Insight on Estate Planning

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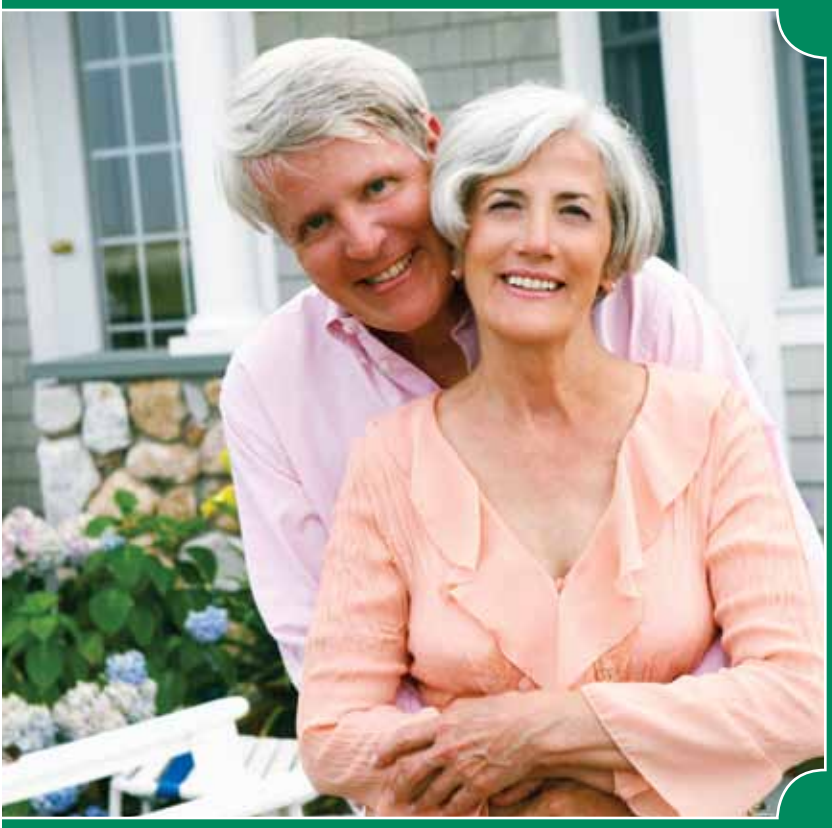

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Bart, Meyer & Company LLP

Wills, Trusts & Probate ■ Wealth Transfer Planning

Attorneys at Law ■ 15 Lake Street, Suite 130, Savannah, Georgia 31411 ■ T: 912 598 5151 F: 912 598 5152

Fiscal cliff deal brings some certainty to estate planning

Congress's eleventh-hour deal to avert the "fiscal cliff" produced the American Taxpayer Relief Act of 2012 (ATRA). The act focuses on income taxes, but it also provides much-needed certainty for people engaged in estate planning.

After several years of *un*certainty over whether estate tax rates and exemptions would revert to their pre-2001 tax law levels, ATRA offers a long-term fix. Among other things, the act makes the following estate tax provisions permanent: an inflation-adjusted $5 million exemption amount, portability of exemptions between spouses and a top tax rate of 40%.

In tax law, "permanent" is a relative term. There's no guarantee Congress won't make changes down the road. However, because the new estate tax laws have no expiration date or "sunset" provision, people can plan their estates with a greater level of comfort.

What's changed?

The 2010 tax act had established a $5 million unified gift and estate tax exemption and a $5 million generation-skipping transfer (GST) tax exemption, both of which were adjusted for inflation ($5.12 million in 2012). It also had set a top tax rate of 35% for all three taxes.

These provisions were temporary, however. Absent ATRA, the gift and estate tax exemption amounts would have dropped to an unadjusted $1 million (the GST tax exemption would have been an *adjusted* $1 million) and the top tax rate would have increased to 55% (with an additional 5% surtax on estates between $10 million and just over $17 million).

ATRA preserves the $5 million indexed exemption amounts, with the 2013 amounts at $5.25 million, and bumps up the top rate to 40%. It also eliminates the surtax on larger estates.

Portability more valuable

The 2010 tax act also had made the gift and estate tax exemption "portable" in 2011 and 2012. This provision allowed an estate to file an election to permit the surviving spouse to use the deceased's unused exemption amount.

It offered a simple alternative to more complicated estate planning vehicles, such as credit shelter trusts, for making the most of a couple's combined exemptions. But its short time window limited its value. By making portability permanent, ATRA eliminates this disadvantage. So portability is now a viable alternative to credit shelter trusts for many couples.

Trusts continue to offer valuable benefits, however, including creditor protection, professional asset management, state tax benefits, and the ability to freeze asset values for gift and estate tax

Charitable IRA rollover extended

The American Taxpayer Relief Act of 2012 extends a valuable tax incentive for charitable IRA donations through the end of 2013: the qualified charitable distribution, more commonly known as the "charitable IRA rollover." It permits taxpayers age 70½ or older to annually make up to $100,000 in tax-free IRA distributions to qualified charities.

These distributions can be used to satisfy a taxpayer's required minimum distribution for the year. And they provide a tax advantage for IRA owners who otherwise would be unable to deduct an equivalent charitable donation because, for example, they don't itemize or they have already exceeded adjusted gross income (AGI) limitations on charitable deductions for the year.

If you're considering a charitable IRA rollover, consult your estate planning advisor to be sure you meet the requirements. Among other things, the funds generally must be transferred *directly* from a traditional or Roth IRA to a public charity. In addition, the donation must be "otherwise deductible" (without regard to AGI limitations) and the distribution must be "otherwise taxable" (that is, it would be included in the owner's taxable income if he or she received it directly).

purposes. Also, portability isn't available for the GST tax exemption, so trusts remain a more tax-efficient tool for transferring wealth to grandchildren.

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Another potential disadvantage of portability is that it's available only for the most recent spouse's exemption. So, if a surviving spouse remarries, the deceased spouse's exemption is no longer available.

More opportunities

ATRA makes permanent or extends several other estate planning benefits. The act preserves the ability of some estates of owners of closely held businesses to defer related estate taxes and pay them in installments. And it retains various GST tax protections, including deemed and retroactive allocation of GST tax exemptions and relief for late allocations.

The act also makes it easier to do "in-plan" Roth conversions of certain retirement accounts, including 401(k), 403(b) and 457(b) plan accounts, which can provide estate planning benefits. If your employer allows it, converting an account and paying any tax liability now allows you to create an income-tax-free source of wealth for your children or other beneficiaries. Previously, this option was available only to plan participants who were eligible for distributions — generally those who were over age 59½, had left the company or had become disabled.

Update your plan, if necessary

Consult your estate planning advisor to find out whether your plan needs to be updated to reflect ATRA's changes and to be sure you're taking full advantage of currently available gift, estate and GST tax benefits. And keep an eye on Congress: It's possible that lawmakers will limit the benefits of certain estate planning techniques, such as grantor retained annuity trusts, later this year. ▮

Strong governance enhances a family business's value

A successful family business can provide financial security for the founder and his or her loved ones as well as employment opportunities for family members. To improve the chances of success and enhance the value of a family business, however, it's critical to treat it like any other business.

Too often, family members view their business as a source of wealth without making sure that the company is managed by those best suited for the job, that family-member compensation is reasonable and that any "insiders" are held accountable in the same manner as outsiders. Good governance — carefully documented in writing — can help ensure a family business's survival as it makes the transition from one generation to the next. It also reduces the chances of intrafamily conflict.

Lay a solid foundation

Good governance starts with the initial organization (or reorganization) of a business. For the sake of simplicity, we'll focus on governance issues in the context of a corporation, which is required by law to have a board of directors and officers and to observe certain other formalities.

Other business structures, such as partnerships and limited liability companies (LLCs), have greater flexibility in designing their management and ownership structures. But these entities can achieve strong governance with well-designed partnership or LLC operating agreements and a centralized management structure. For example, they might establish management committees that exercise powers similar to those of a corporate board.

For a corporation, the business's articles of incorporation and bylaws lay the foundation

for future governance. The organizational documents might:

- Define and limit the authority of each executive,
- Establish a board of directors,
- Require board approval of certain actions,
- Authorize the board to hire, evaluate, promote and fire executives — whether inside or outside the family — based on merit,
- Authorize the board to determine the compensation of top executives and to approve the terms of employment agreements, and

- Create nonvoting classes of stock to provide equity to family members who aren't active in the business but without conferring management control.

For many family businesses, governance concerns don't arise until the business passes to the next generation. When a founder remains active in the business and isn't ready to cede control to a board, it may be appropriate to delay implementation of certain governance practices until the founder retires or dies.

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One of the trickiest aspects of transitioning a business can be the communication to the succeeding leaders. This is especially true in a family business, where the expectations of the next generation may not be in sync with the intentions or desires of the current generation.

To ensure a smooth transition, it's critical to coordinate the business's organizational documents and shareholder agreements with the founder's estate and succession plans and to communicate those plans appropriately.

Create an independent board

Whether it's part of the business's structure from the beginning or implemented when the founder leaves, an independent board offers several important benefits. Outsiders on the board provide an objective voice on management issues and an opportunity to tap their expertise on financial, operational, legal or other matters. Independent directors can approve "insider transactions" between the business and family members and serve as an impartial forum for resolving disputes within the business.

To establish an effective board, the business's organizational documents should clearly specify the number of independent directors, as well as the length of their terms and the mechanism for electing them. Staggered terms help provide some continuity and stability to the board. And cumulative voting can help empower minority owners by enabling them to combine their votes to elect one or more directors.

Keep the business in the family

Careful estate planning can ensure that a family business continues to benefit family members and that ownership of the business isn't diluted — at least until the business is ready to accept outside investors. For example, a well-designed buy-sell agreement can prevent owners from transferring their shares outside the family, while providing the liquidity they need to exit the business. And prenuptial agreements can prevent married owners from losing a portion of their shares in a divorce.

Owners' estate plans should use trusts or other mechanisms to restrict the ability of their heirs to transfer shares. If shares are held in trust, however, it's important to include mechanisms for providing beneficiaries with a say in the business's affairs — particularly if they work in the business.

For example, the trust agreement might give some or all of the beneficiaries control over how voting and other ownership rights associated with the underlying shares are exercised. Or, if the beneficiaries are minors or otherwise not ready to assume this responsibility, these rights might be exercised by a trustee, advisory board or other fiduciary (with or without input from the beneficiaries).

Have a plan

These are just a few examples of how good governance practices can help ensure that a family business is managed in a professional manner. Incorporating these practices into your business, estate and succession plans can help preserve the business's value for future generations.

Should you donate life insurance to charity?

For the philanthropic minded, donating a life insurance policy to a favorite charity should rank high on their list of possible giving strategies. Why? Because doing so is an excellent opportunity to make a larger donation than may otherwise be affordable.

However, donating life insurance isn't right for everyone. If, for example, your family's financial security after you're gone might depend on the policy's payout, donating it won't be a viable idea, even if it does allow for a larger donation. In addition, there are tax implications to consider.

An attractive option

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) plans 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.

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

Consider Clare, for example. She's a 65-year-old widow with two children, both of whom are financially successful. She has substantial savings in an IRA and her 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 Clare's

cost basis in the policy, based on premiums paid, is $250,000. If she simply surrenders the policy in exchange for its cash value, she'll recognize $150,000 in ordinary income.

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

The tax impact

The most tax-effective way to donate life insurance is to transfer the policy so that the charity becomes the owner and beneficiary. You'll generally be 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 taxable estate, which can mean significant estate tax savings.

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.

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, Clare would be entitled to a $250,000 charitable deduction.

Consider your family first

If you have a charity that's near and dear to your heart, donating a life insurance policy to it can be rewarding. But before taking action, discuss with your estate planning advisor your goals and your family's financial situation. He or she can help you determine whether you can donate the policy while still providing for your loved ones to the extent you desire. ▮

Estate Planning Pitfall

Transferring home ownership to your children

If you're considering giving your home to your children, talk to your estate planning advisor first to make sure you do it the best way for your situation. Many people mistakenly believe they can transfer their home to their children while retaining the right to continue living in it for the rest of their life, and remove a substantial portion of the home's value from their taxable estate. It's a simple, inexpensive way — they reason — to avoid probate and reduce estate taxes.

But, on the contrary, retaining such a "life estate" *guarantees* that the home's value will be included in your taxable estate when you die. That's not necessarily a bad thing, though. It depends on your situation and what you're trying to achieve.

If you give your home to your children outright, they'll take over your tax basis in the property. So if the home has appreciated significantly in value, or you expect it to appreciate in the future, your children won't be able to sell it without triggering substantial capital gains taxes. On the other hand, if the home passes to your children as part of your estate, they'll receive a stepped-up basis, which reduces potential capital gains.

To determine the best course, compare the potential tax implications of each strategy. Retaining a life estate may be a good option if, for example, you believe that potential capital gains taxes would outweigh any estate tax savings an outright gift would create.

Of course, you can achieve the same result simply by leaving your home to your children in your will or living trust. But transferring your home while retaining a life estate may offer certain benefits, including protecting the home from your creditors and reducing your assets in order to qualify for Medicaid.

John H. Oldfield, Jr. ▪ Thomas B. Sayers ▪ Amy R. Henderson ▪ Randall K. Bart ▪ Paul D. Meyer ▪ Andrew W. Lohn ▪ Roy E. Paul ▪ Patrick R. LeMaster

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Bart, Meyer & Company LLP

The Lake Side Center ▪ 15 Lake Street, Suite 130 ▪ Savannah, Georgia 31411 ▪ Phone 912.598.5151 ▪ Web www.bart-law.com