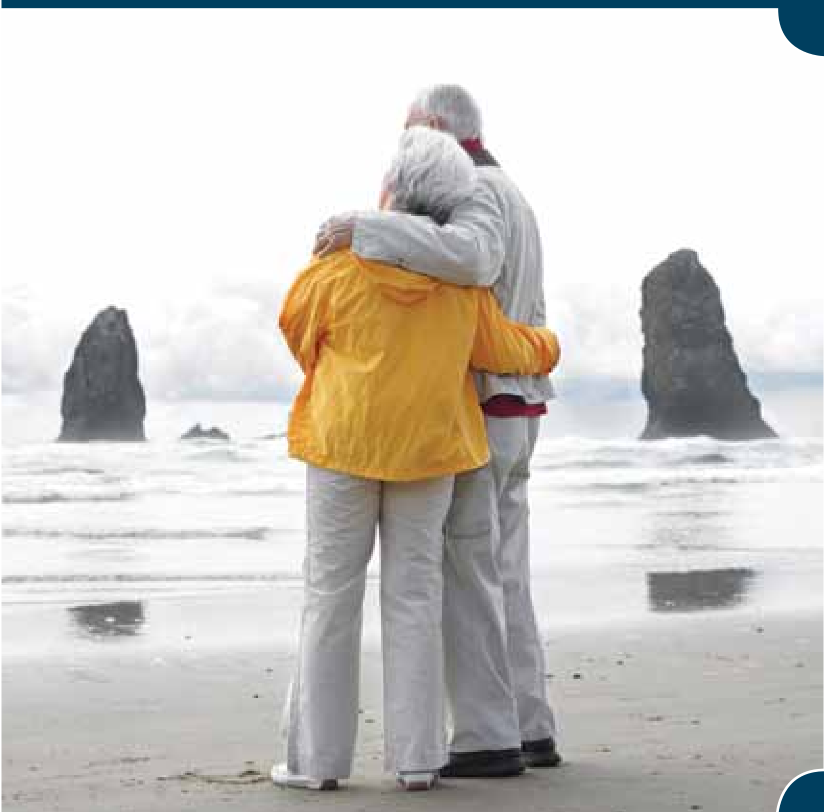
# Insight on Estate Planning

Year End 2012



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Weinstock Manion
A Law Corporation

1875 Century Park East • Suite 2000
Los Angeles, California 90067
(310) 553-8844 • Facsimile (310) 553-5165
www.weinstocklaw.com
www.trustlaw.la

# The spousal lifetime access trust: A safety net in uncertain times

If you're married and looking for a last-minute strategy to take advantage of the $5.12 million federal gift and estate tax exemption, consider a spousal lifetime access trust (SLAT). Uncertainty about the future of the federal estate tax regime makes setting up a SLAT in 2012 particularly useful. But regardless of what happens to the exemption, the SLAT can continue to be a valuable tool for removing significant wealth from your estate while providing a safety net in the event your financial circumstances change.

## How it works

A SLAT is simply an irrevocable trust that authorizes the trustee to make distributions to the grantor's spouse, during the spouse's lifetime, if a need arises. Like most irrevocable trusts, SLATs typically are set up to primarily benefit children or grandchildren.

You transfer cash or other assets to the trust, reducing or eliminating gift taxes using annual exclusion gifts as well as your lifetime exemption. You can also reduce exposure to generation-skipping transfer (GST) taxes by allocating some or all of your GST tax exemption to the trust.

After you transfer assets to a properly structured irrevocable trust, all future growth in the trust's value takes place outside your estate and passes to your heirs free of estate and GST taxes. Irrevocable life insurance trusts (ILITs) are especially powerful, because death benefits received by the trust pass to your beneficiaries tax-free.

In addition to tax savings, irrevocable trusts offer several other benefits, including probate avoidance and some protection of the trust assets from your creditors and your beneficiaries' creditors. They also provide a vehicle for consolidating and managing family assets.

### Watch out for the reciprocal trust doctrine

If you're considering setting up a spousal lifetime access trust (SLAT) for the benefit of your spouse while your spouse creates a SLAT for your benefit, be aware of the reciprocal trust doctrine.

Reciprocal trusts are substantially identical, interrelated trusts, created by a husband and wife for each other's benefit. If the IRS believes that the arrangement places a couple in roughly the same economic position as if each spouse had created a trust for his or her own benefit, it may invoke the doctrine to "uncross" the trusts, undoing the tax benefits.

There are a couple of ways to avoid the reciprocal trust doctrine. One is to establish the trusts at different times — far enough apart to refute any argument that one trust was a quid pro quo for the other. Another is to vary the terms of the trusts so that they're not substantially identical. For example, you might give one spouse, but not the other, a special power of appointment.

Keep in mind that the law regarding reciprocal trusts is unsettled, so anytime you and your spouse create dual trusts there's some risk of an IRS challenge.

The primary drawback of an irrevocable trust is that to obtain these benefits you must relinquish control over the trust assets. You may be reluctant to part with large amounts of wealth, particularly in uncertain economic times. That's where a SLAT comes into play. So long as your marriage is strong, providing your spouse with access to the trust in the event of financial need will indirectly benefit you as well.

You can even appoint your spouse as trustee of a SLAT, provided his or her authority to make distributions is limited to an "ascertainable standard," such as funds needed for your spouse's health, education, maintenance or support. It may be preferable, however, to appoint an independent trustee with full discretion to make distributions to your spouse.

## Planning considerations

There are several requirements and potential pitfalls to be aware of before creating a SLAT. To keep the trust assets out of *your* estate, you must not serve as trustee. Also, the trust document must prohibit distributions that would satisfy your legal obligation of support to your spouse. To ensure that the trust assets aren't included in *your spouse's* estate, your contributions to the trust must consist only of your separate property.

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If you live in a community property state, you may need to "bifurcate" community property into equal shares of separate property to fund the trust. And once the trust is funded, you must take care to preserve the separate property status of the trust assets. For example, you should avoid

commingling the trust assets with community property or taking other actions that might convert those assets into community property.

A disadvantage of a SLAT is that, if your spouse dies before you, you'll lose the safety net it provides. Remember, your spouse is a beneficiary of the trust — you aren't. Any financial benefits you enjoy from the trust are indirect ones provided by virtue of your spouse's access to the trust.

One potential solution is to create two SLATs: You establish one for the benefit of your spouse and your children or grandchildren, and your spouse establishes one for the benefit of you and your children or grandchildren. That way, you'll both be protected regardless of who dies first.

But with two SLATs, there's a risk that the IRS will challenge your arrangement under the reciprocal trust doctrine. If such a challenge is successful, the tax benefits will be lost. See "Watch out for the reciprocal trust doctrine" on page 2.

## Upsides and downsides exist

If you're married and planning large year-end gifts to make the most of the $5.12 million exemption, consider a SLAT. It allows you to potentially lock in the exemption but also provides some peace of mind by enabling your spouse to obtain funds if needed. Bear in mind, however, that there are significant tax and nontax risks associated with SLATs, and they haven't all been discussed here. Before taking action, ask your estate planning advisor about the pluses and minus of this trust type for your situation. ■

# Be prepared for a triggering event

## *If you own interests in a closely held business, consider a buy-sell agreement*

Brothers Bob, Doug and Bruce owned a chain of furniture stores. When Bruce died unexpectedly, Bob and Doug were unsure of how to handle Bruce's share of the family business. If the brothers had had a buy-sell agreement, the aftermath of Bruce's death wouldn't have been so complicated.

A buy-sell agreement provides for the disposition of each owner's business interest after a "triggering event," such as death, disability, divorce, termination of employment or withdrawal from the business. However, to be effective, the agreement must include the appropriate provisions.

### Buy-sell agreement benefits

A buy-sell agreement gives the company or the remaining owners the right or the obligation to buy a departing owner's interest. Properly structured, it restricts ownership or control to family members, management or some other select group, creates liquidity for a departing owner's family to pay estate taxes (if applicable) and other expenses, and provides a market for otherwise unmarketable interests.

A buy-sell agreement can also help avoid disputes over ownership and control of the company when an owner leaves the business. In addition, in some cases, a buy-sell agreement can establish an ownership interest's value for gift and estate tax purposes.

### 3 categories of agreements

A buy-sell agreement can fall into one of three general categories: redemption, cross-purchase or hybrid. A *redemption* agreement permits or requires the company to repurchase an owner's interest. A *cross-purchase* agreement permits or requires the remaining owners to purchase the interest, usually on a pro-rata basis.

*The right type of buy-sell agreement for your business and the specific provisions that should be included depend on several tax and practical business factors.*

A *hybrid* agreement involves some combination of redemption and cross-purchase features. For example, it might require a selling owner or his or her representatives to first offer the interest to the company. If the company declines, the remaining owners are required to purchase the interest.

Typically, buy-sell agreements are funded using life insurance. On the death of an owner, the insurance provides a ready source of funds to purchase his or her shares. A properly structured funding arrangement will also provide for the liquidity needed on the retirement or disability of the owner.

The right type of buy-sell agreement for your business and the specific provisions that should be included depend on several tax and practical business factors.

### Tax issues

From a tax perspective, cross-purchase agreements have an advantage, particularly if your business is organized as a C corporation. If a redemption agreement is funded by life insurance, the company's receipt of insurance proceeds might trigger corporate alternative minimum tax.

Also, a redemption agreement boosts the value of the remaining C corporation owners' shares without increasing their basis, which may result in higher taxes if they sell their interests. A cross-purchase, on the other hand, *does* increase basis, because the owner is purchasing additional shares.

Another tax concern for C corporations is constructive dividends. If a buy-sell agreement requires the remaining owners to purchase a departing owner's shares, but they have the corporation redeem the shares instead, the purchase may be treated as a taxable dividend. You can avoid this result by making the corporation a party to the agreement and permitting, but not requiring, the remaining shareholders to buy back the stock.

For pass-through entities — such as S corporations or limited liability companies (LLCs) — the tax implications of redemption and cross-purchase agreements are usually roughly the same. Nevertheless, don't overlook potential issues that may give rise to additional liability.

For example, if your S corporation used to be a C corporation and has accumulated earnings and profits, there could be some undesirable tax consequences. So, it's important to review the specifics of your situation to ensure there are no lurking issues.

## Valuation provisions

A buy-sell agreement's valuation provision is critical. It sets the price — or establishes a method for calculating the price — that will be paid for a departing owner's interest.

The most effective approach is to conduct regular appraisals to ensure that the price is fair and accurately reflects the value of the interest at the time it's transferred. Some companies use valuation formulas tied to book value or earnings, but these formulas often lead to skewed results if the valuation is done at a time when the business is doing particularly well or, conversely, is going through a particularly difficult stretch.

## Can a buy-sell agreement benefit you?

If you own interests in a family or closely held business, a buy-sell agreement may be right for you. Your estate planning advisor can give you more details. ■

# Is your IRA safe from creditors?

If a substantial portion of your wealth is in one or more IRAs, protecting the assets in those accounts is critical to your estate plan. IRAs provide significant benefits, including tax-deferred wealth accumulation during your life and, with proper planning, during the lives of your beneficiaries.

## Asset protection during your life

The extent to which IRAs are protected against creditors' claims first depends on whether the claims are brought in a bankruptcy context. In bankruptcy, federal law controls.

Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, IRAs are exempt from creditors in bankruptcy up to $1 million (in contrast to qualified retirement plans, which are fully exempt). The $1 million limit doesn't apply, however, to amounts rolled over from a qualified plan, including earnings on those amounts. So, for example, if you roll over $2 million from a 401(k) plan into an IRA, the full $2 million, plus all future earnings, is exempt.

To ensure that rollover IRAs are fully protected, maintain documentation of the rollover transaction. It's also a good idea to include "rollover" in the account name and to segregate rollover IRAs from other IRAs.

Outside of bankruptcy, the answer depends on state law. Most states offer some level of asset protection for IRAs, a majority offering full protection. Some states exempt only a portion of an IRA, such as the amount reasonably necessary for the owner's support. Even in states that offer a complete exemption, the IRS can reach IRA assets to satisfy a federal tax lien.

## Asset protection for your heirs

If you name your spouse as beneficiary of your IRA, he or she can roll the funds over into his or her own IRA after you die. Although nonspousal beneficiaries can take a lump sum distribution or distribute the funds over five years, typically they choose to hold the funds in an "inherited IRA," which allows them to maximize tax deferral by spreading distributions over their life expectancies.

Unfortunately, there's some uncertainty about whether the asset protection available to IRAs extends to inherited IRAs. In bankruptcy, the courts are divided on this issue. Outside of bankruptcy, some states expressly apply their exemptions to inherited IRAs, but most simply exempt "IRAs" without specifying how inherited IRAs are treated. In those states, courts have gone both ways, some finding that inherited IRAs are exempt and some finding that they aren't.

If you're concerned about creditor protection for an heir who lives in (or might move to) a state with unfavorable or uncertain asset protection laws for inherited IRAs, consider alternative strategies. For example, you might set up a spendthrift or asset protection trust for the heir and name the trust as beneficiary of your IRA. If the trust is designed properly, it will allow distributions to be spread out over your heir's life expectancy while protecting the trust assets against creditor claims.

## Act now

If you have large balances in one or more IRAs, consult your estate planning advisors to discuss strategies for protecting these funds from creditors and preserving as much of the wealth as possible for future generations. If you need to set up trusts or change beneficiary designations, the sooner you do so, the better.

## Estate Planning Pitfall

### You're unsure whether you need to file a 2012 gift tax return


If you transferred anything of value to another person during 2012, consider whether you need to file a gift tax return. Some transfers require a return even if you don't owe tax. And, in some cases, it's desirable to file a return even if it's not required.

Generally, you'll need to file a gift tax return for 2012 if, during the tax year, you:

- Made gifts that exceeded the $13,000-per-recipient gift tax annual exclusion (other than gifts to your spouse that qualify for the marital deduction),
- Made gifts that exceeded the $139,000 annual exclusion for gifts to a noncitizen spouse,
- Made gifts of *future* interests — such as remainder interests in a trust — regardless of amount,
- Contributed to a Section 529 college savings plan for your child, grandchild or other loved one and wish to accelerate up to five years' worth of annual exclusions ($65,000) into 2012,
- Made gifts that you wish to split with your spouse to take advantage of your combined $26,000 annual exclusions, or
- Made gifts of jointly held or community property.

No return is required if your gifts for the year consist solely of annual exclusion gifts, present interest gifts to a U.S. citizen spouse, qualifying educational or medical expenses paid *directly* to a school or health care provider, and political or charitable contributions.

If you transfer hard-to-value property, consider filing a gift tax return even if the transfer isn't taxable. Adequate disclosure of the transfer in a return triggers the statute of limitations, preventing the IRS from challenging your valuation more than three years after you file.

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**Comprehensive Estate Planning Services**

For over 50 years, the attorneys and staff of Weinstock Manion have focused on providing personalized, high-quality counsel to moderate to high net worth individuals, real estate investors, business owners, charitable organizations, beneficiaries and fiduciaries in the following practice areas:

- Estate Planning
- Wealth Transfer Planning
- Estate and Trust Administration
- Estate and Trust Litigation
- Business Succession Planning
- Charitable Planning and Family Foundations

Working with our client's other trusted advisors, our team of specialized attorneys and paralegals create and implement comprehensive, creative and practical estate plans with the goals of maximizing wealth transfer in accordance with our clients' wishes and reducing taxation.

Estate and trust administration can have significant financial consequences for both current and future beneficiaries. In an effort to minimize income and estate taxes, while maximizing estate and trust income for beneficiaries, our process involves an extensive amount of collaboration between our estate planning, taxation and transactional attorneys.

Weinstock Manion's litigators represent both fiduciaries and beneficiaries in estate and trust disputes. Our litigators are skilled at handling claims for breach of fiduciary duty, beneficiary disputes, disputes regarding the validity of wills and trusts, undue influence and all aspects of conservatorships and guardianships.

For many clients, ensuring the future of their family business through a well-structured succession plan is an essential component of their estate plan. Our team of transactional, tax and estate planning attorneys work with our clients' other trusted advisors to develop plans for retirement, management transition and liquidity events.

Supporting charitable causes is important to many of our clients. We help our clients support the causes they are passionate about in a tax-efficient manner through thoughtful charitable planning, including the creation of family foundations.

At Weinstock Manion, we understand that significant wealth can lead to complex personal and financial issues that may result in family conflict. Our goal is to help implement wealth transfer plans that minimized potential conflicts while promoting enduring legacies for generations to come.

We invite you to explore our team and services, and to contact us to learn more about how we may collaborate to preserve your legacy.