The Estate Planner

May/June 2008

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A simple plan

Installment sale offers alternative to complex estate planning strategies

If you've explored estate planning options, you know there are a variety of tools at your disposal, from the simple to the sophisticated. Complex strategies have their place, but in some cases, simple is best.

Consider the installment sale. Under the right circumstances, it's one of the simplest tools available to freeze asset values for estate tax purposes and remove any future appreciation from your taxable estate.

Appreciable benefits

An installment sale can be an effective technique for transferring a family business, real estate or other assets you expect to appreciate dramatically in the future. By selling the property — at fair market value — to your children or other loved ones rather than gifting it, you avoid gift taxes on the transfer and freeze the property's value for estate tax purposes as of the sale date. All future appreciation benefits the buyer and won't be included in your taxable estate.

Because the transaction is structured as a sale rather than a gift, your buyer must have the financial resources to buy the property. But by using an installment note, the buyer can make the payments over time. Ideally, the purchased property will generate enough income to fund these payments.

An installment sale can be an effective technique for transferring a family business, real estate or other assets you expect to appreciate dramatically in the future.

An advantage of an installment sale is that it gives you the flexibility to design a payment schedule that corresponds with the property's cash flow as well as with your and your children's financial needs. You can have the payments increase or decrease over time, or even provide for interest-only payments with a balloon payment of the principal at the end of the term.

A disadvantage of installment sales over strategies that involve gifted property is that you'll be subject to tax on any capital gains. Fortunately, you can spread this tax liability over the term of the installment note. But, you'll want to keep in mind that the low 15% long-term capital gains rate is scheduled to be in effect only through 2010.

Also, you'll have to charge interest on the note and pay ordinary income tax on the interest payments. IRS guidelines provide for a minimum rate of interest that must be paid on the note.

Selling vs. giving

From an estate planning perspective, if you have a taxable estate it's usually more advantageous to give property to your children than to sell it to them. Why? Because by gifting the asset you'll be depleting your estate and thereby reducing your estate tax liability. That is, your estate will be taxed on fewer assets than if you had sold the property to your children. But an installment sale may be desirable if you've already used up your $1 million lifetime gift tax exemption or if your cash flow needs preclude you from giving the property away outright.

Other strategies are available to freeze asset values while providing you with a current income stream, but they can be more complex and present certain disadvantages. One example is the grantor retained annuity trust (GRAT). A GRAT is an irrevocable trust to which you make a one-time contribution of assets. The trust pays you an annual annuity — a fixed dollar amount typically expressed as a percentage of the trust's initial value — during the trust term. At the end of the term, the remaining assets are transferred tax-free to your children or other beneficiaries.

A GRAT allows you to remove future appreciation from your taxable estate without giving up control over the property right away. It also avoids the need for your beneficiaries to come up with the purchase price.

GRATs have some disadvantages, though. For example, contributions to the trust may involve taxable gifts to your beneficiaries (though the property's value is substantially discounted for gift tax purposes). More significant, however, is that for a GRAT to work you must survive the trust term; otherwise, all of the trust assets — including any future appreciation — are brought back into your taxable estate.

With an installment sale, if you die during the term of the note your estate will include the present value of all future installment payments. But all postgift appreciation in the property's value remains outside of your estate.

Explore your options

The simplicity of the installment sale is appealing, but it's not for everyone. The right estate planning strategies — whether simple or complex — depend on your particular circumstances. ✤

Installment sale with a twist

An interesting variation on the basic installment sale is an installment sale to an intentionally defective grantor trust (IDGT). Ordinarily, you create a grantor trust for your own benefit. You can, however, establish an IDGT for your children or other beneficiaries. But by reserving certain powers over or interests in the trust, you're treated as owner of the assets for income tax purposes without causing the assets to be included in your estate.

Like an ordinary installment sale, a sale to an IDGT allows you to transfer future appreciation to your beneficiaries tax-free. But, you retain some control over the property during the trust term. In addition, there's no need for your beneficiaries to fund the payments.

Most important, because you're considered the owner of the trust assets for income tax purposes, selling property to an IDGT is like selling it to yourself. Thus, provided the trust is designed properly, there should be no current capital gains tax on the transaction.

For an installment sale to an IDGT to be most effective, the property transferred to the trust must generate enough income to make the installment payments. Also, this technique is quite complex, so be sure to discuss the potential risks with your advisors.

Balance competing goals with a QTIP trust

Estate planning can be a delicate balancing act. You want to provide for your spouse, but you also want to preserve a significant amount of wealth for your children. You want to minimize federal gift and estate taxes, but you also want to maintain control over your assets during your life.

A qualified terminable interest property (QTIP) trust is a versatile tool that can help you strike a balance between these often competing goals.

How does it work?

The unlimited marital deduction allows you to transfer any amount of property to your U.S. citizen spouse — either during your life or at death — free of gift and estate taxes. A QTIP trust allows you to take advantage of the deduction while controlling the ultimate disposition of the trust's assets.

Ordinarily, to qualify for the marital deduction, you must transfer property to your spouse outright or through a trust in which your spouse's interest cannot terminate for any reason. A QTIP trust is an exception to this rule; it allows you to provide your spouse with a "terminable interest" in the trust while still qualifying for the marital deduction.

For a trust to qualify as a QTIP trust, the following requirements must be met:

- The trust must require all income to be paid to or for the benefit of your spouse, at least annually, for his or her lifetime.
- The trust must require its assets to be invested in income-producing property or give your spouse the power to require the trustee to convert investments to income-producing property.
- Your spouse must be the only current beneficiary during his or her lifetime.
- Your executor must make a QTIP trust election on your estate tax return.
- Your spouse must be a U.S. citizen; otherwise, the usual rules for the marital deduction won't apply and you'll need to use a special type of trust called a qualified domestic trust.

When your spouse dies, the assets remaining in the trust go to your children or other beneficiaries you've named, but they're treated as part of your spouse's estate for estate tax purposes.

Is a QTIP trust right for you?

Consider a QTIP trust if you expect the value of your estate to be substantially more than the estate tax exemption amount. The exemption is $2 million per person this year, increasing to $3.5 million next year. Under current law, the estate tax is scheduled to disappear in 2010, only to reappear in 2011 with an exemption of only $1 million.

Although the future of the estate tax is uncertain, if there's a good chance your estate will be exposed to estate taxes, a QTIP trust is worth a look. Here are three ways you can incorporate a QTIP trust into your estate plan.

1. The equalizer. Although QTIP trusts are often established at death by a will or trust, you can also use a lifetime QTIP trust to correct imbalances in your estate. If one spouse owns the bulk of assets, the couple risks wasting the other spouse's exemption and incurring unnecessary estate taxes.

Consider Scott and Emily: The couple's combined wealth is $7 million, but $6.5 million in assets are Emily's separate property, while Scott's estate is worth only $500,000. Suppose Scott dies in early 2009, when the federal estate tax exemption is $3.5 million, leaving his property to their children. There's no estate tax, but $3 million of Scott's exemption amount goes unused and is lost forever. If Emily dies later that same year, $3 million of her estate ($6.5 million less her $3.5 million exemption) will be subject to estate taxes at a top rate of 45%.

If Scott and Emily had equalized their estates at $3.5 million each and left their assets to their children, they would have avoided estate taxes altogether. Regardless of which spouse died first, their estates would have been within the exemption amount.

The simplest way to equalize estates is for the wealthier spouse to transfer assets to the other spouse. This may not be a viable option, however, especially if the wealthier spouse is concerned that his or her spouse might squander the money or later marry someone who's after the inheritance.

With a lifetime QTIP trust, you can equalize your estates without placing your children's inheritance at risk. The trust must pay all of its income to your spouse for the rest of his or her life, but you can retain control over the assets and restrict your spouse's access to the principal. When your spouse dies, the assets go to your children (either outright or in trust), but they're treated as part of your spouse's estate so you don't waste his or her exemption.

This strategy has one potential disadvantage: If you and your spouse divorce, he or she will still be entitled to all of the trust income for life.

2. The protector. Providing for your spouse is important, but it may be just as important to preserve as much wealth as possible for your children. If you leave property to your spouse outright, there's no guarantee that this objective will be met.

A properly designed QTIP trust provides your spouse with income for life while protecting the trust principal and preserving it for your children. By appointing a qualified trustee, you have greater confidence that the assets are invested and managed wisely. By limiting or eliminating your spouse's access to the trust principal, you protect your family's property against those with dishonorable intentions.

Consider a QTIP trust if you expect the value of your estate to be substantially more than the estate tax exemption amount.

3. The conciliator. Even in the most harmonious families, matters of inheritance can create conflicts. This may be the case if you've remarried and want to provide for your current spouse as well as children from a previous marriage. But conflicts can also arise between a surviving spouse and his or her own children. In either case, a QTIP trust can help ease the tension by providing for your spouse while giving some assurances to your children that something will be left for them down the road.

This strategy may backfire, however, if your spouse is considerably younger than you. In that case, your children may have to wait a long time to receive their interests in the trust (or they may be disinherited altogether if your spouse survives them). Under these circumstances, it may be preferable to use life insurance or some other planning technique that enables your children to receive their inheritance sooner.

Don't put all your eggs in one basket

A QTIP trust can be a powerful tool for leveraging the marital deduction, but you should avoid placing all of your wealth in one. Although the marital deduction defers estate taxes on these assets, ultimately they will be taxed as part of your spouse's estate, so unless you have assets other than those held in the QTIP trust, you will have wasted your own estate tax exemption.

To avoid this result, you should combine a QTIP trust with other tools, such as a credit shelter trust, which take advantage of your estate tax exemption to provide for your family tax-free. ✤

Take care when choosing IRA beneficiaries

If you're like many people, you've built up a sizable nest egg in one or more IRAs. With traditional IRAs — as opposed to Roth IRAs — distributions are taxable, so it's important to select your beneficiaries carefully. Failing to designate a beneficiary, or choosing the wrong beneficiary, can have significant tax implications.

Why it matters

If you own a traditional IRA, you're required to start taking taxable distributions on your required beginning date (RBD), which is April 1 of the year following the year in which you reach age 70½. Your IRA's beneficiary designation affects the speed with which the remaining funds must be distributed after you die. From your heirs' perspective, it's generally preferable to put off distributions and allow the IRA funds to continue growing tax-deferred as long as possible.

If you die without having named an IRA beneficiary, however, distributions — and income taxes — generally will be accelerated:

- ✦ If you die *before* your RBD, the entire IRA becomes part of your estate and must be distributed to your heirs by the end of the fifth year following the year of your death.
- ✦ If you die *after* your RBD, the IRA must be distributed at least as quickly as it would have been if you were alive (generally based on your life expectancy).

Your IRA's beneficiary designation affects the speed with which the remaining funds must be distributed after you die.

By naming a beneficiary, you enable your spouse or children to defer taxation of the IRA funds for a substantially longer period of time. If you name your spouse as beneficiary, for example, he or she can roll the funds into his or her own IRA. If your spouse is under age 70½, this means distributions can be delayed until his or her own RBD. If you name someone other than your spouse — such as a child — your beneficiary must start taking distributions immediately but can generally withdraw the funds over his or her own life expectancy.

Maximizing the benefits

To enjoy the benefits of income tax deferral, your IRA beneficiary must qualify as a "designated beneficiary,"

which includes individuals, as well as trusts that meet certain requirements, but not estates or charities. You shouldn't name your estate as beneficiary of your IRA. Doing so is the equivalent of not naming a beneficiary, which can accelerate distributions as previously described.

Naming a charity, on the other hand, can be a good strategy. Acceleration of distributions isn't an issue, because the charity is tax-exempt. If you contemplate making a charitable bequest anyway, it can be advantageous to make the gift from your IRA — thereby avoiding income taxes on the distribution — and using other assets to provide for your family.

Have a plan

Failing to name a designated beneficiary for your IRA is like not having a will: If you don't have a plan, one will be provided for you — and it may not be in your family's best interests. ✤

Estate Planning Red Flag

Your company uses EOLI and you're unfamiliar with PPA provisions

If you own an interest in a business, a buy-sell agreement should be an integral part of your estate and succession plans. It can help ensure an orderly business transition and provide your family with liquidity to pay estate taxes and other expenses when you die (or if you become disabled).

Typically, buy-sell agreements are funded by insurance policies on the owners' lives, and in many cases those policies are purchased by the company. If your business uses employer-owned life insurance (EOLI), it's critical to become familiar with the requirements of the Pension Protection Act of 2006 (PPA).

One of the benefits of using life insurance to fund a buy-sell agreement is that the proceeds generally are tax-free. Now, however, this tax-free treatment will be lost unless certain requirements are met. Under the PPA, a company is subject to tax on EOLI death benefits to the extent they exceed the company's basis in the policy, *unless*:

- The insured was an employee at any time during the 12 months before his or her death or was a director or highly compensated employee at the time the policy was issued, and
- The company notified the insured of its intent to purchase the policy (as well as certain other details) and obtained his or her advance written consent.

The PPA also provides an exception for insurance proceeds paid to the insured's heirs or used to redeem the insured's interest in the business from one of those heirs. This exception would appear to protect a business to the extent it uses the proceeds to buy back a deceased owner's shares. But if it uses any of the proceeds for other purposes, it will lose tax-free treatment unless it meets the requirements of the PPA.

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