The Estate Planner

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Your estate plan doesn't contain a no-contest clause

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Donating life insurance

Turbocharge your charitable gifts

If philanthropy is one of your goals, donating your life insurance policy to charity can be a powerful strategy. It allows you to make larger gifts than you might otherwise afford, while generating current tax benefits.

Whether this strategy is right for you depends on your specific circumstances and your family's financial situation. It's also important to understand the tax implications of a charitable gift of life insurance.

A versatile tool

Life insurance can be a versatile financial planning tool. It provides a significant source of wealth for a relatively modest investment and creates instant liquidity your family can use to pay estate taxes or other expenses.

In addition to death benefits, permanent life insurance policies — such as whole, variable or universal policies — allow you to build substantial cash values on a tax-deferred basis. You can withdraw or borrow against these funds to provide a source of retirement income or to meet other needs (keeping in mind that this may reduce the death benefit paid to your beneficiaries).

Have you reached a point in your life where you no longer need life insurance? Perhaps your children are financially independent and your IRAs, 401(k)s or other savings are more than sufficient to meet your retirement needs. Under these circumstances, donating life insurance to charity may be an attractive option.

Consider Phil, for example. He's a 60-year-old widower with two children, both of whom are finished with college and gainfully employed. He has substantial savings in an IRA and his company's retirement plan, but continues to pay premiums of $10,000 per year on a $1 million life insurance policy. The policy's cash surrender value is $400,000, and Phil's cost basis in the policy, based on premiums paid, is $200,000. If he simply surrenders the policy in exchange for its cash value, he'll recognize $200,000 in ordinary income.

In a meeting with his financial advisor, Phil expresses an interest in giving more to charity. The advisor explains how Phil can accomplish this goal, while actually *improving* his cash flow, by donating his life insurance policy. Phil would enjoy a charitable income tax deduction for the initial donation as well as for any premiums he pays in the future. And when Phil dies, the charity would receive a $1 million gift.

Tax considerations

The most tax-effective way to donate life insurance is to transfer the policy so that the charity becomes the owner and beneficiary. You're entitled to an immediate charitable deduction for income tax purposes. If you continue to pay the premiums, each payment is also a deductible charitable donation.

In addition, the policy is removed from your estate, which can mean significant estate tax savings. (Even though, as of this writing, an estate tax repeal is in effect for 2010, the estate tax is scheduled to return in 2011. Plus the repeal may be repealed. Check with your estate planning advisor for the latest information.)

You may be surprised to learn that you can't necessarily deduct the policy's face value or cash surrender value; rather, the deduction is limited to the policy's fair market value or your cost basis, *whichever is less*. Determining a policy's fair market value is complex, requiring consideration of factors such as the policy's cash surrender value, the cost of purchasing a comparable policy and the insurer's actuarially calculated reserves.

> *The most tax-effective way to donate life insurance is to transfer the policy so that the charity becomes the owner and beneficiary.*

Cost basis generally means the total amount of premiums you've paid on the policy (less any dividends received). In our previous example, assuming that the policy's fair market value is roughly equal to its cash surrender value, Phil would be entitled to a $200,000 charitable deduction.

Other options

Donating a life insurance policy to charity outright is just one potential strategy for leveraging unneeded life insurance to achieve your philanthropic goals. Others include:

Charitable gift annuities. Exchanging a life insurance policy for a charitable gift annuity allows you to deduct the value of the benefit received by the charity while retaining an income stream for the rest of your life. Typically, the annuity payments consist of a combination of ordinary income and tax-free return of basis.

Wealth replacement. You can use other assets to make charitable gifts and to hold on to the life insurance policy to replace that wealth. By using other assets to fund a charitable remainder trust or similar vehicle, you can generate current income to pay the insurance premiums or for other purposes.

Income tax charitable deductions for donated life insurance policies (as well as future premium payments) generally are limited to 50% of your adjusted gross income (30% for gifts to a nonoperating private foundation), though excess deductions can be carried forward for up to five years. Deductions for noncash gifts in excess of $5,000 must also be supported by a qualified appraisal.

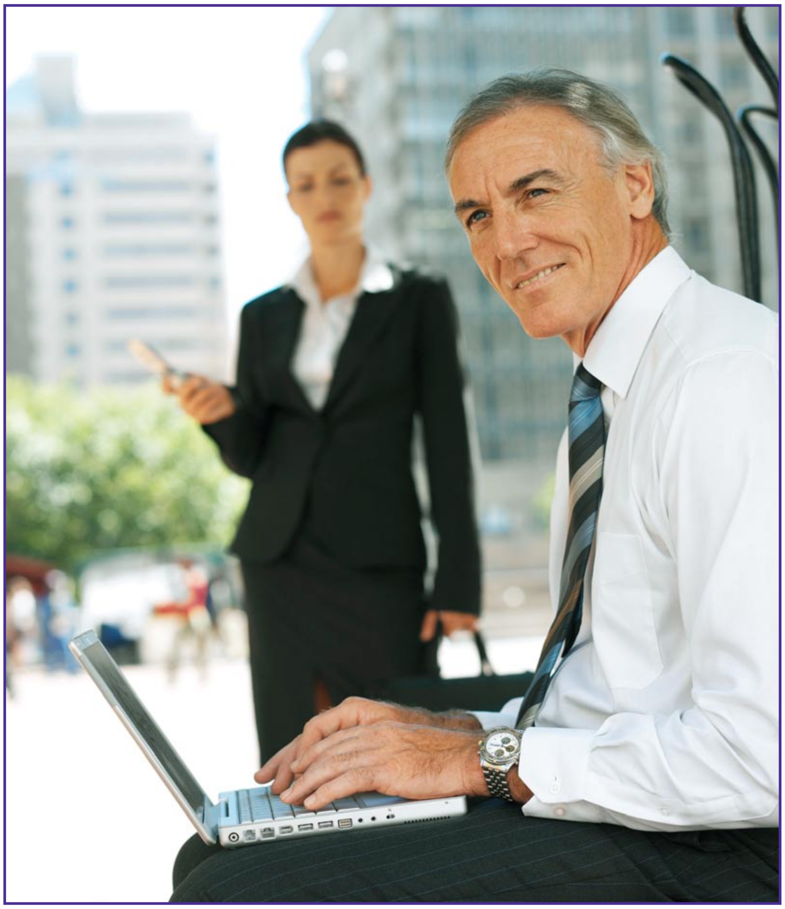
There are several other life insurance strategies that can help you satisfy your philanthropic desires while preserving some benefits for yourself. See "Other options" above for more information.

Review your finances

Donating a life insurance policy to charity can be a smart move under the right circumstances. By working with your advisors to review your family's financial situation, you can determine whether your needs would be best served by a charitable donation. ✤

Estate planning for digital assets

In an increasingly paperless world, we live much of our lives online. We conduct business online, we communicate electronically and we manage our finances through e-mail and Web sites. As a result, most people today have accumulated significant "digital assets" that require special consideration in your estate plan.



No paper trail

When a person dies, one of the first things his or her executor or family members must do is get a handle on assets and liabilities. In a paper-based world, that generally means sifting through the deceased's mail, desk drawers and filing cabinets to look for tax returns, bank and brokerage account statements, bills, check registers, and loan documents.

In a digital world, however, it's not unusual for people to conduct many of these transactions online, in many cases leaving no paper trail at all. Many people receive statements by e-mail, receive and pay bills using online services, and use programs like Quicken® to track and reconcile their bank accounts and other financial records.

Without careful planning, it may be difficult or even impossible for your representatives or loved ones to locate your assets or identify your creditors. And even if they do, they won't be able to gain access to or manage your accounts without your user name, password and other security information (at least not without following time-consuming procedures or seeking a court order).

What if deposits are made to your accounts automatically, or if bills are automatically debited from your accounts? How will your representatives find out about these transactions so that they can settle your financial affairs?

Creating a record

To ensure that none of your digital assets or debts fall through the cracks, it's critical to create a detailed record of these items, including Web addresses, account numbers, user names, passwords and other security information one might need to access and manage your accounts.

Your record should include e-mail accounts you use to receive statements or other financial information. If you use an online bill paying service, list creditors that you pay through the service, especially those whose bills are automatically debited from your bank account.

After you create your list, the question becomes, "What do I do with it?" Leaving a copy at home or in your office could be risky because of the possibility that someone could steal the list and use your username and passwords for nefarious reasons.

You could store the list on your computer in a password-protected file — or use an "electronic wallet" program that stores passwords and other sensitive information. Of course, you'd need to give the master password to a family member or some other trusted person, something you may not be ready to do. Plus, if the computer is stolen or the hard drive crashes, the information may be lost.

Another option is to keep the list in a safe deposit box. But this can be inconvenient if you follow recommended security practices, including changing your passwords regularly.

Not surprisingly, several companies have developed online solutions to this problem. Sometimes referred to as "virtual safe deposit boxes," these services store all of your user names, passwords and other electronic data on a secure Web site in an escrow-like arrangement. They can also store digital copies of important paper documents, such as insurance policies, wills, trusts, deeds and mortgages.

After you die, your designated representatives can retrieve the information, typically by presenting identification and a death certificate.

Ease the pain during a difficult time

Documenting your digital assets relieves your family of the difficult and often impossible task of tracking down these assets themselves during an already difficult time. Ask your estate planning advisor about whether a virtual safe deposit box makes sense for your situation. ✤

Ready to buy a new home?

If so, consider using a joint purchase to ease estate tax liability

You've found the perfect property on which to settle down and enjoy your golden years. You know you'll eventually want to pass the home on to your adult children, but you wish to do so with as little estate tax liability as possible. One technique — and a relatively simple one at that — is a joint purchase.

Current and remainder interests

The joint purchase technique is based on the concept that property can be divided not only into pieces, but also over time. One person (typically of an older generation) buys a current interest in the property and the other person (typically of a younger generation) buys the remainder interest.

A remainder interest is simply the right to enjoy the property after the current interest ends. If the current interest is a life interest, the remainder interest begins when the owner of the current interest dies.

Joint purchases offer several advantages. The older owner enjoys the property for life, and his or her purchase price is reduced by the value of the remainder interest. The younger owner pays only a fraction of the property's current value and receives the entire property when the older owner dies.

Best of all, if both owners pay fair market value for their respective interests, the transfer from one generation to the next should be free of gift and estate taxes. (Note that even though, as of this writing, an

estate tax repeal is in effect for 2010, the estate tax is scheduled to return in 2011. Plus the repeal may be repealed. Check with your estate planning advisor for the latest information.)

The relative values of the life and remainder interests are determined using IRS tables that take into account the age of the life-interest holder and the applicable federal rate (the Section 7520 rate), which is set monthly by the federal government.

An exception to the rule

At one time, the joint purchase was a popular way for parents to leave all types of property to their children — from securities to rental real estate — without transfer taxes. But in 1990, Congress, concerned about the potential for abuse, eliminated the tax advantages for most joint purchases.

Internal Revenue Code Sec. 2702 provides that, when members of the same family acquire a split interest in property, the owner of the current interest is treated as if he or she acquired the entire property and then transferred it to the owner of the remainder interest. In other words, the entire purchase price is treated as a taxable gift.

But there's an exception for a joint purchase of a home. As long as the owner of the current interest uses the property as his or her "personal" residence (that is, as a principal or second home), the transaction is exempt from gift tax.

For purposes of Sec. 2702, the definition of "family members" is quite limited — it includes only your spouse, your and your spouse's ancestors and descendants and their spouses, and your and your spouse's siblings and their spouses. The definition *doesn't* include the descendants of your siblings.

The joint purchase technique is based on the concept that property can be divided not only into pieces, but also over time.

Consider the downsides

Like many estate planning vehicles, joint purchases have disadvantages. The younger owner must buy the remainder interest with his or her own funds. Also, while the tax basis of inherited property is "stepped up" to its date-of-death value, a remainder interest holder's basis is equal to his or her purchase price.

But, in most cases, the estate tax savings far outweigh any capital gains tax liability. That's because the highest capital gains rate generally is significantly lower than the highest estate tax rate.

For example, in 2009 the top long-term capital gains rate was 15%, and the top estate tax rate was 45%. Without Congressional action, in 2011 both rates are scheduled to go up, but the capital gains rate (20%) would still be much lower than the estate tax rate (55%) — in fact, the difference between the two rates would be even greater than in 2009.

Keep it simple

In a world where many estate planning techniques can be complicated, a joint purchase isn't. Of course, that doesn't mean you should move forward with one without first consulting with your estate planning advisor. He or she can assess your situation to determine if a joint purchase is right for you. ✤

Estate Planning Red Flag

Your estate plan doesn't contain a no-contest clause

It's not uncommon for heirs to contest the terms of wills and living trusts. Litigation over the validity of a will or trust can disrupt your estate plan and create unnecessary expense and delay for your family.

A no-contest clause can help prevent such disruptions. Essentially, a no-contest clause threatens to disinherit a beneficiary who unsuccessfully challenges your will or trust. Generally, the only people who can contest your plan are those who, under applicable state law, would have received a share of your estate in the absence of a will or trust. Grounds for challenge include lack of testamentary capacity and undue influence.

Keep in mind that a no-contest clause is ineffective against heirs you've disinherited, because they have nothing to lose by contesting your plan. If an heir has fallen out of favor, a better approach is to leave him or her an amount substantial enough to discourage frivolous claims.

Most states permit no-contest clauses in some form, though in at least one state — Florida — they're unenforceable. Even in states where they're allowed, no-contest clauses must be worded precisely to achieve the desired result and may be limited to specific types of challenges.

Even in Florida, it pays to include a no-contest clause in your will or trust because:

- You might own real estate or other assets in states where no-contest clauses are enforceable,
- Florida permits trusts to specify that they're governed by the laws of another state, and
- You might move to a state that allows no-contest clauses.

A no-contest clause provides an extra layer of protection against challenges to your estate plan. But the most effective way to avoid litigation is to communicate with your heirs to make sure they understand your motives.

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- A high level of quality, sophistication, and experience.
- A creative and imaginative approach that focuses on finding solutions, not problems.
- Accessible attorneys who give clients priority treatment and extraordinary service.
- Effectiveness at a fair price.

Since 1925, Shumaker has met the expectations of clients that require this level of service. Our firm offers a comprehensive package of quality, experience, value and responsiveness with an uncompromising commitment to servicing the legal needs of every client. That's been our tradition and remains our constant goal. This is what sets us apart.

Estate planning is a complex task that often involves related areas of law, as well as various types of financial services. Our clients frequently face complicated real estate, tax, corporate and pension planning issues that significantly impact their estate plans. So our attorneys work with accountants, financial planners and other advisors to develop and implement strategies that help achieve our clients' diverse goals.

Shumaker has extensive experience in estate planning and related areas, such as business succession, insurance, asset protection and charitable giving planning. The skills of our estate planners and their ability to draw upon the expertise of specialists in other departments — as well as other professionals — ensure that each of our clients has a comprehensive, effective estate plan tailored to his or her particular needs and wishes.

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We welcome the opportunity to discuss your situation and provide the services required to help you achieve your estate planning goals. Please call us today and let us know how we can be of assistance.

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