The Estate Planner

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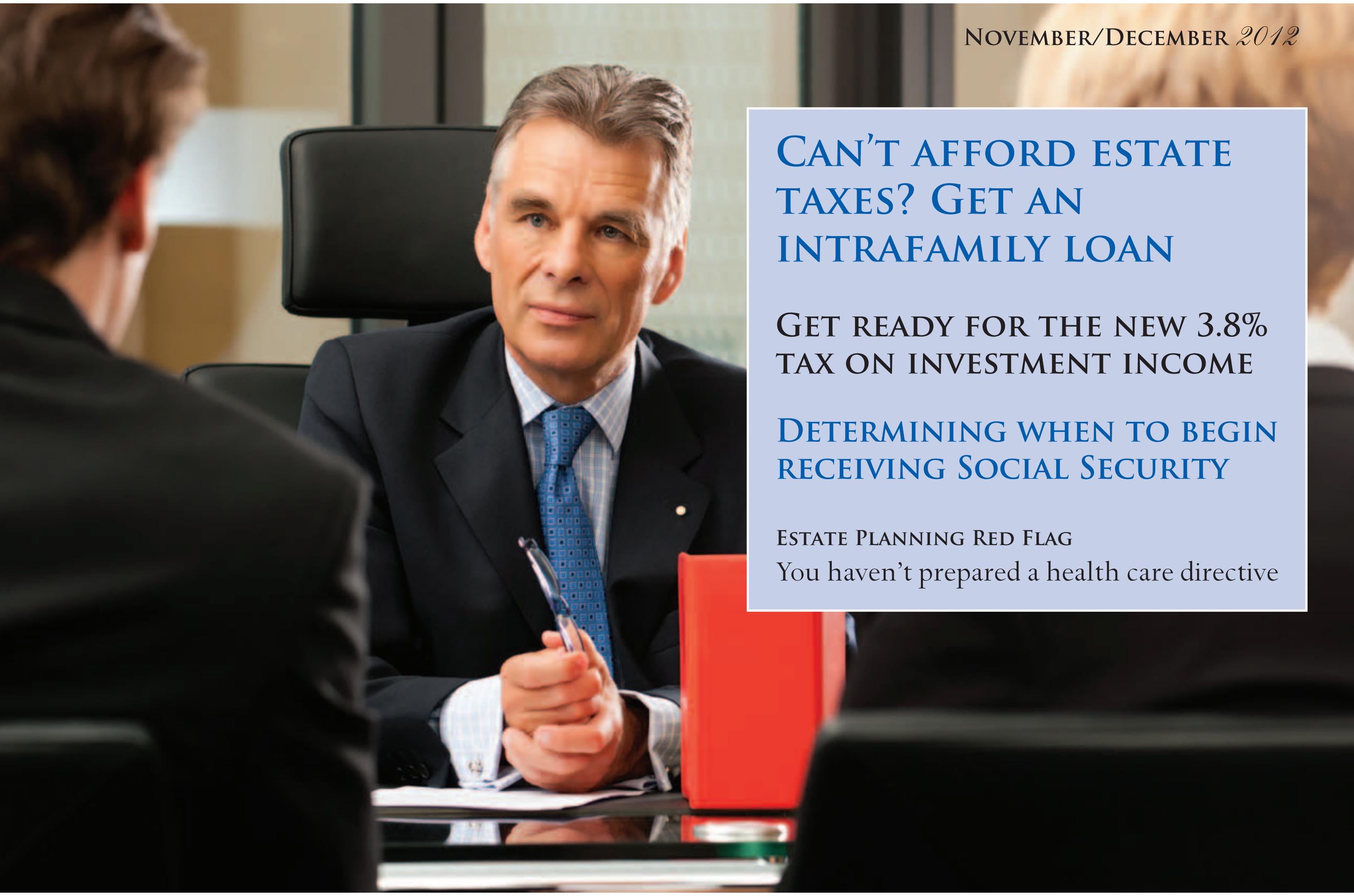

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Can't afford estate taxes? Get an intrafamily loan

If an estate consists primarily of closely held business interests, real estate or other illiquid assets, it may not have the liquidity it needs to pay estate taxes and other expenses. Life insurance is an effective tool for covering these expenses and avoiding a forced sale or liquidation. But if insurance is unavailable or insufficient, another option is to borrow the necessary funds.

Borrowing may also provide a significant benefit: If the loan is structured properly, the estate can deduct the full amount of interest upfront, reducing the size of the estate and, therefore, its estate tax liability. Interest may be deductible even if the funds are borrowed from a related party, such as a family-controlled trust or corporation.

How borrowing saves taxes

Here's an example: Frank dies in 2012 with a $15.12 million estate, consisting of illiquid assets. After applying the $5.12 million exemption, his estate owes $4.5 million in estate taxes (45% × $10 million). To fund this tax liability, the executor borrows $3.25 million from a family trust. The loan calls for interest-only payments (at 6%) for 15 years, followed by a balloon payment of principal.

The executor deducts the total amount of interest payments ($2,925,000) on the estate tax return, shrinking the taxable estate to $12,195,000 and reducing the tax — after the exemption amount — to $3,183,750.

What are the requirements?

An estate can deduct interest if it's:

- A permitted expense under local probate law,
- Actually and necessarily incurred in administration of the estate, and
- Ascertainable with reasonable certainty and will be paid.

Under probate law in most jurisdictions, interest is a permitted expense. And, generally, interest on a loan used to avoid a forced sale or liquidation is considered "actually and necessarily incurred."

To ensure that interest is "ascertainable with reasonable certainty," the loan terms shouldn't allow prepayment and should provide that, in the event of default, all interest for the remainder of the loan's term will be accelerated. Without these provisions, the IRS or a court would likely conclude that future interest isn't ascertainable with reasonable certainty and would disallow the upfront deduction. Instead, the estate would deduct interest as it's accrued and recalculate its estate tax liability in future years.

The requirement that interest "will be paid" generally isn't an issue, unless there's some reason to believe that the estate won't be able to generate sufficient income to cover the interest payments.

Intrafamily loan challenges

For the interest to be deductible, the loan also must be bona fide. A loan from a bank or other financial institution shouldn't have any trouble meeting this standard.

But if the loan is from a related party, the IRS may question whether the transaction is bona fide. So the parties should take steps to demonstrate that the transaction is a true loan.

Among other things, they should set a reasonable interest rate (based on current IRS rates), execute a promissory note, provide for collateral or other security to ensure the loan is repaid, pay the interest payments in a timely manner, and otherwise treat the loan as an arm's-length transaction. It's critical that the loan's terms be reasonable and that the parties be able to demonstrate a "genuine intention to create a debt with a reasonable expectation of repayment."

Continued viability

In *Estate of Duncan*, the U.S. Tax Court affirmed the continued viability of this strategy. In that case, the deceased's revocable trust, which held illiquid oil and gas interests, paid estate taxes with a 15-year loan from an irrevocable trust established by the deceased's father.

The court allowed the interest deduction, even though the two trusts had the same trustees and beneficiaries. The trustees' fiduciary duties under state law obligated them to maintain the trusts' individuality and to respect the terms of the loan. They weren't, as the IRS suggested, "free to shuffle money between these 'trusts' as they please."

The court also rejected the IRS argument that the loan was unnecessary because the deceased's trust could have sold illiquid assets to the irrevocable trust at full price. If unrelated buyers would have insisted on a discount, the trustees had a duty to do the same. The court wouldn't force the trust to sell assets at a discount, rather than take a loan, to fund the payment of estate taxes.

A loan that didn't pass muster

To withstand an IRS challenge, an intrafamily loan must, among other things, have a legitimate purpose other than generating interest deductions. In *Estate of Black*, for example, the U.S. Tax Court disallowed an estate's deduction of interest on a $71 million loan from a related family limited partnership (FLP).

The FLP's principal asset was an interest in Erie Indemnity. It funded the loan by selling a portion of its Erie stock in a $98 million secondary offering.

The court found that the only way the estate could repay the loan on time was through redemption of a portion of its interest in the FLP. The loan was unnecessary, the court concluded, because the parties were in the same economic position as if the FLP had simply redeemed a portion of the estate's interest to fund the payment of estate taxes. "The only distinction between the loan scenario and the partial redemption scenario," the court explained, "is that the former gave rise to an immediate estate tax deduction for interest in excess of $20 million…."

Finally, the court found the terms of the loan were reasonable. The interest rate was based on a quote from a bank, and the 15-year term was reasonable because the volatility of oil and gas prices made it difficult to predict how long it would take to repay the loan.

Weigh the options

Estates faced with liquidity issues should review various strategies for funding estate taxes. In addition to borrowing, options include applying to the IRS for a hardship extension or deferring taxes under Internal Revenue Code Section 6166, which allows qualifying estates that hold closely held businesses to pay estate taxes in installments over a period as long as 14 years. ✤

Get ready for the new 3.8% tax on investment income

The Patient Protection and Affordable Care Act of 2010 established a new 3.8% Medicare tax on investment income for high-income taxpayers, which is scheduled to take effect in 2013. The tax will also apply to trusts and estates, and the income threshold that triggers the tax for them is low.

Now that the U.S. Supreme Court has upheld most provisions of the health care act, these taxes — barring congressional action — will soon become a reality. This means they could take a bite out of the legacy you may be trying to build for your loved ones.

How it works

For individuals, the 3.8% tax will apply to net investment income (gross investment income less deductible investment expenses) to the extent modified adjusted gross income (MAGI) exceeds $200,000 ($250,000 for joint filers).

For individuals, you can minimize or eliminate the 3.8% tax by reducing MAGI or the amount of net investment income — or both.

Suppose, for example, that you're a joint filer and in 2013 your MAGI is $400,000, which includes $75,000 in net investment income. Your net investment income is subject to the 3.8% tax to the extent your MAGI exceeds the $250,000 threshold ($400,000 − $250,000 = $150,000), so the entire $75,000 is taxable. The tax is $75,000 × 3.8% = $2,850.

For trusts and estates, the 3.8% tax is imposed on undistributed net investment income for the year to the extent that adjusted gross income (AGI) exceeds the dollar amount at which the highest tax bracket begins ($11,650 in 2012 but will likely go up slightly for 2013). Some trusts are exempt, including certain charitable trusts, grantor trusts (because income is passed through to the grantor) and "simple trusts" (because they distribute all current income to beneficiaries).

Net investment income includes the sum of the following, less any applicable deductions:

- Gross income from interest, dividends, annuities, rents and royalties,
- Net capital gains, and
- Trade or business income that is considered either passive activity income or is derived from trading in financial instruments or commodities.

It doesn't include *active* trade or business income. Also excluded are distributions from IRAs and qualified retirement plans and income from tax-exempt or tax-deferred investments.

Tax planning strategies

For individuals, you can minimize or eliminate the 3.8% tax by reducing MAGI or the amount of net investment income — or both. Potential strategies include:

- Converting to a Roth IRA by Dec. 31, 2012,
- Gifting income-producing investments to loved ones who won't be subject to the new Medicare tax,
- Investing in growth rather than income stocks,

- ✦ Investing in tax-free municipal bonds,
- ✦ Selling appreciated capital assets before the end of 2012, or
- ✦ Using installment sales to spread gain over several years.

Putting more money into traditional qualified retirement plans can also be a good strategy because contributions reduce taxable income and distributions aren't included in investment income (although they do increase MAGI).

For trusts, reducing AGI usually isn't an option, because the 3.8% tax's threshold is so low. But there are several strategies trusts can use to minimize the tax, including shifting funds into tax-exempt or tax-deferred investments.

Also, because the 3.8% tax applies only to *undistributed* net investment income, a trust can reduce its tax liability by distributing more income to beneficiaries. Keep in mind, though, that these distributions may increase the *beneficiaries'* exposure to the tax.

Act now

With 2013 right around the corner, now is the time to take action. If the new 3.8% tax will affect you, consult your estate planning advisor to discuss potential strategies for reducing the impact. ✤

Determining when to begin receiving Social Security

A key question people ask when planning for retirement is: "When should I begin receiving Social Security benefits?" The right answer depends on each person's individual circumstances. Estate planning also factors into the equation. For example, the amount of funds you and your spouse need to continue your desired lifestyle during retirement will affect the amount of wealth you ultimately are able to pass on to your heirs.

Age affects monthly benefit amount

You can begin receiving Social Security benefits as early as age 62 or as late as age 70. The longer you wait, the higher the monthly benefit. This is because the system is designed to provide you with roughly the same total benefit (based on government life expectancy tables) regardless of when you begin receiving payments.

If you start benefits before your "normal" retirement age, you'll receive a smaller check over a greater number of years. If you start later, you'll receive a larger check over a smaller number of years.

If you were born at any time in 1943 through 1954, for example, your normal retirement age is 66. If you start receiving benefits at age 66, you're entitled to a full benefit based on a formula tied to your earnings history. Many people can maximize wealth accumulation by delaying Social Security benefits to normal retirement age or even later.

Calculating your break-even point

Assuming that you can live comfortably without Social Security benefits, when is the optimal time to begin receiving them? A useful tool for choosing the right starting age is to calculate your break-even point.

For example, Jan, who is retired, is about to turn 62. She's trying to decide between taking a reduced Social Security benefit right away or waiting until her normal retirement age of 66. Her full monthly benefit at 66 would be $2,000 and her reduced benefit at 62 would be $1,500.

Ignoring cost of living adjustments for simplicity, Jan's break-even point is just before her 78th birthday. At that point, her total benefits will be about the same whether she starts at age 62 (192 months × $1,500 = $288,000) or at age 66 (144 months × $2,000 = $288,000). If Jan lives to at least age 78, waiting until age 66 to start collecting will provide her with greater lifetime benefits. If she doesn't reach that age, she's better off starting at age 62.

Suppose that Jan's mother and grandmother both lived to be 90. If Jan follows suit, she'll receive more than $72,000 more in Social Security benefits by waiting until her normal retirement age of 66.

After determining your break-even point, the right choice for you depends on several factors, including your actuarial life expectancy, your health and your family history. Also, keep in mind that the above example doesn't consider potential earnings on Social Security benefits. If you plan to invest your benefits, you may need to adjust your break-even point upward or downward, depending on your expected rate of return.

If you plan to continue working after you become eligible for Social Security, you're likely better off delaying benefits at least until you reach your normal retirement age.

Working past eligibility age

If you plan to continue working after you become eligible for Social Security, you're likely better off delaying benefits at least until you reach your normal retirement age. If you start any time before the year in which you reach your normal retirement age, your benefits will be reduced by $1 for every $2 you earn above a certain threshold ($14,640 in 2012). So, for example, if your benefit amount is $1,500 per month, or $18,000 per year, your benefits will be eliminated if you earn $50,640 or more.

After you reach your normal retirement age, you can continue working without reducing your Social Security benefits. But keep in mind that, if your income exceeds certain limits, a portion of your Social Security benefits will be taxable.

Seek your advisor's advice

Several factors must be considered when determining the ideal time to begin taking Social Security benefits. Your estate planning advisor can assess your (and your spouse's) circumstances and help you maximize the potential value of your Social Security benefits. ✤

Estate Planning Red Flag

You haven't prepared a health care directive

A health care directive allows you to communicate your preferences, in advance, for medical care in the event you're incapacitated and cannot express your wishes. Directives go by different names, including living wills, advance medical directives and directives to physicians.

Often, a directive is coupled with a health care power of attorney (sometimes called a durable medical power of attorney or health care proxy). A power of attorney appoints a representative to make health care decisions on your behalf, which may involve interpreting the terms of the directive or addressing situations not expressly covered.

A health care directive provides your physicians and family with instructions regarding life-sustaining medical procedures. It can specify the situations in which procedures — such as CPR and other "heroic measures," artificial nutrition and hydration, invasive diagnostic tests, and pain medication — should be used or withheld. It may also cover issues such as last rites or other religious observances, organ donation, and handling of the body after death.

Most states have health care directive statutes, which often include model forms. In addition, many hospitals provide health care directive forms for the use of their patients. But these generic forms may not accommodate your preferences and values, particularly your religious views.

To ensure that your wishes are carried out, work with your advisors to design a health care directive that meets your particular needs.

Experience. Responsiveness. Value.

At Shumaker, we understand that when selecting a law firm for estate planning and related services, most clients are looking for:

- 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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