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Stretch out estate tax on business interests

If you're like many small business owners, it has taken years, and probably decades, to build a successful operation. Naturally, you hope that the business continues long after you're gone, especially if you've brought children or other family members into the fold. But that's not always the reality.

Frequently, heirs of successful entrepreneurs are forced to sell off business interests at "fire sale" prices to help pay a federal estate tax bill. The current top estate tax rate of 40% is triggered after applying the gift and estate tax exemption of $5.49 million. For example, absent other factors, if the taxable portion of a business interest amounts to $5 million, the estate owes a staggering $2 million (40% of $5 million) in tax.

Could this happen to your business? You can minimize the chances by taking some preemptive steps, including providing instructions for making a special election under Internal Revenue Code Section 6166.

How Sec. 6166 works

Sec. 6166 allows heirs to stretch out estate tax payments over time. Specifically, assuming certain conditions are met, the executor of the estate can elect to postpone any payment for five years before taking another 10 years to meet the tax obligations in equal annual installments. (This 15-year deferral is actually 14 years long because of the way payment due dates are structured.)

Thus, by buying extra time with the election, your family may be able to avoid a distress sale. However, this tax break isn't automatically available. To qualify, three requirements must be met:

1. The deceased must have been a U.S. citizen or resident at death.
2. An interest in a closely held business must compose more than 35% of the deceased's adjusted gross estate.
3. The election must be made by the estate's personal representative on an estate tax return filed in a timely manner.

The calculation of the 35% test is based on subtracting from the gross estate certain

More life in life insurance

Regardless of whether your estate benefits from Section 6166, it may be advisable to secure additional life insurance coverage. This could be the easiest and most cost-efficient method for ensuring that your family will continue to operate your business after your death.

Not only does life insurance provide liquidity to pay estate tax immediately or through annual installments, but the proceeds won't be included in your taxable estate if you make the necessary arrangements. Essentially, you can't retain any ownership rights under the policy. For most business owners, this is a small price to pay for peace of mind.

deductions, such as debts, funeral expenses, administration costs, mortgages and liens. However, these deductions are taken into account prior to applying any available charitable and marital estate tax deductions.

Moreover, the closely held business interest must qualify as an active trade or business. If the business is a passive activity, the value of passive assets must be removed before it can be determined if the value exceeds 35% of the adjusted gross estate.

> *Under Sec. 6166, an executor of the estate can elect to postpone any payment for five years before taking another 10 years to meet the tax obligations in equal annual installments.*

Be aware that this estate tax deferral break isn't limited to sole shareholders of C corporations. It's also available for sole proprietors; partners with an interest of 20% or more in the partnership or with an interest in a partnership that has no more than 45 partners; and corporate stockholders owning 20% or more of the voting stock, or owning stock in a corporation with no more than 45 shareholders.

Other factors in play

If you intend for Sec. 6166 to be elected, be wary of certain actions that will accelerate payment of all the unpaid tax that has been deferred. For instance, payments may be accelerated because of sales, exchanges or other dispositions of 50% or more of the deceased's interest. On the other hand, if the business redeems shares to pay for estate tax, funeral expenses and administrative expenses, this redemption won't cause an acceleration.

Finally, there's one more catch: Interest must be paid annually on the unpaid portion of the tax. However, the estate pays only 2% interest on the tax attributable to the first $1 million of the business interest. The interest rate for tax underpayments applies to any amount above the $1 million threshold, subject to inflation indexing. The threshold for 2017 is $1.49 million.

Don't try this at home

Bear in mind that this technique is complex. Meet with your estate planning advisor to determine the availability of the Sec. 6166 election. This election should be coordinated with other aspects of your estate plan. •

Maintaining family harmony

Balance beneficiaries' needs with a total return unitrust

A traditional trust can sometimes create a conflict among the lifetime and remainder beneficiaries. This makes it more difficult for your estate plan to achieve its objectives and places your trustee in a difficult position. A total return unitrust (TRU) may offer a solution.

What are the trustee's challenges?

When a trust is designed to provide benefits for two classes of beneficiaries, often in different generations, it presents a difficult challenge for the trustee. Consider this example: Adam's will establishes a trust that pays all of its income to his wife, Kristen, for life (the "lifetime beneficiary"), and then divides the trust assets equally among his three children from his first marriage (the "remainder beneficiaries"). The trust names Adam's friend, Roger, as trustee. Kristen outlives Adam by 10 years.

Roger has a fiduciary duty to act in the best interests of all the beneficiaries, but traditional trust design makes it difficult for him to be impartial. Suppose Adam leaves $2 million to the trust. To provide Kristen with a steady income stream, Roger places the trust assets in fixed-income investments that generate a 5% return. Kristen receives income of $100,000 per year, and when she dies the trust's principal — still $2 million — is distributed to Adam's children. Not a bad inheritance, but its value has been eroded by 10 years of inflation.

Suppose, instead, that Roger invests the trust assets in growth stocks that earn a 9% annual return. Ten years later, the trust's value has appreciated to more than $4.7 million. That's good news for Adam's children, but this approach likely generates little or no income for Kristen.

In an effort to make everyone happy, Roger compromises: He invests half of the assets in growth stocks and the other half in fixed-income vehicles. The $1 million in fixed-income investments generates $50,000 per year for Kristen, and at the end of the trust term the principal is just under $2.7 million.

How can a TRU help?

The advantage of a TRU is that it frees the trustee to employ investment strategies that maximize growth (total return) for the remainder beneficiaries without depriving lifetime beneficiaries of income. Rather than pay out its income to the lifetime beneficiary, a TRU pays out a fixed percentage (typically between 3% and 5%) of the trust's value, recalculated annually, regardless of the trust's earnings.

Going back to our previous example, suppose Adam's trust is designed as a TRU that makes an annual payout to Kristen equal to 3.5% of the trust's value, recalculated annually. Roger, relieved of the duty to generate income for Kristen, invests all of the trust assets in a diversified portfolio of growth stocks that yield a 9% annual return. Kristen's payments from the trust start at $70,000 and grow steadily over the trust's term, reaching more than $113,000 by year 10.

At the same time, the value of the trust principal grows to more than $3.4 million, which is distributed to Adam's children at the end of year 10. Thus, the lifetime beneficiary and the remainder beneficiaries are better off with a TRU than they would have been under the compromise approach described earlier.

Can you convert an existing trust into a TRU?

If you're concerned that an existing, irrevocable, income-only trust may be unfair to certain beneficiaries, it may be possible to convert it into a TRU. In order to do so, however, such a conversion must be permitted by applicable state law.

An IRS private letter ruling clarifies that converting a trust into a TRU according to state law shouldn't have any negative tax implications. It doesn't cause the trust to lose its grandfathered status for generation-skipping transfer (GST) tax purposes. (For example, GST tax doesn't apply to irrevocable trusts in existence on Sept. 25, 1985, so long as no additions, actual or constructive, are made to the trust after that date.)

Issues to consider when creating a TRU

If you're considering implementing a TRU, it's important to plan carefully. Ask a financial advisor to project the benefits your beneficiaries will enjoy under various scenarios, including different payout rates, investment strategies and market conditions. Keep in mind that, for a TRU to be effective, it must produce returns

that outperform the payout rate, so don't set the rate too high.

Be sure to investigate your state's trust laws. Some states disallow TRUs. Also, many states establish payout rates (or ranges of permissible rates) for TRUs, so your flexibility in designing a TRU may be limited. Finally, if a trust is required to pay out all of its income to a current beneficiary, be sure that unitrust payouts will satisfy the definition of "income" under applicable state and federal law.

Is a TRU right for you?

By aligning your beneficiaries' interests, a TRU can relieve tension among your loved ones and allow your trustee to concentrate on developing the most effective investment strategy. Contact your estate planning advisor to learn whether a TRU is right for your family's situation. •

Is a donor-advised fund right for you?

Do you make sizable gifts to charitable causes? If you're fortunate enough to afford it, you can realize personal rewards from your generosity and claim a deduction on your tax return. But once you turn over the money or assets, you generally have no further say on how they're used.

You can exercise greater control over your charitable endeavors using a donor-advised fund (DAF). According to the National Philanthropic Trust (NPT), a nationwide public charity, this has become the fastest-growing charitable vehicle in the country in recent years, with no signs of the trend abating.

Setting up a DAF

As the name implies, your recommendations are integral to a DAF. First, you contribute to a fund typically managed by an independent sponsoring organization or an arm of a reputable financial institution. The minimum contribution generally is $5,000. In exchange for handling the management of the fund, the financial institution or organization usually charges an administrative fee based on a percentage of the deposit.

Next, you make recommendations to the fund about how to dole out the money to your favorite charities. Though technically you no longer have control of the money that has been contributed, the fund administrator will generally follow your advice. While you're deciding which charities to support, your contribution is invested and grows tax-free. Then, your charitable choices are vetted by the organization to ensure that the recipients are qualified charitable organizations. Finally, the administrator cuts the checks and the funds are distributed to the charities.

Although contributions to a DAF are often made in cash, publicly traded securities are also readily accepted. In fact, other assets, such as real estate and closely held business interests, may also be contributed.

DAF pros and cons

Here are the advantages and disadvantages of using a DAF:

Immediate tax deduction. Your contribution to the DAF is deductible in the tax year in which the initial contribution is made. You don't have to wait until the fund makes distributions to the designated recipient.

Convenience. It's easy to establish and contribute to the fund. All the administrative duties and paperwork are handled for you.

Simplicity. You only have to keep track of a single contribution, as opposed to multiple donations to several charities.

No capital gains tax. If you contribute appreciated property such as securities, there's no capital gains tax on the appreciation in value. It remains untaxed forever.

No estate tax. Contributions to a DAF aren't subject to estate tax or the probate process.

Tax-free growth. The amounts contributed to the fund are invested and can grow without any tax erosion.

Security. Using a DAF ensures that money becomes available only to legitimate charities.

Anonymity. If you prefer, distributions can be made to charities anonymously. Alternatively, if you don't mind the limelight, you can name the fund after your family.

Conversely, despite some misconceptions, contributors to DAFs have effectively no control over how the money is spent once it's disbursed to charities. Donors can't benefit personally. For instance, you can't direct that the money be used to buy tickets to a local fundraiser. In addition, detractors have complained about high administrative fees.

Naturally, the basic tax rules relating to charitable contributions continue to apply.

For example, monetary contributions generally are deductible in full, but the amount you can claim each year is limited to 50% of your adjusted gross income (AGI). Your deduction for donations of appreciated property may be based on the property's fair market value if you owned it longer than one year. But the annual deduction limit for such gifts is 30% of AGI. Finally, certain itemized deductions, including those for charitable donations, are reduced for upper-income taxpayers.

Do your homework

If you believe a DAF is the right charitable funding vehicle for you, be sure to shop around. Fund requirements — such as minimum contributions, minimum grant amounts and investment options — vary from fund to fund, as do the fees they charge. So work with your estate planning advisor to find a fund that meets your needs. •

ESTATE PLANNING PITFALL

You've videotaped your will

You've probably seen it on TV shows or in movies: A videotape of a will is shown to members of a squabbling family. The deceased, who likely owns a small fortune, reads aloud from a document containing his or her wishes or simply speaks from the heart. Typically, this video reveals a hidden agenda or unexpectedly cuts a family member out of the will. It makes for good entertainment. But the question remains: Are videotaped wills legally binding? The answer is, essentially, "no."

Technology enables the deceased person to express wishes to the assembled family from beyond the grave, but states generally require wills to be physical documents that are written, signed and properly witnessed during a person's lifetime. By itself, a videotape isn't a legally valid substitute for a will. To avoid intestacy, the deceased must have supplied a physical copy of a will. If this document otherwise meets state requirements, it may be supplemented by a video.

However, a videotaped will can still be used to show that the deceased was of sound mind and competent at the time the will was created. Thus, it could prove useful in settling court challenges, including ones by disgruntled family members.

The best approach is to contact an experienced attorney to help you draft a will that meets your personal needs. At a minimum, the will should provide for distribution of assets, establish guardianship of young children and name the executor to handle the estate. Review the will periodically to ensure that it remains up to date. If you then want to supplement the will with a videotape, go right ahead. Just don't rely on this video exclusively.

Clark Hill Personal Legal Services Group

Thomas M. Dixon specializes in litigating cases involving wills, trusts, and probate estates. Tom has substantial experience with will and trust contests and related litigation involving claims of undue influence, lack of testamentary capacity, fraud, and duress.

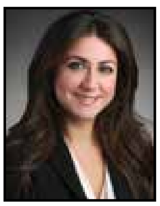
Tel: (313) 965-8587 • Fax: (313) 309-6887
Email: tdixon@clarkhill.com

Thomas E.F. Fabbri is an Associate in the Personal Legal Service Group of Clark Hill's Birmingham office and concentrates his practice in estate planning, tax planning, and probate matters.

Tel: (248) 988-5856 • Fax: (248) 988-2319
Email: tfabbri@clarkhill.com

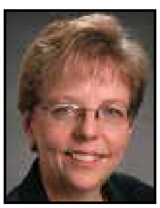
Ryan M. Holmes focuses his practice on estate and trust planning and administration, estate planning for digital assets, special needs planning and administration, income, gift, generational and estate tax planning, probate and guardianship administration, and probate, trust and guardianship litigation.

Tel: (312) 985-5918 • Fax: (312) 985-5594
Email: rholmes@clarkhill.com



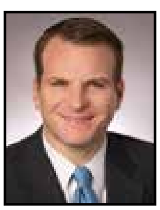
Mallory A. Kallabat is an Associate with the firm's Personal Legal Services Practice Group of Clark Hill's Birmingham office. She focuses her practice on estate planning, tax planning and probate matters.

Tel: (248) 530-6342 • Fax: (248) 988-2307
Email: mkallabat@clarkhill.com



Andrea M. Kanski's estate planning background includes analysis and development of tax and estate planning strategies consistent with the objectives of the individual and his/her family, including closely held, family-owned businesses. She has extensive trust administration experience and probate experience with both supervised and informal proceedings involving deceased estates, guardianships and conservatorships.

Tel: (313) 965-8589 • Fax: (313) 965-8252
Email: akanski@clarkhill.com

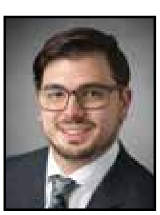


Ray J. Koenig III practices in the areas of probate litigation, trust litigation, fiduciary litigation, elder law, estate planning, and estate administration, with an emphasis on will, trust, guardianship, and advance directive contests and other fiduciary litigation. Ray has represented individuals, families, financial institutions, medical institutions and governmental organizations in all areas of his practice. Ray has extensive trial, appellate and mediation experience in state and federal courts.

Tel: (312) 985-5938 • Fax (312) 985-5999
Email: rkoenig@clarkhill.com

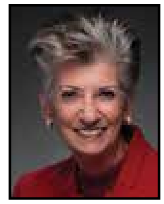
J. Thomas MacFarlane specializes in estate, tax and business succession planning and in probate matters. He is a Fellow of the American College of Trust and Estate Counsel, and he is listed in *The Best Lawyers in America*, *Michigan Super Lawyers* and *Michigan Leading Lawyers*.

Tel: (248) 988-5846 • Fax: (248) 642-2174
Email: jmacfarlane@clarkhill.com



Nicholas E. Papasifakis is an Associate in Clark Hill's Personal Legal Services Group in Birmingham, Michigan. Nick focuses his practice on estate, tax and business succession planning, and probate and trust administration and litigation.

Tel: (248) 530-9132 • Fax: (248) 530-9170
Email: npapasifakis@clarkhill.com



Darra L. Rayndon, a Member in Clark Hill's Estate Planning & Probate Practice Group, has over 30 years of practice experience and is certified as a tax specialist by the Arizona Bar. Darra's work includes tax planning, business entity formation and representation including corporations, partnerships, limited liability companies, and other businesses, estate and wealth succession planning, asset protection, exempt private offerings, and real estate matters.

Tel: (480) 822-6746 • Fax: (480) 684-1170
Email: drayndon@clarkhill.com

Heather C. Stumpf is an Associate in the firm's Estates and Trusts Practice Group. She focuses her practice on all aspects of estate and trust planning and administration. Heather advises her clients on the various complexities of estate and trust documents, including special and supplemental needs trust provisions, tax planning implications and the division of assets. She utilizes her experience acting as a corporate fiduciary to support individuals and families with retirement planning and multi-generational wealth transfer.

Tel: (412) 394-2485 • Fax: 412-394-2555
Email: hstumpf@clarkhill.com

Thomas F. Sweeney is very experienced in the planning, administering and dispute resolution of trusts and estates, business planning and the taxation of trusts, estates and gifts. He is a frequent writer and speaker for ICLE. Thomas is an adjunct tax professor at Wayne State Law School and he is listed in *The Best Lawyers in America*.

Tel: (248) 988-5867 • Fax: (248) 642-2174
Email: tsweeney@clarkhill.com

Steven J. Tjapkes, previously a veterinarian in private practice, works with family businesses, family farms, and agribusiness to meet the challenges of transferring family assets to the next generation. Steven lectures on estate administration and on buying and selling business assets.

Tel: (616) 608-1111 • Fax: (616) 608-1199
Email: stjapkes@clarkhill.com

Michelle Margolies Tran, Senior Counsel in Clark Hill's Estate Planning and Probate Practice Group, focuses her practice in the areas of sophisticated estate and tax planning for individuals, families, and businesses, using trusts and business entities to help her clients achieve their asset succession, estate tax reduction, and asset protection goals. She also assists her clients in the creation of business entities and business transfers, complex trust and estate administration, probate, prenuptial agreements, and QDROs.

Tel: (480) 822-6745 • Fax: (480) 684-1169
Email: mtran@clarkhill.com

Keith H. West is a Member with Clark Hill's Personal Legal Services practice group, has been involved in all facets of estate planning and estate administration for over 25 years. While in law school, Keith received the American Jurisprudence awards in estate planning and conflicts of law. In 2005, 2006 and 2011, Keith was named a Pennsylvania Super Lawyer, an honor bestowed upon the top five percent of Pennsylvania lawyers.

Tel: (412) 394-7756 • Fax (412) 394-2555
Email: kwest@clarkhill.com