INSIGHT ON ESTATE PLANNING

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QTIP trust
Strange name, powerful trust

ESTATE PLANNING PITFALL
You didn’t make specific references in a letter of instruction

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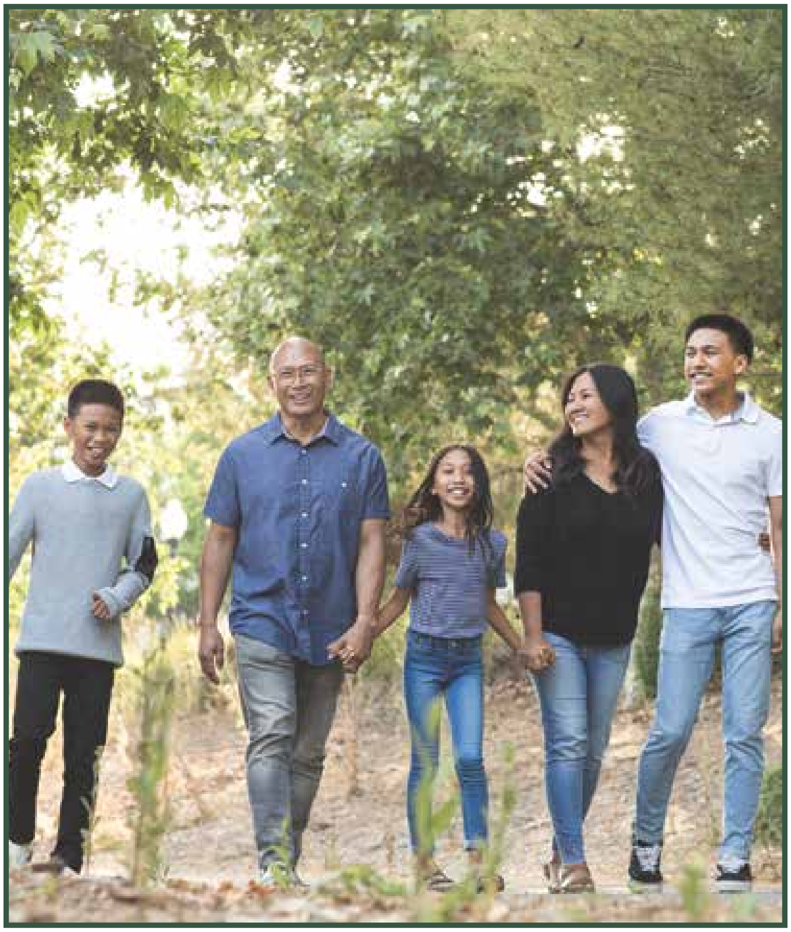
Does your family situation call for a spendthrift trust?

You've likely spent most of your adult life accumulating wealth that you intend to eventually pass on to your loved ones. But are you concerned that the beneficiaries of your estate might squander their inheritance?

One solution is to establish a spendthrift trust that can provide protection for the rest of your lifetime and beyond. Along with certain other trusts, a spendthrift trust may incorporate various tax benefits, including taking advantage of the federal gift and estate tax exemption. But that's not its primary focus: Its main purpose is asset protection.



Restricting trust fund access

The benefit of a spendthrift trust is that it restricts a beneficiary's ability to access and use trust funds. Briefly stated, the beneficiary can't tap directly into the principal or transfer rights to it to someone else. This can also deny access to creditors or a divorced spouse of a beneficiary.

Instead, the trust beneficiary relies on the trustee to provide payments based on the trust's terms. This could be in the form of regular periodic payouts or on an "as needed" basis. The trust document will spell out the nature and frequency, if any, of the payments. Once a payment has been made to a beneficiary, the money then becomes fair game to any creditors.

As previously mentioned, a spendthrift trust isn't designed primarily for tax-reduction purposes. Typically, this trust type is most beneficial when you want to leave money or property to a family member but worry that he or she may squander the inheritance. For example, you might think that the beneficiary doesn't handle money well based on past experience or that he or she could easily be defrauded, has had prior run-ins with creditors or suffers from an addiction that may result in a substantial loss of funds.

If any of these scenarios is a possibility, a spendthrift trust can provide asset protection. It enables the designated trustee to provide funds for the beneficiary without the risk of misuse or overspending. But that brings up another critical issue.

Appointing the trustee

Depending on the trust terms, the trustee may be responsible for making scheduled payments or have wide discretion as to whether funds should be paid, how much and when. For instance, the trust may empower the trustee to make set payments or retain discretion over amounts to be paid or even if there should be any payment at all.

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Or perhaps the trustee will be directed to pay a specified percentage of the trust assets, so the payouts fluctuate, depending on investment performance. Similarly, the trustee may be authorized to withhold payment upon the occurrence of certain events (for example, if the beneficiary exceeds a debt threshold or declares bankruptcy).

Drafting a spendthrift trust: Not for DIYers

Unless you're an experienced legal or financial professional, drafting a spendthrift trust isn't a do-it-yourself proposition. An experienced estate planning advisor or attorney will know how to satisfy all the legal formalities. Your advisor will consider applicable federal and state laws and can help ensure that no dire tax consequences will result.

Typically, the advisor will ask you a series of questions to determine the best way to proceed. The questions will likely touch on the method and timing of payments, plans should the beneficiary's circumstances change, and provisions for terminating the trust.

The designation of the trustee can take on even greater significance if you expect to provide this person with broad discretion. Frequently, the trustee will be a CPA, attorney, financial planner or investment advisor, or someone else with the requisite experience and financial know-how. You should also name a successor trustee in the event the designated trustee passes away before the term ends or otherwise becomes incapable of handling these duties.

Determining when to terminate

Is that all there is? Not quite. Consider various other issues relating to spendthrift trusts. For example, you must establish how and when the trust should terminate. It could be set up for a term of years or for termination to occur upon a stated event, such as a child reaching the age of majority.

Finally, work with your estate planning advisor to anticipate other possibilities, such as enactment of new tax legislation or changes in family circumstances that could affect your spendthrift trust. •

Family businesses would be wise to consider IRC Section 6166

It's true that because of the current record-high gift and estate tax exemption amount, most families don't have to worry about transfer taxes. However, there are high net worth individuals who must continue to work to reduce their estate tax liability. In fact, these taxes continue to place a burden on families with significant amounts of wealth tied up in illiquid closely held businesses.

A bit of good news: Internal Revenue Code Section 6166 provides relief, by allowing the estates of family business owners to defer estate taxes and pay them in installments if certain requirements are met.

What are the benefits?

For families with substantial closely held business interests, an election to defer estate taxes under Sec. 6166 can help them avoid having to sell business assets to pay estate taxes. It allows an estate to pay interest only (at modest rates) for four years and then to stretch out estate tax payments over 10 years in equal annual installments. The goal is to enable the estate to pay the taxes out of business earnings or otherwise to buy enough time to raise the necessary funds without disrupting business operations.

Be aware that deferral isn't available for the entire estate tax liability. Rather, it's limited to the amount of tax attributable to qualifying closely held business interests. For example, if the value of an interest in a closely held business were equal to 60% of the adjusted gross estate, 60% of the tax would be eligible for deferral. The remaining 40% would be payable within nine months after the deceased's date of death.

What are the requirements?

Estate tax deferral is available if:

1. The deceased was a U.S. citizen or resident who owned a closely held business at the time of his or her death,
2. The value of the deceased's interest in the business exceeds 35% of his or her adjusted gross estate, and
3. The estate's executor or other personal representative makes a Sec. 6166 election on a timely filed federal estate tax return.

Typically, the estate is required to provide security for future tax payments by furnishing a bond or allowing a tax lien to be filed against the business or other assets.

To qualify as a "closely held business," an entity must conduct an active trade or business at the time of the deceased's death. Only assets used to conduct that trade or business count toward the 35% threshold. Merely managing investment assets isn't enough. Distinguishing between an entity that conducts an active business and one that holds passive investments can be a challenge, particularly when it owns rental real estate. (See "Does Sec. 6166 apply to real estate businesses?")

In addition to conducting an active trade or business, a closely held business must be structured as:

- A sole proprietorship,
- A partnership (including certain limited liability companies taxed as partnerships), provided either 1) 20% or more of the entity's total capital interest is included in the deceased's estate, or 2) the entity has a maximum of 45 partners, or
- A corporation, provided either 1) 20% or more of the corporation's voting stock is included in the deceased's estate, or 2) the corporation has a maximum of 45 shareholders.

Several special rules make it easier to satisfy Sec. 6166's requirements. For example, if an estate holds interests in multiple closely held businesses, and owns at least 20% of each business, it may combine them and treat them as a single closely held business for purposes of the 35% threshold.

In addition, Sec. 6166 treats stock and partnership interests held by certain family members as owned by the deceased. That means the estate can count interests held by the deceased's spouse, siblings, ancestors and lineal descendants toward the 35% and 20% thresholds.

On the other hand, the interests owned by corporations, partnerships, estates and trusts are attributed to the underlying shareholders, partners or beneficiaries. This can make it harder to stay under the 45 partner/shareholder limit.

Does Sec. 6166 apply to real estate businesses?

When an entity owns rental real estate, the line between active business and passive investment can be blurred. To determine whether an entity is an active business entitled to the estate tax deferral benefits of Section 6166, the IRS examines four factors:

1. The amount of time the deceased or his or her employees, including the entity's employees, devote to the business,
2. Whether the entity maintains an office with regular business hours,
3. The extent to which the deceased or his or her employees provide services beyond the mere furnishing of leased premises (for example, landscaping or grounds care), and
4. The extent to which the deceased or his or her employees arrange, perform or supervise repairs and maintenance and handle tenant repair requests or complaints.

IRS guidance recognizes, however, that real estate businesses often engage third parties to handle day-to-day real estate activities. But using independent contractors doesn't prevent an entity from qualifying as an active trade or business, so long as its activities go beyond "merely holding investment property."

Can Sec. 6166 ease your family's estate tax liability?

A family business can be a source of great wealth. But if that business is illiquid, the estate tax burden on the surviving family members can be heavy. Using an estate tax deferral under Sec. 6166 can help you keep the business in the family after your death. •

QTIP trust

Strange name, powerful trust

Granted, a QTIP trust is an odd sounding name for an estate planning technique. Nevertheless, it can be a valuable strategy, especially if you're currently in a second marriage. The QTIP moniker is an acronym for the technical term of "qualified terminable interest property." Essentially, this trust provides future security for both a surviving spouse and children from a prior marriage, while retaining estate planning flexibility.

Notably, the federal estate tax due on QTIP trust assets is postponed until the death of the surviving spouse. At that time, his or her gift and estate tax exemption may shelter the remaining trust assets from tax.

A QTIP trust in action

Generally, a QTIP trust is created by the wealthier spouse, although sometimes both spouses will establish a corresponding trust. When the grantor dies, the surviving spouse assumes a "life estate" in the trust's assets. This provides the surviving spouse with the right to receive income from the trust, but he or she doesn't have ownership rights — thus, he or she can't sell or transfer the assets. Upon the death of the surviving spouse, the assets are passed to the final beneficiaries, who are typically the children from the grantor's first marriage.

Accordingly, you must designate the beneficiaries of the QTIP trust, as well as the trustee to manage the assets. This could be your spouse, adult child, close friend, or, as is often the case, a third-party professional.

A side benefit of establishing a QTIP trust is that it may alleviate family tensions. Your current spouse can relax, realizing that he or she will be taken care of. At the same time, your children from a prior marriage know that they won't be "cut out of the estate" by a stepparent who might turn against them or remarry.

Of course, a QTIP trust can't provide ironclad protection against family conflicts that may arise after your death. For instance, the parties may differ over the allocation of assets from an investment viewpoint. This is one of the reasons why it's often a good idea to appoint an independent professional trustee.

Ultimately, however, the decision is up to you. Talk things over with your spouse and children before you make any commitments.

Estate tax ramifications

A QTIP trust is designed to combine the estate tax benefits of the unlimited marital deduction and the gift and estate tax exemption. When you create the trust and provide a life estate to your spouse, the assets are sheltered from tax by the unlimited marital deduction after your death.

After your spouse passes, assets in the QTIP trust are subject to federal estate tax. However, the gift and estate tax exemption will likely shelter most estates from estate tax liability.

Planning flexibility

A QTIP trust can provide added flexibility to your estate plan. For example, at the time of your death your family's situation or the estate tax laws may have changed. The executor of your will can choose to not implement a QTIP trust if that makes the most sense. Otherwise, the executor makes a QTIP trust election on a federal estate tax return. (It's also possible to make a partial QTIP election.)

Once the election is made and the estate tax return is filed within nine months after the death (plus an additional six months if the executor obtains an extension), it's irrevocable. There's no going back.

Right for your plan?

If you wish to provide for your spouse after your death, but at the same time ensure that your children ultimately receive the inheritance you want to provide for them, a QTIP trust might be the right option. A QTIP trust may also be viable if you have concerns about transferring assets outright to your spouse. Contact your estate planning advisor to learn if a QTIP trust is right for you. •

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You didn't make specific references in a letter of instruction

A letter of instruction provides insights into the management of your affairs after your death. But the letter won't be of much help if it's vaguely written. Thus, you need to include specific references in your letter.

First, some background information. A letter of instruction is an informal document providing your loved ones with vital information about personal and financial matters to be addressed after your death. Be aware that this letter, unlike a valid will, isn't legally binding. However, in addition to identifying the location and nature of your possessions, it enables you to impart your final thoughts and wishes.

For instance, a letter of instruction will typically include particulars about funeral and burial arrangements. This can be helpful information for grieving family members. Specifically, consider mentioning whom you'd like to preside over the service, the setting and musical selections. If you want to be cremated rather than buried, state that in the letter.

However, if you're not specific, your expressions may be misinterpreted. If you indicate only that you wish music to be played at your funeral, your family may choose compositions you wouldn't have approved. Similarly, if you weren't raised in a particular faith, be clear about the religious aspects of the service.

The worst thing you can do is to create uncertainty among family members that could lead to discord. The bottom line: Say exactly what you mean and mean what you say. Of course, there are no guarantees that all your wishes will be fulfilled but writing them plainly in your letter improves the chances.

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