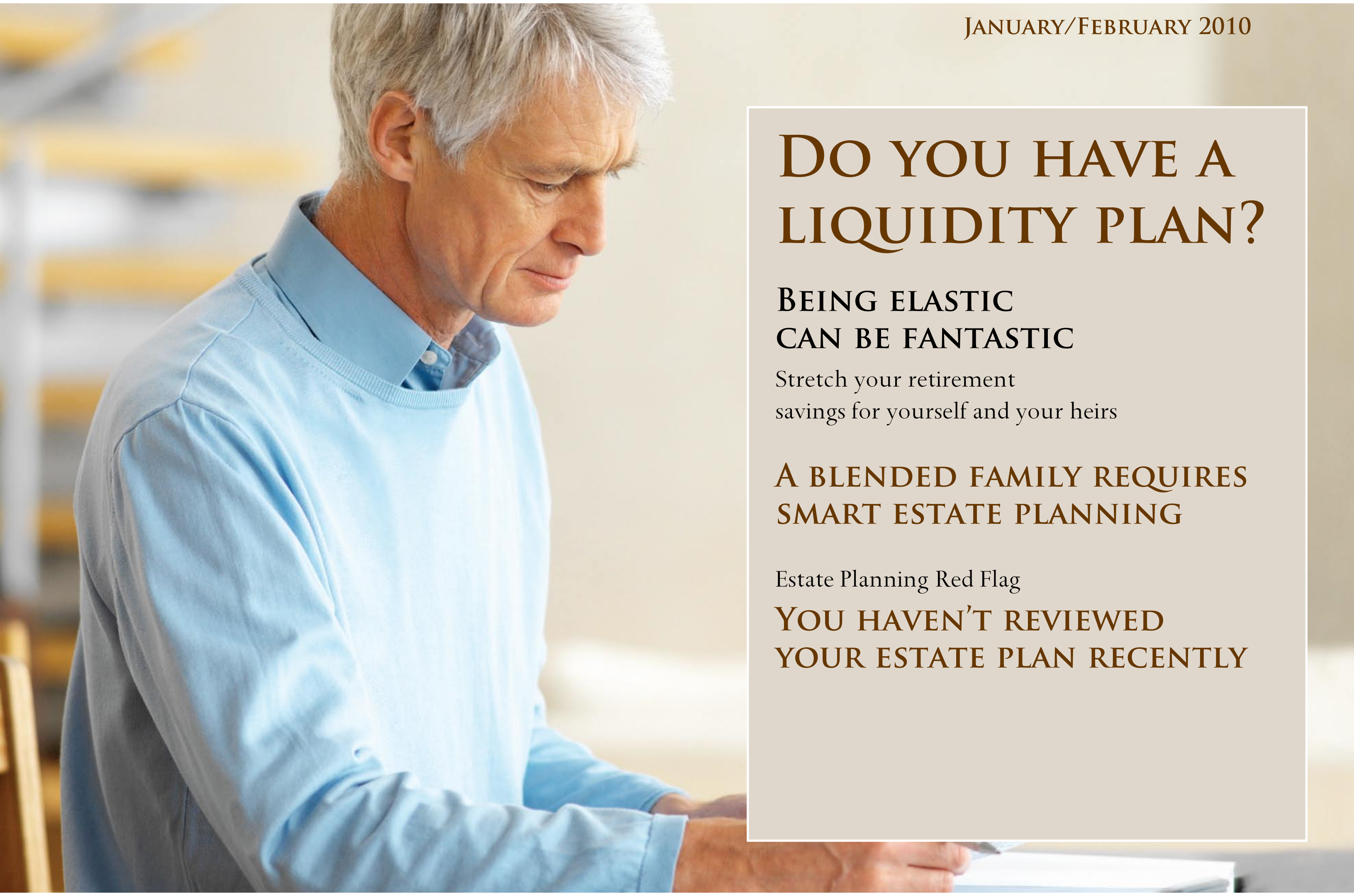
The Estate Planner



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Do you have a liquidity plan?

Being elastic can be fantastic

Stretch your retirement savings for yourself and your heirs

A blended family requires smart estate planning

Estate Planning Red Flag

You haven't reviewed your estate plan recently

Do you have a liquidity plan?

A liquidity plan is an essential component of an effective estate plan, particularly if a substantial amount of your wealth is tied up in a closely held business, real estate or other illiquid assets. No matter how much effort you've put into planning the disposition of your wealth, you can't achieve your estate planning goals without liquidity to pay estate taxes and other expenses. And the sooner you start planning to build that liquidity, the better.

Note that this article is written with the assumption that there will be a federal estate tax. For information on the 2010 estate tax repeal, see the Estate Planning Red Flag on page 7.

Liquidity options

For most people, the most effective liquidity tool is life insurance held in a carefully designed irrevocable life insurance trust (ILIT). The cash value of life insurance grows tax free and, with proper planning, the death benefits will be income-tax free to your beneficiaries and shielded from being taxed as part of your estate.

Other liquidity options include buy-sell agreements for interests in closely held businesses, IRAs, employer-provided retirement plans and other investment vehicles.

What if life insurance or other assets are unavailable or insufficient to meet your liquidity needs? Your estate has several options. One, of course, is to sell assets to generate the necessary cash. But this option may be undesirable, especially if your estate includes interests in closely held businesses or real estate that you wish to keep in the family. Plus, your heirs may be forced to sell assets for much less than they're worth to meet estate tax filing deadlines.

Borrowing to pay estate taxes

It may be possible for an estate to borrow funds from a bank or other third party to pay taxes or other expenses and, if certain requirements are met, to deduct the interest payments as an administration expense. Projected interest payments can be deducted for estate tax purposes as of the time of death, provided the loan is "actually and necessarily incurred in the administration of the decedent's estate" — that is, the estate must be illiquid. This includes loans obtained to avoid the sale of interests in a closely held business.

To qualify for the deduction, projected interest should be ascertainable, which generally means that the loan must provide for a fixed rate of interest and prohibit prepayment (or impose a substantial penalty for prepayment). In addition, the loan must be bona fide (more on that below), the lender must report the interest income to the IRS, and borrowing funds to pay taxes must be permitted under local law.

In some cases, an estate may be able to borrow funds internally, typically from the business that created

Relief for business owners

Internal Revenue Code Section 6166 allows your executor to defer estate taxes associated with a qualifying closely held business. The estate can pay interest only (at rates as low as 2%) for five years and then pay the tax and additional interest in 10 annual installments.

To qualify, the value of your interest in a closely held business (or, in some cases, several closely held businesses) must exceed 35% of your adjusted gross estate. A closely held business includes sole proprietorships, partnerships, limited liability companies (LLCs) and corporations that meet certain requirements with respect to the number of owners and the size of your estate's interest. In addition, the company must conduct an active trade or business, and the value of any passive assets the business holds doesn't count toward the 35% test.

Keep in mind that tax deferral is available for only the portion of your overall estate tax liability that's attributable to the qualifying closely held business interests.

the illiquidity in the first place. However, when the loan is from a related party — for instance, an entity that's controlled by the deceased and his or her family — you can expect the transaction to be scrutinized by the IRS to determine whether it is, in fact, bona fide. Further, the IRS may deny the interest deduction (not to mention valuation discounts associated with interests in the entity) if it concludes that the estate's illiquidity has been created by an entity such as a family limited partnership (FLP) or an entity that the IRS determines to have no valid business purpose.

Receiving an extension

The tax code contains two provisions that may allow estates with liquidity problems to obtain an extension of time for payment of federal estate taxes. One allows qualifying estates to defer taxes attributable to a closely held business. (See "Relief for business owners" above.)

The other provision, Internal Revenue Code Section 6161, combined with related tax regulations, allows the IRS to grant extensions of up to 12 months for reasonable cause and up to 10 years for undue hardship. Examples of reasonable cause include an estate with liquid assets located in multiple jurisdictions and not immediately accessible by the executor, an estate with substantial assets that consist of rights to future payments, and an estate that lacks sufficient funds without borrowing at an above-market interest rate.

The regulations also provide examples of undue hardship, one of which is particularly relevant today: "The assets in the gross estate which must be liquidated to pay the estate tax can only be sold at a sacrifice price or in a depressed market if the tax is to be paid when otherwise due."

The cash value of life insurance grows tax free and, with proper planning, the death benefits will be income-tax free to your beneficiaries and shielded from being taxed as part of your estate.

Start planning now

Building liquidity takes time, so it's a good idea to consult your estate planning advisor now about strategies for meeting your estate's tax obligations. If you anticipate liquidity problems, your advisor can help you and your family arrange for loans, extensions or other financing alternatives. ✤

Being elastic can be fantastic

Stretch your retirement savings for yourself and your heirs

If you have a substantial amount of savings in a traditional IRA, a 401(k) plan or another "qualified" retirement account, you probably know that you must begin taking required minimum distributions (RMDs) when you reach age 70½. You probably also know that, unless you need the funds for living expenses, the best strategy is to let them continue compounding on a tax-deferred basis (or tax-free in the case of Roth accounts) as long as possible. Fortunately, there are several strategies you can use to achieve this objective.

The Roth conversion

Contributions to a traditional IRA can be tax deductible, but withdrawals are subject to ordinary income taxes. With a Roth IRA, on the other hand, your contributions aren't deductible, but qualified withdrawals of contributions — as well as earnings — are tax free. And you're not required to take RMDs from a Roth IRA, so converting can be an option to stretch your retirement savings.

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Since the inception of Roth IRAs, Roth IRA conversions have been available only to people with modified adjusted gross income of $100,000 or less. But starting in 2010, conversion to a Roth IRA is available to taxpayers at all income levels.

Keep in mind that if you convert you'll take a tax hit: It's treated as if you withdrew the funds from the traditional IRA in a taxable (but penalty-free) distribution and reinvested them in a Roth IRA. If the value of your IRA investments has taken a beating in the current economy, making the conversion soon may allow you to minimize the tax hit. Plus, for conversions in 2010, you can opt to defer half of the taxable income to 2011 and the other half to 2012.

If you have a 401(k), 403(b) or other retirement plan, you'll need to roll it over to a traditional IRA before you can make the conversion. You generally can make the rollover only after you've separated from the employer sponsoring the plan. As long as the rollover is done properly, no tax will be due on it.

The Roth rollover

If you have a Roth 401(k) or Roth 403(b) plan, consider rolling it over to a Roth IRA. Why? Because Roth 401(k)s and Roth 403(b)s still have RMDs. Even though you won't have to pay tax on the distributions, you'll lose out on the opportunity for continued tax-free growth on them.

There are no income limits on rollovers from a Roth 401(k) or Roth 403(b) to a Roth IRA. Similar to the rollover of a traditional 401(k) or 403(b) mentioned above, you generally can make the rollover only after you've separated from the employer sponsoring the plan. As long as the rollover is done properly, no tax will be due on it.

The stretch IRA

Designating a child or other young person as beneficiary of your retirement account allows you to provide your heirs with the opportunity to stretch distributions for many years — perhaps even over several generations. If you don't designate a beneficiary or you name your estate as beneficiary, distributions will be accelerated after your death.

Bear in mind that, if you designate multiple beneficiaries, distributions will be based on the oldest beneficiary's life expectancy — that is, the shortest life expectancy. You can avoid this result, however, by splitting your retirement plan into separate accounts for each beneficiary so that each beneficiary's distributions are based on his or her own life expectancy.

If you wish to take advantage of this strategy, be sure that your IRA custodian permits — and is familiar with the concept of — the stretch IRA. Likewise, be sure that your 401(k) permits rollovers to a beneficiary other than a spouse.

The see-through trust

A disadvantage of the stretch IRA is that there's nothing to prevent your beneficiary from taking more than the RMD, defeating the purpose of the technique. You can avoid this risk — and provide some creditor protection as well — by designating a trust as beneficiary of your retirement account, including a trust provision that account withdrawals are limited to RMDs, and naming your desired heir as trust beneficiary.

For this strategy to work, the *trust* beneficiary's life expectancy must be recognized for RMD purposes. And for this to happen, the trust must qualify as a "see-through" trust. The rules for qualifying are complex, but the simplest approach is to use a "conduit" trust, under which the trustee is required to distribute any retirement account withdrawals to the trust beneficiary. Because the withdrawals are limited to RMDs, distributions from the trust will be relatively small.

Weigh your options

If you have a significant amount of wealth in IRAs or other retirement accounts, talk to your estate planning advisor about ways you can stretch out their tax benefits for years or generations to come. ✤

A blended family requires smart estate planning

If you're married and have children from a previous marriage plus children or stepchildren from your current marriage, your family is considered a blended family. And because you'll likely wish to pass your wealth on to all of your biological children but also provide for your spouse and perhaps any stepchildren, estate planning can get tricky. Two estate planning strategies to consider involve a qualified terminable interest property (QTIP) trust and an irrevocable life insurance trust (ILIT).

QTIP trust: The upside and downside

One of the most effective estate planning tools for blended families is a QTIP trust. This trust is designed to qualify for the estate tax marital deduction, so that assets you transfer to the trust aren't taxed when you die. (This article is written with the assumption that there will be a federal estate tax. For information on the 2010 estate tax repeal, see the Estate Planning Red Flag, opposite.)

One of the most effective estate planning tools for blended families is a QTIP trust.

Unlike an ordinary marital trust, however, a QTIP trust provides your spouse with income for life but can preserve the principal for your children from your previous marriage. Note that, when your spouse dies, the trust assets are includible in his or her taxable estate.

Under the right circumstances, a QTIP trust is a great tool for balancing competing estate planning goals and preserving family harmony. But in some cases — particularly when one spouse is considerably older than the other — it can hinder estate planning efforts.

For example, Pete and Kim got married 10 years ago and have two children, ages six and four. Pete is 50 and has two children from a previous marriage, ages 17 and 24. Kim is 34 and this is her first marriage. Pete wants to make sure that Kim and their young children are provided for after he's gone, but he also wants to share his wealth with his older children. In addition, it's important to him that everyone in the family feels they've been treated fairly.

A QTIP trust would allow Pete to spread his wealth among the family, but it has a big disadvantage: Pete's older children would have to wait until Kim died to receive their inheritance. And with a relatively small age difference between the children and their stepmother, that could be a long time. Pete worries that such an arrangement would create tension.

ILIT: The alternative

As an alternative, Pete's advisor suggests an ILIT. The ILIT purchases insurance on Pete's life, and Pete makes annual exclusion gifts to the trust to cover the premiums. If the ILIT is designed properly, there won't be any estate tax on the insurance proceeds.

When Pete dies, the ILIT collects the death benefit and pays it out to his children from his first marriage. The older children receive their inheritance immediately, and Pete's other assets remain available to provide for Kim and the younger children.

Communication is key

Whether you choose a QTIP trust, an ILIT or another strategy, explain your plans — and the reasons behind them — to your children and spouse. Communication is key to maintaining blended family harmony. ✤

Estate Planning Red Flag

You haven't reviewed your estate plan recently

It's a good idea to review your estate plan regularly, but now it's especially important. The Economic Growth and Tax Relief Reconciliation Act of 2001 created a one-year estate tax repeal for 2010. It's not likely to remain in effect, though.

It had been expected that Congress would pass legislation by the end of 2009 repealing the repeal. However, that didn't happen. Such legislation is still on Congress's agenda, and it may be retroactive to Jan. 1, 2010. In fact, by the time you're reading this, Congress may have passed legislation extending the 2009 estate tax exemption amount ($3.5 million) and top estate tax rate (45%) — or taking other measures to repeal the repeal.

You may also need to update your plan if:

- Your net worth or the value of certain assets substantially increases or decreases,
- Your family circumstances change (for example, marriage, divorce, or birth of a child or grandchild),
- A beneficiary dies or his or her financial circumstances change,
- A person you named as an executor, trustee or guardian dies or is no longer suitable,
- You move to a new state, or
- Your estate planning goals change.

Check with your estate planning advisor to get the latest information on estate tax law changes and to discuss whether your plan should be modified in light of legislation or changes in your specific situation.