a key to avoiding step transaction treatment is to establish that the intermediate steps have tax-independent significance. Among other things, this means that enough time should pass between funding an FLP or LLC and transferring minority interests so the assets are subject to "real economic risk" during the interim.

Unfortunately, there's no magic number for determining how long you should wait; it depends on the nature of the assets, economic factors and other circumstances. Generally, funding an FLP or LLC and transferring interests later the same day won't be enough.

But the U.S. Tax Court has held that a six-day delay is sufficient. In that case, *Holman v. Commissioner*, the parents funded an FLP with heavily traded, highly volatile stock and assumed the risk during the six-day period that the stock's value would fluctuate before they transferred limited partnership interests to their children.

themselves into trouble because they're lax about business formalities or they commingle personal and business assets. Failing to adhere to these formalities may cause the IRS to conclude that the entity is a sham, disregard it for gift and estate tax purposes, and assess tax on the full value of the assets, rather than the discounted amount.

To ensure the desired tax treatment, an FLP or LLC should have a legitimate nontax business purpose.

Another common mistake is to complete all of the transfers at around the same time. People often set up an FLP or LLC, transfer assets to the entity and transfer FLP or LLC interests to family members all in the same meeting. If the IRS determines that the transactions were simultaneous — or, worse, that FLP or LLC interests were transferred *before* the entity was funded — it will likely apply the step transaction doctrine and treat the arrangement as an indirect gift of the underlying assets, taxable at full value. Even if the transactions are completed in the right

More stable assets, such as lightly traded securities or real estate, may require a longer waiting period to establish economic risk.

Taking the right steps

Using an FLP or LLC in your estate plan is a smart strategy for transferring a large sum of assets to loved ones at a discounted value for gift tax purposes. Before you take action, though, work with an estate planning advisor to determine the appropriate waiting period between funding an FLP or LLC and transferring interest to your family. Doing so can help you avoid having the IRS invoke the step transaction doctrine on your FLP or LLC. ▮

Estate Planning Pitfall

A beneficiary designation or joint title overrides your will

Inattention to beneficiary designations and jointly held assets can quickly unravel an estate plan. Suppose, for example, that your will provides for all of your property to be divided equally among your three children. But what if your IRA, which names the oldest child as beneficiary, accounts for half of the estate? In that case, the oldest child will inherit half of your estate plus a one-third share of the remaining assets — hardly equal.

The same goes for jointly owned property. When you die, the surviving owner takes title to the property regardless of the terms of the will.

Unfortunately, many don't realize that their will doesn't control the disposition of "non-probate assets." These are assets that are transferred automatically according to a beneficiary designation or contract, overriding the will. Examples include life insurance policies, retirement plans and IRAs, jointly owned real estate, joint bank or brokerage accounts, payable on death (POD) accounts, and transfer on death (TOD) securities. Even savings bonds come with beneficiary forms.

To ensure the estate plan reflects your wishes, review beneficiary designations and property titles regularly, particularly after significant life events, such as a marriage or divorce, the birth of a child, or the death of a loved one. To better control the disposition of your assets, consider setting up a living trust and transferring property to the trust or naming the trust as beneficiary of assets or accounts that require a beneficiary designation.

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