

# *the* **Estate** **PLANNER**

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Strategies that lower the price of business succession

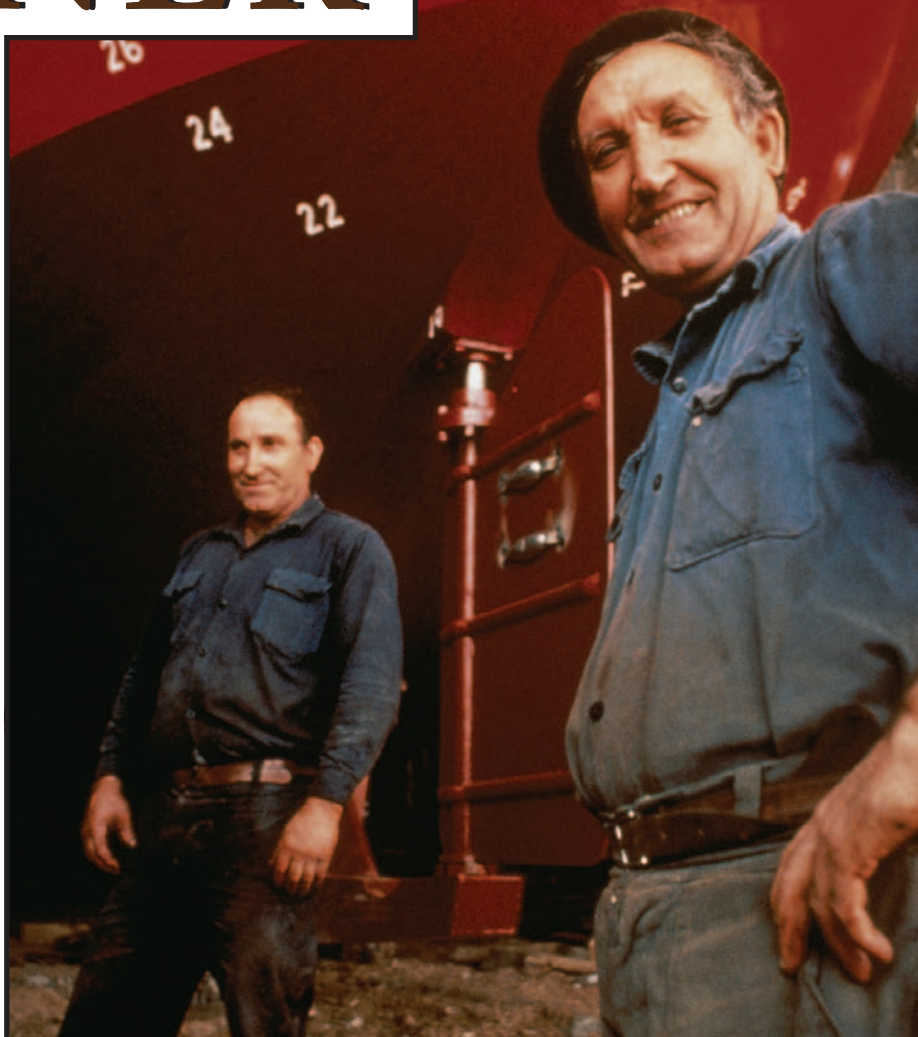
## **Estate planning for unmarried couples**

## **Looking for the best way to provide for a disabled child?**

The answer may be a special needs trust

### **Estate planning red flag:**

You don't have backup beneficiaries for your life insurance policy



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# Keep it in the family

Strategies that lower the price of business succession

It's every business owner's worst nightmare: The founder dies and the heirs are forced to sell the business to pay the estate taxes. This scenario is becoming less common as the federal estate tax exemption increases. And if the estate tax is repealed permanently, it should become a nonissue (although *state* death taxes are a growing concern). But for now, it's a very real problem for many family and closely held businesses.

The most effective way to avoid this predicament is to begin planning early in the life of the business and to take steps to mitigate the effects of estate taxes. (See "Lifetime estate planning strategies for business owners" on page 3.) But there are some last-minute strategies that can be used to ease the pain. These include special-use valuation, which allows an estate to discount the value of business real estate, and deferred estate tax payment, which doesn't reduce the tax but gives heirs some breathing room to raise the necessary funds.

## Reducing estate tax with a special-use valuation

If a significant portion of your estate consists of real property used in a family business or farm, your family may be able to reduce estate taxes with a special-use valuation. The purpose of special-use valuation is to assist families struggling to hang on to a small business or a farm.



Ordinarily, real property's fair market value is based on its "highest and best use." A piece of prime real estate in a downtown financial district, for example, would likely be valued based on its use for an office building, even if the owner operates a parking lot on the property. Highest-and-best-use valuation can lead to harsh tax consequences for successors who wish to continue the property's current use.

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So if certain requirements are met, the tax code allows an executor to elect to value real property based on its actual use, rather than its highest and best use. For example, let's say you own a manufacturing plant on the outskirts of a growing suburb. The land's value, based on its current use, is \$1 million, but its fair market value is \$1.5 million based on its highest and best use as a residential subdivision. If the property qualifies for special-use valuation, your loved ones can reduce the property's value for estate tax purposes by \$500,000. The special valuation cannot reduce the gross estate by more than \$870,000, as indexed for 2005.

## Qualifying for special-use valuation

The tax code imposes strict requirements designed to ensure special-use valuation is used only for its intended purpose. You must meet the following qualifications to be eligible for special-use valuation:

- You (the decedent) must be a U.S. citizen or resident.
- The property must be located in the United States and must be used for business or farming.

## Lifetime estate planning strategies for business owners

Special-use valuations and deferred estate tax payments are valuable tools your heirs can take advantage of after your death to lower the cost of business succession. But they're no substitute for planning during your lifetime to soften the blow of estate taxes.

Strategies to consider include:

- Establishing a family limited partnership or limited liability company to take advantage of valuation discounts on interests you transfer to family members and to remove future appreciation from your estate,
- Making systematic gifts of business interests to family members, taking advantage of the \$11,000 annual gift tax exclusion,
- Purchasing life insurance — ideally through an irrevocable life insurance trust — to provide loved ones with a source of liquid funds to pay estate taxes and other expenses,
- Developing a buy-sell agreement that sets the terms for sale of your business interest and, if structured properly, establishes its estate tax value,
- Selling your business interest outright to your heirs, and
- Transferring your business interest to a grantor retained annuity trust or other trust that removes future appreciation from your estate and allows you to transfer assets to beneficiaries at a reduced gift and estate tax cost.

- You or a family member must have owned the land for at least five of the eight years immediately preceding your receipt of Social Security benefits, disability or death (the qualifying period).
- You or a family member must have materially participated in the business during the qualifying period.
- The property's adjusted value must account for 25% or more of your gross estate's adjusted value. Adjusted value is the highest-and-best-use value, reduced by certain debt.
- The adjusted value of all real and personal property used in the business must account for 50% or more of your gross estate's adjusted value.
- The property must pass to a "qualified heir," which includes your spouse, parents, grandparents, children and grandchildren.
- The qualified heir must materially participate in the business or farm operations for at least 10 years after the decedent's death.

If the heir sells or otherwise disposes of the property or stops operating the business during the

10-year period, the IRS can collect some or all of the estate taxes that would have been owed absent the special-use election.

### Deferring estate tax payments

Another tax code provision designed to ease the burden on closely held businesses allows your estate to defer estate tax payments for five years and then pay the tax liability in 10 annual installments. Your estate pays only interest for the first four years, including a special 2% rate on taxes attributable to a specified portion of the business's taxable value (\$1,170,000 in 2005).

To qualify for deferred payments, your interest in a closely held business must exceed 35% of your adjusted gross estate. A closely held business includes:

- A sole proprietorship,
- A partnership, if you own at least 20% of the capital interests or the partnership has 45 or fewer partners, or
- A corporation, if you own at least 20% of the capital interests or the corporation has 45 or fewer shareholders.

The tax code contains special rules for determining whether a business passes the 35% test.

For example:

- Certain passive assets — or assets not used in the business — are excluded,
- You can combine more than one business to meet the 35% test, as long as you own at least 20% of each, and
- An interest in a farm also includes any interest in farmhouses and certain other structures.

Keep in mind that your estate can't defer *all* of its tax liability, only the portion attributable to the closely held business. Also, your estate must secure its payments either by furnishing a surety bond or consenting to a tax lien on the property.

Your estate will lose the right to defer tax payments, and the entire tax liability will become due immediately, if there's a default in the payment of tax or interest, if your estate fails to distribute sufficient income or violates lien conditions, or if 50% or more of the value of your business interest is sold or withdrawn from the business.

### Planning today for tomorrow

There are some moves you can make now to ensure that the benefits of special-use valuations and deferred estate tax payments will be available to your heirs. Both tax breaks require that business assets account for a certain percentage of your estate. You can help ensure those tests can be met by gifting nonqualifying assets or acquiring additional qualifying assets during your lifetime. ■

## Estate planning for unmarried couples

Every couple should have an estate plan, especially if they have children. But if you're unmarried and in a long-term relationship and wish to leave property to your partner when you die, estate planning is indispensable.

### Overcoming the disadvantages

When it comes to estate planning, marriage has many benefits. Foremost among them is the marital deduction, which allows unlimited gifts to a spouse (as long as he or she is a U.S. citizen) without incurring gift or estate taxes.

Without the deduction, it's more difficult for unmarried couples to transfer large amounts of property to each other. The annual gift tax exclusion lets you transfer up to \$11,000 a year tax-free, but anything beyond that may be subject to gift tax. If one partner pays all of the couple's living expenses, for example, a portion of those expenses may be a taxable gift.

Even with no estate planning, married couples have an advantage. If one dies without a will or

living trust, generally state law provides that a certain amount of property will pass to the other spouse. Spouses also may have guaranteed interests in each other's retirement plans. But you can't leave property to an unrelated partner without a will or living trust (or a beneficiary designation, in the case of retirement plans). Even then, unmarried partners' wills may be more vulnerable to contest than those of married partners, especially if family members are excluded.

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Another advantage for married couples is that they can hold property as tenants by the entirety, a form of ownership authorized in many states that offers asset protection benefits. One popular property ownership strategy for unmarried couples is to hold property as joint tenants with rights of

survivorship. If one partner dies, the surviving partner automatically becomes the sole property owner. An advantage of this approach is that you can ensure that your partner receives the property.

A disadvantage is that, unlike a will, once you transfer title you usually can't undo it. Also, creating a joint tenancy may be a taxable gift if the property previously belonged to you or your partner individually or if one of you provides the funds to buy the property.

And married couples also generally can make health care decisions for each other without a medical directive or health care power of attorney. Unmarried couples, on the other hand, must take pains to document their relationships to ensure that their wishes are carried out. Health care proxies and careful beneficiary designations are critical, for example.

### One advantage for unmarried couples

In some cases, unmarried couples have a tax *advantage* over their married counterparts. One of the most effective planning tools for unmarried couples is a grantor retained income trust (GRIT). A GRIT is an irrevocable trust to which you transfer stocks and bonds, real estate, or other assets.

You reserve the right to receive trust income for a specified time period, and at the end of the term the assets are transferred to your partner (or other beneficiary). You also may retain a contingent reversionary interest, meaning the assets will revert to your estate if you die before the term expires.

When you establish a GRIT, you make a taxable gift to the beneficiary, but the gift's amount for gift tax purposes is calculated by subtracting the actuarial value of your reserved income and reversionary interests from the value of the assets. What makes a GRIT so effective as an estate planning tool is that the trust assets are assumed to produce income at the applicable federal rate (AFR), whether they actually produce income or not. This allows you to transfer substantial amounts of property at deeply discounted gift tax values.

In 1989, Congress, concerned about perceived abuses of GRITs, imposed strict limitations that

essentially eliminated their benefits when used to transfer property to *family* members. But GRITs remain a powerful tool for transferring wealth to *nonfamily* members.

For example, let's say you, at age 60, transfer \$1 million worth of real estate to a 15-year GRIT for the benefit of your partner, retaining a contingent reversionary interest. At the end of the term, the property has appreciated in value to \$2 million.

At the time you create the trust, the AFR is 5%, so the GRIT is assumed to produce \$50,000 in income per year. The gift tax value, based on IRS actuarial tables, is approximately \$340,000. Assuming you survive the term, your partner receives \$2 million worth of property at a gift tax value of just \$340,000, well under your \$1 million lifetime gift tax exemption.

### Estate plan a must for everyone

Despite the estate planning benefits of marriage, unmarried couples have a variety of planning opportunities and even some tax advantages. To obtain these benefits, however, planning for unmarried couples is even more critical than it is for married ones. ■



# Looking for the best way to provide for a disabled child?

The answer may be a special needs trust

If you have a disabled child (or other disabled family member you provide for), you likely are looking for the best way to provide for him or her after you're gone. If your child is unable to work and requires long-term care or other assistance, the financial burden can be enormous. A special needs trust can help you enhance your child's quality of life without making your child ineligible for important government benefits.

## Preserve eligibility

A disabled child may be eligible for a variety of valuable government benefits, including Medicaid and Supplemental Security Income (SSI).

Medicaid and SSI pay for basic medical care, food, clothing and shelter. But to be eligible for these benefits, your child's resources must be limited to no more than \$2,000 in "countable" assets, which generally includes everything except:

- A principal residence (with certain exceptions),
- A car (which may be subject to value limits),
- A small amount of life insurance,
- Burial plots or prepaid burial contracts, and
- Certain personal belongings, such as furniture, clothing and jewelry.

Too much income also can disqualify your child from government benefits. This puts parents in the difficult position of choosing between providing for their children without the government's help or leaving them at the mercy of the health and welfare system.

One solution is to disinherit the disabled child and leave excess assets to a sibling or other relative who will be responsible for the child's support.



This may be a dangerous strategy, though. For one thing, the sibling has no legal obligation to use the assets for the disabled child's care. Plus, even with the best intentions, some or all of these resources could be lost if the sibling dies, divorces or runs into legal trouble.

## Supplement government benefits

A better solution is to implement a special needs trust — also called a supplemental needs trust — because it's designed to supplement, rather than replace, government assistance. You can fund the trust during life or at death using a variety of assets, including cash, stock, real estate or life insurance proceeds. The trust doesn't have to be irrevocable, but a revocable trust may have negative tax consequences, including inclusion of the trust assets in your estate.

To preserve eligibility for government benefits, trust funds must not be used for the child's support — in other words, for medical care, food, clothing or shelter covered by Medicaid or SSI. But they can be used for just about anything the government doesn't pay for, including

rehabilitation and medical care not covered by public benefits, education and training, transportation, insurance, wheelchair-accessible vans, and modifications to the child's home.

A special needs trust also can be used to pay for quality-of-life expenses, such as travel, recreation, hobbies, entertainment, and stereo and television equipment.

### **Ensure trust is drafted carefully**

A special needs trust must be drafted carefully to avoid disrupting government benefits. It should give the trustee sole discretion over distributions and prohibit or strictly limit cash distributions to your child. It also must prohibit the trustee from distributing funds for support items covered by Medicaid or SSI.

In addition, the trust should expressly state that your intention is to use the funds for nonsupport purposes and to preserve the beneficiary's eligibility for government benefits. If you wish, you can provide specific instructions on the types of nonsupport expenses the trust should pay, such as tuition or travel expenses for attending family gatherings.

### **Make your intentions known**

Be sure that your relatives and friends know about your plans. Otherwise, they could unwittingly sabotage your efforts by making gifts or bequests directly to the disabled person. If they would like to help, ask them to make their gifts to the special needs trust. ■

## **Estate planning red flag**

### **You don't have backup beneficiaries for your life insurance policy**

Life insurance is a valuable estate planning tool that can provide your family with liquid funds to pay estate taxes and other expenses. You may have heard that it's usually a mistake to name your estate as beneficiary. But did you know that failure to name at least two backup beneficiaries can be just as big a mistake?

Naming your estate as beneficiary of a life insurance policy may have a number of undesirable consequences, including:

- Triggering unnecessary state inheritance taxes or causing the insurance proceeds to be taxed at a higher rate (depending on the state),
- Exposing the insurance proceeds to creditors' claims, and
- Increasing the likelihood that your estate will go through probate, causing needless expense and delay.

Even if you diligently designate a beneficiary for each of your life insurance policies, your efforts will be wasted if the beneficiary dies before you do but the designation is never changed. That could easily happen if, for example, you named your spouse as beneficiary and you both die in a car accident.

Without a living beneficiary, the insurance proceeds are paid to your estate, just as if you had named your estate as beneficiary in the first place. To avoid this problem, be sure to name at least two backup, or contingent, beneficiaries for each of your life insurance policies, one of which may be a trust created by your will.

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