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TRUST & ESTATE **INSIGHTS**

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INSIDE THIS ISSUE

In This Issue

Life Insurance – A Powerful Estate Planning Tool for Nontaxable Estates

For years, life insurance has played a critical role in estate planning, providing a source of liquidity to pay estate taxes and other expenses. It's been particularly valuable for business owners, whose families might not have the liquid assets they need to pay estate taxes without selling the business.

Today, the estate tax exemption has climbed above $5 million, so estate taxes are no longer a concern for the vast majority of families. But even for nontaxable estates, life insurance continues to offer significant estate planning benefits.

Replacing Income and Wealth

If you die unexpectedly, life insurance can protect your family by replacing your lost income. It can also be used to replace wealth in a variety of contexts. For example, suppose you own highly appreciated real estate or other assets and wish to dispose of them without generating current capital gains tax liability.

One option is to contribute the assets to a charitable remainder trust (CRT). As a tax-exempt entity, the CRT can sell the assets and reinvest the proceeds without triggering capital gains tax. In addition, you and your spouse will enjoy an income stream and charitable income tax deductions. Typically, distributions you receive from the CRT are treated as a combination of ordinary taxable income, capital gains, tax-exempt income and tax-free return of principal.

After you and your spouse die, the remaining trust assets pass to charity, reducing the amount of wealth available to your children or other heirs. But you can use life insurance (a cost-effective second-to-die policy, for example) to replace that lost wealth.

You can also use life insurance to replace wealth that's lost to long term care (LTC) expenses, such as nursing home costs, for you or your spouse. Although LTC insurance is available, it can be expensive, especially if you're already beyond retirement age. For many people, a better option is to use personal savings and investments to fund their LTC needs and to purchase life insurance to replace the money that's spent on such care. One advantage of this approach is that, if neither you nor your spouse needs LTC, your heirs will enjoy a windfall.

Funding Charitable Gifts

If you're philanthropically inclined, life insurance can help you support your favorite charities in a cost-effective manner. One strategy is to donate life insurance to charity. If you transfer a policy to a charitable organization, so that the organization becomes both owner and beneficiary, you'll enjoy a charitable income tax deduction (subject to certain limitations), plus additional deductions if you continue to pay the premiums. Or, you can simply name a charity as beneficiary. You won't be entitled to any charitable income tax deductions, but you'll retain control over the policy, including the right to tap its cash value or change beneficiaries. When you die, your estate will be entitled to an estate tax charitable deduction.

Another strategy is to use other assets to fund charitable gifts and purchase life insurance to replace the wealth donated to charity. This strategy is particularly valuable if you have a significant amount in traditional IRAs or retirement plans. If you leave these assets to your heirs, they'll be subject to income tax on any distributions they receive. But if you leave the assets to charity and purchase a life insurance policy for your heirs' benefit, both the charity and your heirs will receive the funds tax-free. You can even withdraw funds from an IRA or retirement plan and use the after-tax proceeds to pay the premiums.

Treating Your Children Equally

If much of your wealth is tied up in a family business, treating your children fairly can be a challenge. It makes sense to leave the business to those children who work in it, but what if your remaining assets are insufficient to provide an equal inheritance to children who don't work in the business? For many families, the answer is to purchase a life insurance policy to make up the difference.

Protecting Your Assets

Depending on applicable state law, a life insurance policy's cash surrender value and death benefit may be shielded from creditors' claims. For additional protection, consider setting up an irrevocable life insurance trust (ILIT) to hold your policy. (See the sidebar "Why ILITs are still relevant.")

Finding the Right Policy

These are just a few examples of the many benefits provided by life insurance. Talk to your estate planning advisor to help determine which type of life insurance policy is right for your situation.

Sidebar:

Why ILITs are Still Relevant

Historically, the primary purpose of an irrevocable life insurance trust (ILIT) has been to remove an insurance policy — and its proceeds — from your taxable estate. But even in a nontaxable estate, an ILIT offers significant benefits. A properly drafted ILIT can protect the trust assets against creditors of the grantor as well as of the beneficiaries, particularly if it's established in a state with favorable asset protection laws.

In addition, an ILIT will shield your insurance proceeds against estate taxes in the event your estate becomes taxable in the future — either because your wealth grows unexpectedly or because Congress decides to reduce the estate tax exemption.

Sidebar:

Donating a Life Insurance Policy to Charity

A number of charities now ask their donors to consider donating life insurance policies rather than (or in addition to) cash in order to make substantially larger gifts than would otherwise be possible. The advantage to donors is that they can make a sizable gift with relatively little up-front cash (or even no cash, if an existing policy is donated). The fact that a charity may have to wait many years before receiving a payoff from the gift is typically not a problem, because charities normally earmark such gifts for their endowment or long-term building funds.

Of course, good reasons may exist for keeping the policy in force (such as to provide liquidity for a taxable estate or to meet the continuing needs of a surviving spouse or disabled child). Still, for individuals with both excess life insurance and a charitable intent, the donation of a life insurance policy may make sense.

If handled correctly, a life insurance policy donation can net the donor a charitable deduction for the value of the policy. A charitable deduction is also available for any cash contributed in future years to continue paying the premiums on a policy that was not fully paid up at the time it was donated. However, if handled incorrectly, no deduction is allowed. For this reason, we encourage you to contact us if you are considering donating a life insurance policy. We can help ensure that you receive the expected income or transfer tax deduction and that the contribution works as planned.

4 Ways to Transfer a Family Business

For many people, a family-owned business is their primary source of wealth, so it's critical to plan carefully for the transition of ownership from one generation to the next.

The best approach depends on your particular circumstances. If your net worth is well within the estate tax exemption, for example, you might focus on reducing income taxes. But if you expect your estate to be significantly larger than the exemption amount, estate tax reduction may be a bigger concern.

Here are four estate-tax-wise techniques to transfer a family business:

1. **IDGT**
   An intentionally defective grantor trust (IDGT) is an income defective trust. As such, it can be a highly effective tool for transferring business interests to the younger generation at a minimal gift and estate tax cost.

   An IDGT is designed so that contributions are completed gifts, removing the trust assets and all future appreciation in their value from your taxable estate. At the same time, it's "defective" for income tax purposes; that is, it's treated as a "grantor trust" whose income is taxable to you. This allows trust assets to grow without being eroded by income taxes, thus leaving a greater amount of wealth for your children or other beneficiaries.

   The downside of an IDGT is that, when your beneficiaries inherit the business, they'll also inherit your tax basis, which may trigger a substantial capital gains tax liability if they sell the business. This result may be acceptable if the estate tax savings outweigh the income tax cost. But what if the value of your business and other assets is less than the current estate tax exemption amount, so that estate taxes aren't an issue? In this case, you might consider an estate defective trust.

2. **Estate Defective Trust**
   Essentially the opposite of an IDGT, an estate defective trust is designed so that beneficiaries are the owners for income tax purposes, while the assets remain in the estate for estate tax purposes. This technique provides two significant income tax benefits. First, assuming your beneficiaries are in a lower tax bracket, this strategy will result in lower "familywide" taxes. Second, because the trust assets remain in your estate, the beneficiaries' basis in the assets is "stepped up" to fair market value, reducing or eliminating their potential capital gains tax liability.

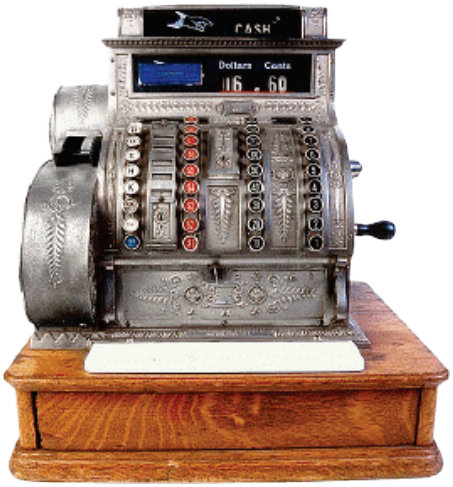
   This strategy assumes you'll have little or no estate tax liability. If your estate increases unexpectedly or Congress decides to reduce the exemption, the benefits may be lost.

3. **Sale to an IDGT**
   If you prefer to sell the business to your children, consider an installment sale to an IDGT (with the payments funded by the business's cash flow). Selling to a trust allows you to retain some control over the business while removing it from your taxable estate. And by structuring the transfer as a sale, you'll avoid gift taxes. Also, when you sell assets to a grantor trust you're essentially selling them to yourself, so there are no capital gains taxes on the transaction.

4. **BIDIT**
   One drawback to selling to an IDGT is that, if you die before the sale is complete, the IDGT will be converted to a nongrantor trust and your estate will be hit with a capital gains tax liability (usually based on the present value of all unpaid installments).[1] To avoid this risk, some taxpayers have started using business intentionally defective irrevocable trusts (BIDITs). A BIDIT works like an IDGT, except it's established by the business itself rather than the owner. Because the grantor is an entity rather than a person, this technique eliminates the income tax risk associated with the grantor's death.

Be aware that the BIDIT is relatively new and untested, but its proponents believe that it can provide a variety of estate tax, income tax and asset protection advantages over an IDGT.

If you own a family business, be sure to review your ownership succession plan in light of recent tax developments. Determining the right strategy to implement when transferring ownership of the business to heirs depends on the value of your business and other assets and the relative impact of estate and income taxes.



[1] The IRS has not issued definitive guidance on installment sales with grantor trusts, and there are differences of opinion in the professional community. Many commentators have made the case that the grantor's death should not cause recognition of the gain from the sale. Please consult your tax professional at Seiler to review your situation.

The BDIT – Realize Estate Planning Benefits while Retaining Control

After working hard your entire life to build your net worth, it's normal to not want to give up control of your property, as is required for certain estate and asset protection strategies. A relatively new trust — the beneficiary defective inheritor's trust (BDIT) — provides powerful estate tax planning benefits while allowing you to retain control of your property.

ABCs of a BDIT

The BDIT strategy is based on the principle that, unlike the person who establishes a trust (the grantor), a trust beneficiary can receive substantial rights in a trust without causing the assets to be included in his or her taxable estate.

A BDIT is set up by a third party — typically, a parent or grandparent — who names you as beneficiary and trustee. As trustee, you manage the trust assets and exercise certain other rights over the trust.

To ensure the desired tax treatment, however, the trust should also name an independent trustee to make decisions regarding discretionary distributions, tax issues and trust-owned insurance on your life. Usually, BDITs are structured as dynasty trusts, so the trust can continue to benefit your children, grandchildren and future generations without triggering gift, estate or generation-skipping transfer tax liability.

For this strategy to work, the BDIT must have "economic substance." So it's critical for the third-party grantor to "seed" the trust with his or her own funds.

If you give the funds to the third party, the IRS likely will treat you as the trust's creator and the BDIT's benefits will be lost. If you sell assets to the BDIT in exchange for a note, an oft-cited rule of thumb says that the seed money should be at least 10% of the purchase price. If the grantor lacks the resources to contribute that much, many experts believe that having a creditworthy third party (such as your spouse) personally guarantee the note is sufficient to lend the transaction economic substance.

Creating the "Defect"

A BDIT is structured to be *intentionally* "income tax defective." (The preferred method of creating the "defect" is to grant you, as beneficiary, carefully designed lapsing Crummey withdrawal rights with respect to the entire trust contribution.) This accomplishes two important objectives:

1. It ensures that you're treated as grantor for income tax purposes. By paying the trust's income taxes, you enable the trust to grow tax-free and you reduce the size of your estate.
2. It allows you to enter into tax-free transactions with the trust.

The second item makes it possible to leverage the BDIT to produce significant estate planning benefits. It allows you to sell appreciating, discountable assets to the trust tax-free, thus removing those assets from your estate and allowing you and your heirs to enjoy all future growth transfer-tax-free.

To ensure the transaction isn't treated as a disguised gift, it's critical to sell the assets for fair market value and to ensure that the interest rate and other terms of the note are comparable to those in arm's-length transactions.

Professional Help Required

As with all sophisticated estate planning strategies, the devil is in the details of the planning and execution. If your BDIT is incorrectly set up, you could be in for a surprise from the IRS. An estate planning attorney should be the person who drafts the trust.

Sidebar:

Exercise Your Rights over BDIT Assets

Like other third-party trusts, a properly structured beneficiary defective inheritor's trust (BDIT) will shield assets against claims by your creditors. In addition, you can exercise a variety of rights over the trust assets without triggering estate taxes. These include the right to:

- Manage trust assets,
- Receive trust income,
- Withdraw assets from the trust (limited to an ascertainable standard, such as amounts needed for your "health, education, maintenance or support"),
- Receive discretionary distributions, in any amount, as determined by an independent trustee,
- Remove and replace the independent trustee,
- Use trust assets (such as a home) rent-free, and
- "Rewrite" certain provisions of the trust by exercising a special power of appointment to distribute the trust assets to anyone other than yourself, your estate or your creditors.

21st Century Estate Planning Accounts for Digital Assets

Do you possess digital assets? If you have online bank and brokerage accounts or keep your music and photos stored on your home computer or "the cloud," the answer is "yes." Thus, you need to account for digital assets in your estate plan. If you haven't done so, your heirs or other representatives may not be able to access these assets without going to court and, in some cases, may not even know that they exist.

Identifying and Unlocking Digital Assets

Traditionally, when a loved one dies, family members go through his or her home to look for personal and business documents, including tax returns, bank and brokerage account statements, stock certificates, contracts, insurance policies, loan agreements, and so on. They may also collect photo albums, safe deposit box keys, correspondence and other valuable items.
Today, however, many of these items may not exist in "hard copy" form. Unless your estate plan addresses these digital assets, how will your family know where to find them or how to gain access?

Suppose, for example, that you opened a brokerage account online and elected to receive all of your statements electronically. Typically, the institution sends you an e-mail — which you may or may not save — alerting you that the current statement is available online. You log on to the institution's website and view the statement, which you may or may not download to your computer.

If something were to happen to you, would your family or executor know that this account exists? Perhaps you save all of your statements and correspondence related to the account on your computer. But would your representatives know where to look? And if your computer is password protected, how would they get in?

Even if your family knows about a digital asset, they'll also need to know the username and password to access it. If they don't have that information, they'll have to get a court order to access the asset, which can be a time-consuming process — and delays can cause irreparable damage, particularly when a business is involved. If your representatives lack access to your business e-mail account, for example, important requests from customers might be ignored, resulting in lost business.

Granting Immediate Access to Digital Assets

The first step in accounting for digital assets is to conduct an inventory, including any computers, servers, handheld devices, websites or other places where these assets are stored. Next, talk with your estate planning advisor about strategies for ensuring that your representatives have immediate access to these assets in the event something happens to you.

Although you might want to provide in your will for the disposition of certain digital assets, a will isn't the place to list passwords or other confidential information. For one thing, a will is a public document. For another, amending the will each time you change a password would be expensive and time consuming.

One solution is writing an informal letter to your executor or personal representative that lists important accounts, website addresses, usernames and passwords. The letter can be stored in a safe deposit box, with a trusted advisor or in some other secure place. However, the problem with this approach is that you'll need to update the list each time you open or close an account or change your password, a process that's cumbersome and easily neglected.

A better solution is to establish a master password that gives the representative access to a list of passwords for all your important accounts, either on your computer or through a Web-based "password vault."

It should come as no surprise that several companies now offer online services for passing on digital assets to your loved ones. Popular services include:

- PasswordBox,
- Entrustet,
- AssetLock™,
- VitalLock,
- Digital Beyond, and
- Deathswitch.

Each service establishes procedures for releasing passwords and other information about digital assets to a designated beneficiary in the event you die or become incapacitated. Some require a death certificate or other confirmation, while others send you periodic e-mails and release information to your designated representative in the event you fail to respond.

Addressing Who'll Receive the Assets

In addition to identifying digital assets and giving family members access to them, your estate plan must address ownership issues involving these assets. Consider working with your estate planning advisor to create a trust that provides the trustee with the authority to manage digital assets and transfer them to your beneficiaries according to your wishes.

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For more than 50 years, Seiler LLP has provided tax, advisory and accounting services to some of the world's most affluent individuals, families, closely held businesses and non-profit organizations. Our clients include prominent business, community and philanthropic leaders, as well as high-net-worth multi-generational families and successful entrepreneurs. Based in Silicon Valley and San Francisco, we deliver the sophisticated solutions, innovative thinking, global capabilities and highly personalized service our clients require to navigate the complexities of their financial worlds, not only for today but for many years to come. Our goal is to exceed our clients' expectations in every way.

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