Insight on Estate Planning

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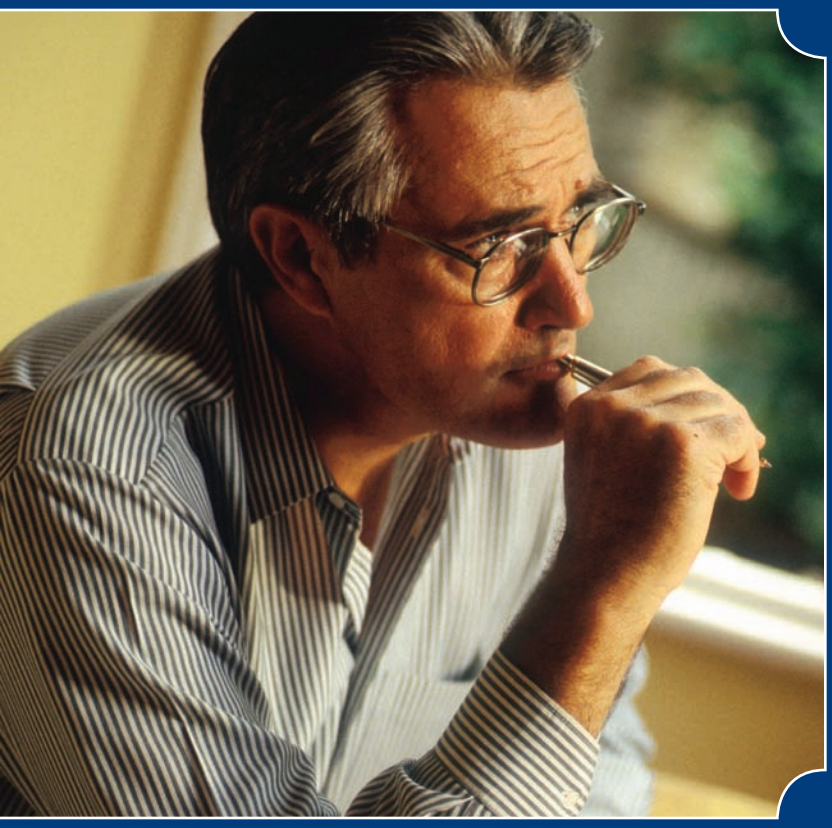

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Estate Planning Pitfall

You don't have a succession plan for your business

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Fraudulent transfer laws

Don't let creditors undo your estate plan

If there's a silver lining to a weak economy, it's that depressed asset values and low interest rates provide an opportunity to transfer wealth at a low tax cost. But before you start giving away property, it pays to familiarize yourself with the fraudulent transfer laws. If creditors challenge gifts, trusts, retitling of property or other strategies as fraudulent transfers, they can quickly undo your estate plan.

Fraud is a highly charged word. Most people wouldn't even consider transferring or hiding assets to avoid paying their creditors. But the fraudulent transfer laws can also jeopardize perfectly innocent, legitimate estate planning moves.

Actual vs. constructive fraud

Most states have adopted the Uniform Fraudulent Transfer Act (UFTA). The act allows creditors to challenge two types of transfers: 1) those involving *actual* fraud, and 2) those involving *constructive* fraud. As you weigh your estate planning options, be mindful of both types of fraudulent transfers.

Actual fraud means that you make a transfer or incur an obligation "with actual intent to hinder, delay or defraud any creditor," including current creditors and probable future creditors. That doesn't mean the fraudulent transfer laws protect anyone who could conceivably become a creditor some day. If that were the case, asset protection planning would be futile.

But suppose you discover that your business property is contaminated with hazardous waste and immediately transfer all of your assets to an offshore trust. Clearly, that would be a fraudulent transfer even though no one has actually filed a lawsuit against you yet.

Even if you harbor no intent to defraud creditors, before you make gifts or place assets in a trust, consider how a court might view the transfer. A court can't read your mind, so to determine whether a transfer involves fraudulent intent it will consider the surrounding facts and circumstances. (See "Fraud factors" on page 3.) To fend off creditor attacks, it's best to make transfers at a time when your financial health is strong and there are no pending or threatened claims against you.

Constructive fraud is a more significant risk for most people because it doesn't involve intent to defraud. Under UFTA, a transfer or obligation is constructively fraudulent if:

1. It's made without receiving a reasonably equivalent value in exchange for the transfer or obligation, *and*

2. The transferor was insolvent at the time or became insolvent as a result of the transfer or obligation.

"Insolvent" means that the sum of your debts is greater than all of your assets, at a fair valuation.

You're presumed to be insolvent if you're not paying your debts as they become due.

Generally, the constructive fraud rules protect only *present* creditors — that is, creditors whose claims arose before the transfer was made or the obligation was incurred. In some cases, however, a future creditor may challenge a transaction if it leaves you with assets that are unreasonably small or if you intend or believe (or reasonably should believe) that you'll be unable to pay your debts as they become due.

Get a financial checkup

Most estate planning strategies have an asset protection component. You may make gifts to your children or set up trusts to minimize taxes or to control how and when your beneficiaries receive your wealth. But as an added benefit, the assets are removed from your estate and protected from your creditors.

Constructive fraud is a more significant risk for most people because it doesn't involve intent to defraud.

By definition, when you make a gift — either outright or in trust — or a bargain sale with a gift component, you don't receive reasonably equivalent value in exchange. So if you're insolvent at the time, or the gift renders you insolvent, you've made a constructively fraudulent transfer, which means a creditor could potentially undo the transfer.

To avoid this predicament, analyze your net worth before making substantial gifts. Even if you're not having trouble paying your debts, it's possible to meet the technical definition of insolvency, especially in the current economy. This can happen, for example, if the value of your real estate or other assets has declined and you have substantial mortgages or other debt.

Fraud factors

According to the Uniform Fraudulent Transfer Act, it may reflect intent to defraud creditors if the debtor:

- Made the transfer to an insider,
- Retained possession or control of the property,
- Concealed the transfer,
- Was sued or threatened with a lawsuit before the transfer,
- Transferred substantially all of his or her assets,
- Absconded,
- Removed or concealed assets,
- Didn't receive reasonably equivalent value,
- Was insolvent or became insolvent after the transfer,
- Incurred a substantial debt around the time the transfer occurred, or
- Transferred the essential assets of a business to a lienor who transferred them to an insider.

Also, if you've cosigned a loan or personally guaranteed someone else's debt, those contingent liabilities count in determining your net worth. And placing a value on these liabilities is no easy task. There are many factors, which could vary widely depending on the circumstances. It's not as simple as estimating the probability that you'll have to honor the guarantee.

Do your homework

To protect your assets and preserve the integrity of your estate plan, be sure you understand the fraudulent transfer laws in your state. The federal bankruptcy laws also contain rules prohibiting fraudulent conveyances and preferential transfers. If bankruptcy may be in your future, work with an attorney to evaluate its potential impact on your estate plan. ▮

2 rules make planning complicated if you already own life insurance

Life insurance often is called one of the building blocks of an estate plan. In addition to providing an income-tax-free source of wealth for your family, a policy can supply instant liquidity* to pay estate taxes and other expenses.

Even though an estate tax repeal went into effect Jan. 1, as of this writing the estate tax is scheduled to return in 2011 and the repeal could even be repealed retroactively. So it's still critical to plan for estate tax — and to take steps to keep life insurance policy proceeds out of your taxable estate. To achieve this goal if you *own* your policy, you need to understand the three-year rule and the transfer-for-value rule.

The downside of ownership

The key to keeping life insurance out of your taxable estate is to make sure you don't own the policy or possess any "incidents of ownership" in it, such as the right to change beneficiaries or borrow against its cash surrender value.

One way to accomplish this is to have someone other than you or your spouse purchase the policy, such as your adult children or an irrevocable life insurance trust (ILIT). You can still contribute the funds needed to pay the premiums — subject to gift taxes, of course. (Note that, with additional planning, you may be able to eliminate or at least reduce these taxes.)

The 3-year rule

What if you already own an insurance policy on your own life? Can you remove it from your taxable estate by transferring it to a family member or to an ILIT? The answer is "yes," but there's a caveat.

The tax code provides that life insurance you transfer within three years of your death be included in your estate. So, if you transfer a life insurance policy and don't survive for at least three years, the proceeds will be pulled back into your estate and potentially subject to estate taxes.

Fortunately, there's an exception to the three-year rule for life insurance (or other property)

you transfer as part of a "bona fide sale for adequate consideration." This basically means that if, say, you wanted to transfer your policy to your son, you could do so without triggering the three-year rule as long as your son paid adequate consideration for the policy. Determining adequate consideration isn't an exact science — one definition is fair market value, which is essentially the price on which a willing seller and a willing buyer would agree.

The transfer-for-value rule

The problem with the bona fide sale exception is that, when life insurance is involved, it may trigger another, equally devastating, rule: the transfer-for-value rule. Under this rule, a transferee who gives valuable consideration for a life insurance policy is subject to ordinary income taxes on the amount by which the proceeds exceed the consideration and premiums the transferee pays. So, in the previous example, even if your son purchased the policy for the appropriate amount to avoid the three-year rule, he could be subject to some income tax on receipt of the proceeds.

There are several exceptions to the transfer-for-value rule, including transfers to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer.

Another option

It may be possible to avoid the three-year rule — without running afoul of the transfer-for-value rule — by selling an existing life insurance policy for adequate consideration to an irrevocable grantor trust. A grantor trust is a trust structured so that you, the grantor, are the owner for *income* tax purposes but not for *estate* tax purposes. You're also treated as the owner of any life insurance policy held by the trust, so the transfer-for-value rule won't apply because you're essentially transferring the policy to yourself.

> *The key to keeping life insurance out of your taxable estate is to make sure you don't own the policy or possess any "incidents of ownership" in it.*

Generally, if the insured is in good health, the value of the policy should be its value for gift tax purposes: the policy's terminal reserve value (roughly equal to its cash surrender value) plus any unearned premiums. For an insured who isn't in good health, the IRS will likely take the position that the policy's value is more closely akin to its death benefit, which effectively rules out a sale of the policy to an irrevocable grantor trust.

Minimizing risk

If you own an insurance policy on your life, there are strategies available to remove the proceeds from your estate while minimizing the risk that they'll be pulled back in if you don't survive for three years after the transfer. Bear in mind that these strategies are complex, so it's best to consult with your estate planning advisor before taking action. ▮

* The cash value in a life insurance policy is accessed through policy loans, which accrue interest at the current rate, and withdrawals. Loans and withdrawals will decrease the cash surrender value and death benefit.

Finding your comfort zone

Manage risk to preserve and grow wealth for future generations

No matter how much effort you put into designing an estate plan, it won't help you sleep better at night unless you address the question of risk. Managing risk is critical to preserving and growing your wealth for future generations.

Until relatively recently, risk management wasn't a high priority for many families. That's not surprising, given several years of uninterrupted economic prosperity. But that prosperity came to an end in late 2007 and early 2008, and the ensuing financial crisis was a wake-up call for many people. It drove home the fact that investment risk is a real concern that families need to define and manage.

> *Risk can be a good thing — without it there would be no rewards.*

Risk can be good

It's important to understand that managing risk doesn't mean eliminating it. Risk can be a good thing — without it there would be no rewards. Too little risk and your asset growth may not keep pace with inflation, eroding your wealth over time. Too much risk, on the other hand, jeopardizes your family's financial security. The key is to determine an appropriate level of risk in light of your family's goals, time horizon and risk tolerance.

A fundamental principle of sound investing is to diversify your portfolio. By spreading your wealth over different asset classes, funds, companies, industries, sectors and geographical regions, you can reduce the risk that poor performance in one area will have a negative effect on your overall portfolio. That being said, however, the right asset allocation for you depends on how you and your beneficiaries evaluate and manage risk.

A balanced approach

One of the biggest challenges in managing risk is addressing the often conflicting needs and risk tolerances of family members. When it comes to investment risk, some may be more conservative while others may be more aggressive.

One way to balance these competing needs is to adopt a "goal-driven" approach. In other words, certain assets are earmarked to provide a safety net to ensure that the family's basic needs are met and are invested more conservatively. Other assets might be invested more aggressively and designated for other goals, such as long-term growth or supporting a particular lifestyle.

Some families are using scenario planning to manage risk. This approach evaluates the risks associated with various scenarios and designs an investment strategy that's flexible enough to adapt to changing circumstances and achieve long-term goals regardless of what the future brings. Scenario planning is similar to a goal-driven approach in that it may call for different investment vehicles or legal structures for different scenarios.

Assess your risk

In business management it's often said that you can't manage what you can't measure, and the same is true of wealth planning: You can't manage your investment risks until you know what they are. It may not be possible to measure those risks with mathematical certainty, but simply starting a family dialogue on the subject can be a powerful planning strategy. ▮

Estate Planning Pitfall

You don't have a succession plan for your business

For business owners, estate planning and succession planning go hand-in-hand. Owners of closely held businesses typically have a significant portion of their wealth tied up in the business. If you own a business and don't take steps to ensure that it lives on after you're gone, you may be placing your family at risk.

An effective plan should address management succession *and* ownership succession. The former means identifying and grooming your company's future leader, such as an adult child who works in the business or another member of your management team. Beginning the process early and preparing for a smooth transition will help ease customer concerns and enhance the company's chances for long-term survival. Consider purchasing key-person insurance to provide capital during the transition phase.

Early planning for ownership succession serves several important purposes, such as:

- Giving you time to transfer the business to your children or others in the most tax-efficient manner,
- Ensuring that your family has the liquidity it needs to pay estate taxes and other expenses without selling business assets, and
- Helping avoid disputes over ownership or control of the business.

Begin transferring ownership of the business as early as possible to make the most of the annual gift tax exclusion, minority interest valuation discounts and other ways to minimize transfer taxes. A variety of tools allow you to transfer ownership without relinquishing control, including family limited partnerships, gifts of nonvoting stock, employee stock ownership plans (ESOPs) and certain trusts.

To ensure that children *not* involved in the family business are treated fairly, be sure that you have nonbusiness assets, such as life insurance, to provide for them.

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