

# Insight on **estate planning**

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while keeping tax filing simple

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Meet two estate planning goals with a private annuity



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# Turbocharge your nest egg with a 412(i) plan

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s a business owner, you may be so busy building your company that you have little time to contemplate either estate planning or building a nest egg for retirement. Fortunately, there is a strategy that allows you to accomplish both objectives. By using a 412(i) plan, you may be able to dramatically increase the amount that you're permitted to contribute to a qualified retirement plan.

Although there are many retirement plan types available, if you want to turbocharge your savings, a 412(i) plan may be a solution. And as you build wealth outside of your company, you broaden your asset base and have more options from an estate planning perspective. For instance, as your nonbusiness assets increase, there is less likelihood you'll be forced to give shares of your business to heirs who aren't involved in — and who have little interest in ownership of — the business.



## Tune up your 412(i) knowledge

A 412(i) plan is a qualified plan that, like a 401(k) plan, takes its name from the Internal Revenue Code section from which it's derived. But unlike a 401(k), which is a defined *contribution* plan, a 412(i) is a defined *benefit* plan. Thus, it's designed to provide a specific benefit at retirement as opposed to the uncertainty of the amount of benefits a 401(k) will provide.

In the right situation, the 412(i) plan can be a powerful arrow in the defined benefit quiver. Why? Because you may contribute a significantly greater amount annually than with a defined contribution plan or even other defined benefit plans.

Any business type can create a 412(i) plan, but remember that the plan must be funded exclusively with life insurance or annuities guaranteed by insurance companies. The policies can be either individual or group, and the benefits need to be funded using level premiums that must end no later than the plan's retirement date. As with other retirement plans, annual contributions to 412(i) plans are fully deductible.

Contributions are based on the amount needed to fund the eventual retirement benefit and calculated actuarially. Like other defined benefit plans, one assumption is the rate of return that will be earned on the invested funds.

IRS rules provide the guidance that is used to determine the presumed rate of return on the plan's assets. They allow you to use the life insurance company's guaranteed rate instead of the IRS' prescribed rate. This is the component that turbocharges these types of plans because, in general, the insurance company's guaranteed rates are significantly lower than the rate that would otherwise be mandated. The contribution amount is a function of the return rate; the lower the presumed return the greater the contribution.

## Reassess your vehicle choice

Although a 412(i) plan can be a valuable tool for the right situation, it's certainly not for everyone. For example, a business with many employees — especially employees who aren't significantly younger than the



owner or other key employees — may find that a 412(i) plan is not viable. This is particularly true if the company is in less than solid financial shape, because a defined benefit plan may require significant annual contributions to maintain the benefit.

Bear in mind other factors when using a 412(i) plan. Defined benefit plans are, by their nature, more complex than most defined contribution plans. Thus, they are more expensive both to establish and to annually administer.

In addition, 412(i) plans are prohibited from having loan provisions, so you can't fund the contribution and then take a loan back from the plan. And you must be comfortable using insurance and annuity contracts to fund the plan because no other investments are permitted. Further, restrictions exist that may potentially impact your company's ability to deduct contributions to 412(i) plans.

Despite these drawbacks, a 412(i) plan's tax benefits may make it overwhelmingly attractive. Even when you make contributions for a nonowner employee, the cost of the contributions may be more than offset by your ability to make contributions that are greater than would otherwise be possible. Plus, the tax deductibility of the contributions may remove some of the bite.

Further, you'll appreciate an added bonus — creditor protection. The 412(i) plan, along with other types of qualified plans, allows you to transfer significant assets out of your company. Thus, company creditors will be unable to reach those funds. More important, your personal creditors will be similarly prevented from reaching the plan's assets.

### Enjoy the ride

A 412(i) plan may be the perfect vehicle to get you up to speed. Be sure, though, to seek professional guidance to set up and monitor your plan to help you avoid the pitfalls that reduce the plan's effectiveness.

This is particularly important in light of the fact that last year the IRS revised the rules in an effort to combat perceived (or actual) taxpayer 412(i) plan abuses.

And bear in mind the other benefit — while a 412(i) plan may be quite attractive as a retirement planning vehicle, it can allow you to reduce the percentage of your estate that is tied up in your business. This, in turn, can provide additional flexibility when it comes to estate planning that may allow you to distribute your estate in a manner that will be more beneficial to your heirs. ■

# To split or not to split assets with your spouse

## A joint revocable trust may be the solution

**T**ypically, estate planning for married couples includes using a credit shelter mechanism, which allows each spouse to transfer estate tax free the maximum amount of assets allowed by law. Generally, this involves each spouse having a revocable trust that mirrors the other's.



But what if you and your spouse are hesitant to split your assets for purposes of creating the trusts? Perhaps the idea of not owning everything jointly may be daunting.

Joint tenancy ownership of assets may work fine while you and your spouse are alive, but a trust arrangement could be

beneficial both during life and after each successive death. A joint revocable trust is one solution, especially if your joint assets are less than your combined lifetime exemption amounts. This trust type allows you to hold assets jointly while enjoying the benefits of the trust.

### The joint tenancy tax trap

Under joint tenancy, property is held so that each joint tenant has unrestricted access to

the funds. Sole ownership automatically vests in the surviving joint tenant at the death of the other joint tenant. If both spouses are U.S. citizens, there are no estate tax consequences because on transfer those assets are eligible for the marital deduction, which is unlimited. Thus, regardless of the size of the first spouse's estate, there will be no estate tax due as a result of that death.

The survivor then owns all of the assets outright, and the entire value of the assets is included in the survivor's estate at death. To the extent that the survivor's taxable estate exceeds his or her lifetime estate tax exemption, there will be estate tax liability. By owning their assets as joint tenants, the couple is forgoing the use of the lifetime exemption of the first spouse to die, which means unnecessary tax liability can be incurred up to \$1.5 million in 2005 — more as the scheduled increases in the estate tax exemption take effect.

For example, suppose Jim and Janice own their combined \$2 million estate in joint tenancy. On Jim's death, the assets pass to Janice and there is no estate tax liability. Janice now has a \$2 million estate, and after using her lifetime exemption of \$1.5 million, \$500,000 is subject to estate tax. Focusing just on federal estate tax, Janice's estate is liable for \$225,000.

### More joint tenancy traps

Unnecessary tax liability isn't the only joint tenancy trap. Keep in mind these additional pitfalls:

**Probate during life.** If there's an issue with the legal competence of the surviving spouse, the survivor's family must manage the assets on

the survivor's behalf. This may include petitioning the court for legal authority to act.

Even once the authority is granted, further proceedings may be required if the court wishes to monitor the person to whom it granted authority. In addition to being a time consuming and potentially costly process, probate proceedings are a matter of public record. Thus, to the extent there is interest, your neighbor or co-worker can learn personal information about your family member.

**Probate at death.** On the death of the second spouse, assets likely will have to go through probate before being distributed to an heir. Again, this can be time consuming and costly, in addition to being a matter of public record.

**Loss of control.** Once assets are distributed through the probate process, a beneficiary owns them outright. Except in cases of an heir not having attained the age of majority or being legally incompetent, there's nothing preventing the beneficiary from doing whatever he or she wants with the asset. This may be a concern if the beneficiary is young or irresponsible.

**Loss of asset protection.** In the same vein, once an heir acquires the assets, those assets are subject to the heir's creditors' claims. And, depending on the jurisdiction, the assets may be subject to the claims of his or her creditors in the event of a divorce.

So, even absent estate tax reasons, joint tenancy may be a less preferred method of holding assets.

### Joint revocable trust

During your and your spouse's joint life, holding assets in a joint revocable trust is virtually synonymous with holding them in joint tenancy — so long as you're both legally competent. But there are potentially significant differences on the first death and then again at the second death.

The largest difference is that, by using a joint revocable trust, you can protect the lifetime exemption amount of the first spouse to die.

## The step-up in basis advantage

A 2001 private letter ruling (PLR) helped to clarify concerns with drafting joint revocable trusts. The upshot of the PLR is that such vehicles are viable and, under the right circumstances, even allow for 100% of the property to be stepped up in basis at the death of the first spouse. This means that the base value of the assets when determining capital gains will be equal to the fair market value at the death of that spouse, not the value when the assets were acquired.

This is a better result than either holding property in joint tenancy or having separate trusts. On the death of the first spouse, in joint tenancy, only 50% of the basis would be stepped up, and, in a separate trust, only the assets held in the trust of the deceased spouse would be stepped up.

But be careful, because, although joint revocable trusts are preferable to joint tenancy in most circumstances, the step-up in basis benefit doesn't mean that such trusts are preferable to using separate trusts. If a married couple's combined estate exceeds their available combined lifetime exemption, the separate trusts would probably be preferred to joint revocable trusts because they avoid the concerns with respect to set-up and administration — specifically, the potential for the trust to be disregarded and the benefits lost.

For example, Jim and Janice will save \$225,000 for their heirs by creating a joint revocable trust. Why? Because the trust language provides a mechanism for using the lifetime exemption. Contrast this with the fact that they'd lose the benefit of the lifetime exemption with joint tenancy. But there also is the issue of the nontax differences.

By avoiding probate, you can keep matters private and save the expense and time of having the court system involved. And, if either you or your spouse becomes legally incompetent, the trust has administration

provisions. There would be a seamless transition, for example, to a successor trustee.

Further, a trust allows you the flexibility of keeping assets in trust for successive generations. Assets can be distributed only according to trust provisions. As a result, there's some control over how beneficiaries can use the assets, and the trust's funds can be protected from your heir's creditors.

### Use a joint revocable trust to your advantage

As with any tool, you must use a joint revocable trust properly for it to be beneficial. This means not only having it appropriately drafted but also understanding when it should *not* be used. If your estate situation fits the right parameters, the joint revocable trust may be right for you. ■

# Weigh your business structure

## A single-member LLC protects you from liability while keeping tax filing simple

**T**he limited liability company (LLC), and in particular the single-member LLC, is a relatively recent phenomenon. But don't confuse its relative newness with a lack of popularity. In fact, nearly every state has approved the use of single-member LLCs.



An LLC offers the advantages of an S corporation while avoiding its limitations. And single-member LLCs generally are treated like sole proprietorships, which means that they're not required to file separate income tax returns.

Thus, single-member LLCs can be the simplest form of liability protection and an excellent tool for preserving your estate.

### Factors favoring single-member LLCs

The key advantage a single-member LLC has over a sole proprietorship is in the area of asset protection. A sole proprietor has no separation between his or her personal assets and the company's assets. If the business

cannot meet its credit obligations, creditors can successfully go after the owner's personal assets.

By using a single-member LLC, a business owner can create a wall between his or her personal assets and the company's assets. Undoubtedly, major liabilities, such as mortgages and lines of credit, would not be protected by an LLC. Why? Because in those cases the lender likely required a personal guarantee from the LLC owner.

Similarly, in situations where a professional liability, such as malpractice, exists as a result of something the single-member has done, the LLC structure would not provide a shield. But, to the extent that there are business debts that have not been personally guaranteed by the owner, or liabilities solely related to the activities of the LLC, there would likely be no recourse beyond the LLC assets.

Further, to the extent a person owns multiple businesses or multiple rental properties, having each one in a separate LLC can insulate each from the liabilities of the other. For instance, by owning multiple properties in your own name you risk the possibility that a liability caused by one property can impact all of the other properties. This won't be the case if you have separate LLCs for each property.

The single-member LLC generally isn't required to be an individual. So, if a

corporation wanted to insulate its various entities, it could create single-member LLCs for each of those entities.

### Single-member LLCs and estate planning

From an estate planning perspective, the single-member LLC may be useful for many of the asset protection reasons — more from an estate preservation perspective.

The single-member LLC might not be useful for direct asset transfer purposes because, once you make a gift of less than the entire LLC interest, the LLC would no longer have just one member. Obviously, if that were to happen, the benefits of the single-member aspect of the LLC would be lost, but there would presumably be even more benefit gained because estate planning goals would be accomplished. In essence, you'd have made the decision to trade one benefit for another.

More likely, the single-member LLC would be used in conjunction with other strategies. For instance, if you create a general partnership to make gifts of business interests to family members, it may be advisable to have a single-member LLC, rather than have you act as the general partner. Thus, you'd avail yourself, through the use of the LLC, to asset protection benefits that would otherwise be unobtainable.

### Is a single-member LLC right for you?

A single-member LLC can be valuable both from an asset protection and estate preservation standpoint. By creating your business as a single-member LLC, you'll have the benefits of a general partnership and some of the benefits of a corporate structure, while enjoying the ease of administration of a sole proprietorship. ■

## Meet two estate planning goals with a private annuity

Perhaps you've wondered if there is a way to transfer an asset to a loved one and a) avoid gift and estate taxes and b) minimize capital gains tax on the transfer. Some strategies allow you to accomplish one or the other, but with a private annuity you may be able to meet both objectives.

A private annuity is an annuity agreement between two parties, neither of whom is a life insurance company. It lets you sell an asset to your heir in exchange for a promise by him or her to pay you an annuity for the remainder of your life or the remainder of your and your spouse's joint life.

As with any annuity, the expected payout period, based on the age of the annuitant (or ages of the annuitants), will affect the annual payment. So too will the prevailing Section 7520 rate. The benefit is that, at the death of the last surviving annuitant, there is nothing included in his or her estate and, thus, there is no estate tax liability on the property. The asset is, at that time, owned by the other party.

A key benefit of the annuity is that the annuitant is able to divest him- or herself of an asset that may be valuable but provides inadequate cash flow. For instance, you may own a nonrental real estate parcel. So long as the annuity is based on the true fair market value of the property, there will be no gift tax on the transaction. And, because the annuitant receives installments as opposed to a lump sum, the capital gain on the sale is spread over several years.

Every annuity payment consists of ordinary income, capital gain and nontaxable return of basis, at least until such time as the entire basis in the property has been recovered. The specific allocation of each payment is determined by a formula based on the deferred capital gain and the total expected payments. Once the entire basis has been paid, the remaining payments are taxed as ordinary income.

# Personal Legal Services Group



**Joseph A. Bonventre** has substantial experience advising individuals on estate planning, charitable planning, business planning, retirement planning, probate, post-mortem trust administration and related tax matters. Mr. Bonventre is a Fellow of the American College of Trust and Estate Counsel and a Fellow of the American College of Tax Counsel. There are only a handful of attorneys throughout the United States who are Fellows of both organizations. Fellows are selected on the basis

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