

# The ESTATE PLANNER

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## BUSINESS-OWNED LIFE INSURANCE: HANDLE WITH CARE

### PROTECTING WHAT'S YOURS

An offshore trust may be the answer  
to your asset protection needs

### HAVE YOU CONSIDERED A SOCIAL SECURITY "DO-OVER?"

#### ESTATE PLANNING RED FLAG

You're leaving your IRA to a child

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# BUSINESS-OWNED LIFE INSURANCE: HANDLE WITH CARE

*B*usiness-owned life insurance (BOLI) serves a number of legitimate purposes, including succession and estate planning. A big advantage of using life insurance is that the proceeds typically are tax free. But there have been abuses, particularly by large companies that purchased insurance on the lives of lower-level employees, often without their knowledge. Indignation over these so-called “janitor policies” led Congress to add Section 101(j) to the Internal Revenue Code (IRC) as part of the Pension Protection Act of 2006 (PPA).

Even though this provision is intended to prevent abusive employment practices, it’s broad enough to encompass life insurance used to fund a buy-sell agreement or for other estate planning purposes. So if your business owns or plans to purchase

policies on the lives of key employees (including owners), it’s critical to comply with Sec. 101(j) to avoid unintended — and potentially disastrous — tax consequences.

*Sec. 101(j) establishes a general rule that BOLI proceeds are taxable (to the extent they exceed the employer’s basis in the policy).*

## WHAT DOES SEC. 101(J) DO?

Sec. 101(j) establishes a general rule that BOLI proceeds are taxable (to the extent they exceed the employer’s basis in the policy). However, it does provide two exceptions. The first exception is for certain owner/employees and highly compensated executives. Unlike rank-and-file employees, the business has a legitimate “insurable interest” in these employees.

The second exception is for BOLI used for certain succession or estate planning purposes. Provided a business meets the notice and consent requirements, the insurance proceeds won’t be taxable if they’re 1) paid to the insured employee’s estate or heirs (or a trust for their benefit) or 2) used to purchase an ownership interest in the business from the insured’s estate or heirs. Under IRS guidance issued in 2009, the ownership interest must be acquired no later than the due date, including extensions, of the company’s income tax return for the taxable year in which the death benefit is paid.



## BOLI and the company's tax return

The Pension Protection Act of 2006 (PPA) also added Sec. 6039I to the Internal Revenue Code. That section requires companies with one or more business-owned life insurance (BOLI) policies to file an annual return with the IRS showing:

- ◆ The number of employees at the end of the year,
- ◆ The number of employees insured under BOLI policies at the end of the year,
- ◆ The total amount of BOLI in force at the end of the year, and
- ◆ The company's name, address, taxpayer ID and type of business.

The return must also include a representation that the company has a valid consent for each insured employee or, if it doesn't, the number of insured employees for whom no consent was obtained.



### WHAT'S REQUIRED?

If one of the exceptions applies, a business isn't home free yet. To avoid taxation of BOLI, it also must satisfy Sec. 101(j)'s notice and consent requirements — *before* a policy is issued. To comply, the business must ensure that an insured employee, *including an owner*:

- ◆ Is notified in writing that the company intends to insure his or her life and of the maximum face amount of the coverage at the time the policy is issued,
- ◆ Provides written consent to being insured and to continuation of coverage after his or her employment with the company ends, and
- ◆ Is informed in writing that the company will be a beneficiary of the policy's death benefits.

After the notice and consent requirements are met, the policy must be issued within one year after the

consent is signed or, if sooner, before termination of the employee's employment with the company.

### WHAT ABOUT EXISTING POLICIES?

The requirements described above apply to insurance policies issued after PPA's effective date (Aug. 17, 2006). They also apply to older policies that are materially modified (by substantially increasing the death benefit, for example) after that date.

If your company owns noncompliant BOLI policies, you may obtain tax-free benefits by surrendering the policies and purchasing new ones that satisfy Sec. 101(j)'s requirements.

### AVOID UNPLEASANT TAX SURPRISES

If your business uses BOLI for estate or succession planning purposes, consult your advisors to be sure that your policies comply with Sec. 101(j)'s requirements. Failure to do so can result in significant, unexpected tax liabilities. ❀

# PROTECTING WHAT'S YOURS

## AN OFFSHORE TRUST MAY BE THE ANSWER TO YOUR ASSET PROTECTION NEEDS

If ensuring your assets are transferred to your loved ones per your wishes and in a tax-efficient manner after your death is a primary goal of your estate plan, protecting those assets during your lifetime should also be a priority. A myriad of asset protection strategies exist, but perhaps one of the strongest is the use of an offshore trust.

Because of the high costs associated with establishing and administering offshore trusts, they make the most sense for high net worth individuals who face a significant risk of spurious claims and litigation — such as entrepreneurs and physicians.

### THE TRUST AT WORK

Offshore trusts are similar to domestic trusts, except they're located in a foreign country with more favorable asset protection laws. The assets you're protecting don't necessarily have to be located in the country where you establish the trust, but moving the assets outside the United States generally offers greater protection. That's why offshore trusts are usually funded with cash or securities that are readily moved, rather than real estate or other property that could be seized by a U.S. court.

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How do offshore trusts insulate wealth from attack by unscrupulous creditors? They're established in foreign countries that generally don't recognize judgments from U.S. courts and whose procedural

rules make it difficult and costly for a U.S. creditor to collect there.

Typically, a creditor must relitigate its claim in the jurisdiction where the trust is located. To do so, however, the creditor must jump through several challenging hoops, starting with the statute of limitations. Foreign jurisdictions often impose tight time requirements on lawsuits — often one to two years after the trust is created.

In addition, many jurisdictions prohibit contingent-fee arrangements, which means the plaintiff will have to pay a retainer to a local lawyer. On top of that, foreign courts often require plaintiffs to post a bond to cover the defendant's legal fees and court costs in the event the defendant prevails. Finally, even if a plaintiff overcomes all of these obstacles, the trustee may be able to relocate the trust to another jurisdiction, requiring the plaintiff to start all over again.

The protection provided by an offshore trust isn't absolute, but the effort and expense required to attack offshore assets can be especially useful for discouraging plaintiffs who are looking to exploit the legal system for personal gain.

### BEWARE OF FRAUDULENT TRANSFER LAWS

Offshore trusts, like domestic asset protection trusts, shouldn't be viewed as vehicles for evading existing creditors — whether they have legitimate claims or not. The key to making an offshore trust work is to establish it early — at a time when there are no pending or threatened claims against you.

If litigation has already commenced or is imminent, moving assets to an offshore trust likely would violate fraudulent transfer laws. Most states have



fraudulent transfer laws that allow creditors to go after assets you've transferred to a trust (or to another person or entity) in certain circumstances.

Generally, to succeed, a creditor must establish either that 1) you made the transfer with the actual intent to defraud creditors, or 2) you made the transfer without receiving reasonably equivalent value in exchange and you were (or became) insolvent.

Planning early pays off for two reasons. First, most fraudulent transfer laws contain a statute of limitations that prevents creditors from challenging a transfer after a specified amount of time has passed (four years, for example).

Second, intent to defraud is a subjective standard that's difficult to defend against. But the longer the period between the time assets are transferred and the time a creditor's claim arises, the more difficult it is for a creditor to prove that you intended to defraud that creditor.

## WHAT AN OFFSHORE TRUST WON'T DO

Contrary to popular belief, an offshore trust won't allow you to avoid taxes or hide your assets. In most cases, the trusts are "tax neutral," meaning you'll pay income taxes on the trust earnings, and the assets transferred to the trust will be subject to gift or estate taxes.

An offshore trust also may not provide as much privacy as you think. In the past, many affluent



people used offshore trusts and other accounts to keep their financial affairs out of the public eye. In today's world, though, that's an increasingly elusive goal. The threat of terrorism and concerns about money laundering have inspired the international community to promote transparency in the banking industry.

## CHOOSING THE RIGHT ASSET PROTECTION

If your business activities expose you to unscrupulous creditors or a greater risk of litigation, an offshore trust may be right for you. Your estate planning advisor can help choose the right asset protection strategies for your specific needs. ❀

# HAVE YOU CONSIDERED A SOCIAL SECURITY “DO-OVER?”

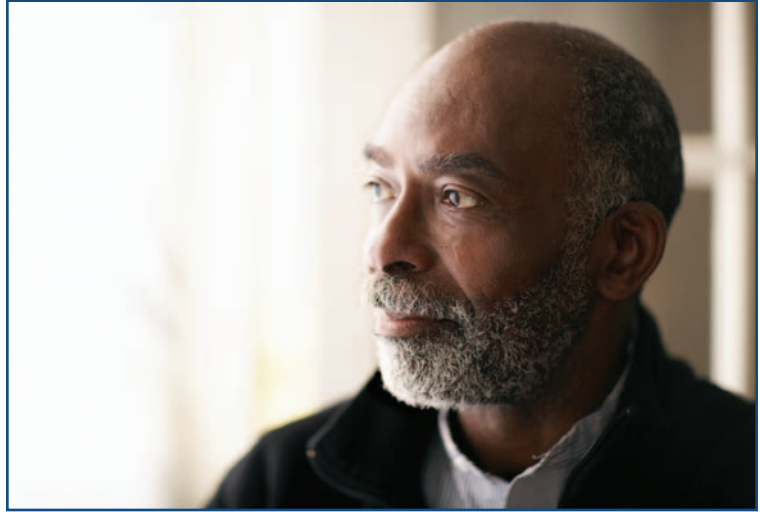
Planning for retirement is an important component of your estate plan. After all, the more wealth you spend during retirement, the less you'll have to provide for your family after you're gone. But what if you're already retired and looking for ways to boost your income without creating a lot of risk?

There are a variety of “safer” options available that allow you to generate relatively risk-free income. One of the most popular is the immediate fixed life annuity (which starts payouts immediately after you purchase it). Although returns on fixed annuities can be modest, annuities offer peace of mind by providing a guaranteed income stream for life. (Be aware that all guarantees are backed by the claims-paying ability of the issuing company.) There's another option, however, that's less well known but may be of interest. Let's call it the Social Security “do-over.”

## THE STRATEGY

How this strategy works is simple: You file Form SSA-521, “Request for Withdrawal of Application,” with the Social Security Administration and repay all of the Social Security benefits you've received. Then you reapply and begin receiving a higher payment based on your current age.

Returning your Social Security benefits to the government may sound like a strange strategy, but think of it as the equivalent of investing a lump sum in an immediate-life annuity. The government doesn't charge interest on the benefits you pay back, and you may even be entitled to a credit for income taxes you paid on the benefits in previous years. Best of all, the return on investment of a Social Security do-over is often significantly higher than that of an annuity.



For example, let's say Joe is 65 years old. He retired at age 62 and began collecting Social Security benefits at a rate of \$1,600 per month. Disregarding cost of living adjustments, Joe has received a total of \$57,600 in benefits. He files Form SSA-521, returns the benefits and reapplies for Social Security.

Based on his current age, his new benefit amount is \$2,200 per month. Essentially, Joe has exchanged a lump-sum payment of \$57,600 for a \$600 per month increase in his guaranteed lifetime income stream.

Had Joe purchased a fixed annuity for the same amount, his return would have been substantially less. According to ImmediateAnnuities.com, for example, a hypothetical 65-year-old man who purchases an immediate fixed life annuity for \$57,600 with no payments to beneficiaries would receive around \$360 per month.

To determine whether this strategy will pay off, you also need to consider life expectancy. It will take Joe 96 months ( $\$57,600/\$600$ ) — or eight years — to recover the \$57,600 in Social Security benefits he returned, so he needs to live at least that long to get his “investment” back. But any benefits he receives after that “breakeven” point will be a windfall.

If Joe doesn't reach his life expectancy, the strategy will fail, but remember that this "mortality risk" applies to the annuity in the example as well. It's one of the tradeoffs for receiving a guaranteed lifetime income stream.

Keep in mind that the numbers used in this example are for purposes of illustration only. Your actual Social Security benefits depend on your actual earnings history and other factors. Also, the example doesn't take into account taxes, cost-of-living adjustments or survivor benefits that would be paid to Joe's wife if he was married.

## READY FOR A "DO-OVER"?

Assuming that you have a source of liquid funds to repay previous benefits received and that you're in good health, a Social Security "do-over" can offer an instant income boost with relatively little risk. Before you take the plunge, though, be sure to talk with your estate planning advisor about the pros and cons.

Finally, be aware that the Social Security Administration is considering a proposal to eliminate the do-over option, so time may be running out to take advantage of it. ♣

### ESTATE PLANNING RED FLAG

## You're leaving your IRA to a child

Many people designate a child or other young person as beneficiary of an IRA. An advantage of these "inherited IRAs" is that beneficiaries can stretch required minimum distributions (RMDs) over their life expectancies, allowing the IRA to continue growing on a tax-deferred basis for many years.



But there's also a downside: Unless the child is a minor, he or she obtains full control over the IRA, so there's nothing to stop him or her from taking larger distributions or even cashing out the entire account. And a young person may be less likely to value the tax benefits of limiting his or her withdrawals to RMDs.

One solution that allows you to preserve your IRA for as long as possible is to name a trust as its beneficiary and then name the child as the trust's beneficiary. When you die, the trust owns the IRA, receives RMDs and makes distributions to the beneficiary according to your wishes. If the trust is structured properly, RMDs are determined based on the oldest beneficiary's life expectancy. Alternatively, you might decide that separate trusts for each beneficiary would be preferred, thereby allowing the RMD to be based on each separate beneficiary's age.

When leaving an IRA to a trust, careful planning is critical. If the trust doesn't meet specific requirements, you may inadvertently accelerate income taxes on the IRA's assets.

Also, keep in mind that any RMDs retained in an "accumulation" trust will be taxed at trust income tax rates, which may be substantially higher than your beneficiaries' individual rates. To avoid these taxes, the trustee can pass RMDs out to the trust beneficiaries, though doing so limits the trust's ability to preserve the IRA's assets.

Two other options are a conduit trust or a trustee IRA. Both require the trustee to distribute RMDs to the beneficiaries, but they allow you to restrict additional distributions as you see fit. Trustee IRAs, offered by many financial institutions, might be the simplest solution, but they require you to accept the financial institution as trustee.

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- 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.

## SHUMAKER

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Shumaker, Loop & Kendrick, LLP

*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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