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Estate Planning Insights

Foster Swift Trusts & Estates Group

Congressional Inaction: The Federal Estate Tax Update

by Erica E. L. Huddas

There is no federal estate tax for decedents dying in 2010 unless Congress enacts legislation to reinstate the tax. Estate planners expected Congress to change the tax law before the end of 2010, due in part to President Obama's Fiscal Year 2010 Budget, in which he anticipated maintaining the estate tax in effect during 2009 for decedents dying after December 31, 2009. Although various bills have been introduced, with proposed estate tax exclusions ranging from $3.5 million to $5 million, Congress has not yet reached an agreement. President Obama's Fiscal Year 2011 Budget Proposal again recommends permanently reinstating the estate tax at the 2009 levels (an exclusion amount of $3.5 million and a marginal tax rate up to 45%), which would apply retroactively to the beginning of 2010. However, as time passes and the mid-term elections approach, the enactment of new legislation addressing the controversial federal estate tax seems less likely, though still possible.

Under current law, the presently repealed estate tax is scheduled to return in 2011 with an exclusion of $1 million (adjusted for inflation) and a marginal tax rate up to 55%. After a decade of increasing exclusion amounts, the return of the $1 million exclusion could result in significant federal estate tax for decedents dying in 2011 or later. In the short-term, this is a particular concern for married individuals if one spouse dies this year leaving all of his or her assets to the surviving spouse without taking advantage of the repealed estate tax. In the long-term, additional planning may be necessary for individuals with taxable estate values approaching or exceeding the reduced exclusion amount.

Protecting Your Child's Inheritance

by Allan J. Claypool & Anna K. Gibson

Parents are becoming increasingly concerned with what will happen to assets they leave to their children through trusts, wills, and beneficiary designations. The recent economic downturn has left many children unemployed or underemployed. Further, there has been a noticeable culture shift in the younger generations toward instant gratification. These two factors have produced a younger generation with a growing amount of unpaid bills and other creditor issues, and rising incidents of divorce.

Although these parents believe it is appropriate for their children to pay their creditors, they would like their children's inheritance to provide long-term economic stability. *The good news is that estate planning techniques are available to protect assets for younger generations.*

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1. **Trusts**. Most people are aware that a trust may be used to avoid probate and to minimize the impact of the federal estate tax. Less well-known is that a trust may also protect against the claims of a trust beneficiary's creditors.

   Under the new Michigan Trust Code, effective April 1, 2010, certain trusts now offer more clearly defined levels of creditor protection. Generally, there is a trade-off between (a) a beneficiary's right to demand or assign trust assets, and (b) the right of a beneficiary's creditor to reach the trust assets [*see the Sidebar for more details*].

2. **Buy-Sell Agreements**. Many clients who own a family business entity (such as a limited liability company, S-corporation, closely-held C-corporation, or a partnership) begin to transfer ownership of the entity to their children before death. Clients may want to consider how their entity structure protects against the claims of an ex-spouse or creditor of an individual owner. For example, does the entity's governing instrument preclude automatic substitution of a new owner without the consent of the current owners?

   In addition, clients may want to consider implementing a buy-sell agreement between and among the owners. This could be a stand-alone document or it could be part of the organizational documents of the entity. While the exact terms of a buy-sell agreement vary depending on the needs of each client, many contain provisions restricting the transfer of an interest in the entity in the event of an owner's death, divorce, or bankruptcy. Often, the buy-sell agreement calls for an optional or mandatory buy-out of the interest by the entity or by the other owners at some previously agreed- upon value or at an appraised value.

3. **Individual Retirement Account (IRA)**. Naming a child as a beneficiary of an IRA may allow the child to "stretch" out the distributions from the IRA over her life expectancy, resulting in favorable income tax treatment. This could be problematic if the child is facing bankruptcy. The law is unsettled as to whether an inherited IRA is exempt from a debtor's bankruptcy estate. A bankruptcy court recently held that an inherited IRA receives the same protection as any other IRA created by the debtor. However, another bankruptcy court previously reached the opposite conclusion.

Trusts Provisions and Their Corresponding Creditor Protection:

A. Pure Discretionary Trusts
- Trustee has uncontrolled discretion to determine distributions. Trust beneficiary has no right to demand distributions.
- Settlor may be able to provide guidance (e.g., withhold distributions if a child has drug problems or is facing bankruptcy or divorce).
- No creditor of the trust beneficiary can reach trust assets.
- Trustee must be independent.

B. Support Trusts
- Trustee must make distributions for health, education, support, or maintenance. Trust beneficiary has a right to these distributions.
- Only the following "super creditors" can reach a beneficiary's interest:
  - Alimony or child support;
  - Claims for services that enhanced, preserved, or protected the beneficiary's interest; and
  - State of Michigan or the United States (e.g., tax liens).

C. Spendthrift Trusts
- Trust beneficiary cannot voluntarily or involuntarily transfer her interest in the trust.
- Only the above "super creditors" can reach a beneficiary's interest.
- Any creditor of a trust beneficiary may reach a mandatory distribution.

D. Other Trusts (e.g., mandatory distribution trusts)
- Any other trust is subject to claims of any creditors of a trust beneficiary

Further, an inherited IRA does not protect against a "spendthrift" child who voluntarily withdraws funds from the IRA, quickly depleting this resource. A client who is worried about his or her child's spending habits could consider leaving the IRA assets in trust. Only a specialized trust will still allow the child to stretch out the IRA distributions. If you have substantial IRA assets and are concerned about a spendthrift child, we can discuss these specialized trusts with you, and develop a plan to meet your needs.

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4. **Marital Agreements**. Clients may wish to encourage a child to execute a pre- or post-marital agreement. A marital agreement clarifies the separate property of each spouse, and defines what each spouse is entitled to in the event of a divorce or death. Separate property could include family businesses or an expected inheritance, thereby protecting these assets from claims of a child's spouse. A marital agreement may be especially important for a second marriage or if either party has children outside of the marriage.

Common Estate Planning Pitfalls

by Charles A. Janssen & Anna K. Gibson

Even the most well-laid plans can go awry. Once your estate plan is in place, **avoid these common pitfalls**:

1. **Beneficiary designations or transfer on death designations that are inconsistent with your estate plan or fail to consider income tax consequences.** Beneficiary designations are an important part of an overall estate plan. Assets that typically pass by beneficiary designation include life insurance, annuities, and retirement or other tax deferred benefits (e.g., IRAs, and 401(k), 403(b), pension and profit sharing plans). In addition, in recent years, several financial institutions have implemented payable on death or transfer on death options that allow you to designate beneficiaries for bank accounts, CDs, stocks, and other assets. However, be sure to carefully follow your estate planning attorney's instructions in designating a beneficiary because an inconsistent beneficiary designation may defeat the intended distribution scheme under your will or trust, including any asset protection you may have built into your trust. Moreover, retirement benefits or other tax deferred benefits that pass by beneficiary designation should be carefully reviewed to ensure that they are distributed with full knowledge of the income tax effects and payout options available to the beneficiaries.

2. **Inappropriately adding a child as joint owner on your bank accounts.** Clients sometimes add a child to bank accounts for convenience, but this can have unintended consequences. The law presumes that a joint owner has an interest in one-half of the asset; thus, a child's creditor could reach one-half of your bank account. In addition, on your death, the bank account will pass directly to that child by law. This could defeat the distribution scheme in your will or trust (such as leaving assets equally to all children).

3. **Not reviewing your estate plan on a regular basis.** Changes in law and the inevitable changes in the nature and value of your assets may necessitate changes to your estate plan. In addition, you should review your estate plan after any major family change, such as a birth, adoption, death, or divorce. We suggest a formal review of your estate plan at least every five years to determine if any changes are appropriate.

Avoiding Conflict Over Tangible Personal Property

by Douglas A. Mielock

A decedent's tangible personal property typically consists of jewelry, clothing, automobiles, furniture, furnishings, silver, books, artwork, photographs, and similar items. In estate planning, clients sometimes overlook the difficulties and conflicts their children may face in dealing with their tangible personal property after their death.

One problem is the overwhelming task of sorting through tangible personal property that may have accumulated in a residence over many decades. On occasion, children are forced to obtain a dumpster and spend several weekends emptying a house of unwanted items that could have been thrown out years ago. A client's move from a large house to a smaller residence later in life often avoids this problem. However, a client who is fortunate enough to live at home until death may leave much work for those responsible for emptying the house of tangible personal

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property. Clients can assist their children by removing excessive items from their house during their lifetime through garage sales, donations to charity, or simply throwing things away.

Another problem encountered is conflict between children over the division of tangible personal property. Disputes over items of limited intrinsic value can lead to legal bills far in excess of the value of the items. You may reduce the likelihood of disputes over the division of your tangible personal property in a number of ways:

1. Identify and recognize the potential for conflict among your children, whether it is because of existing conflicts or because of the nature of the tangible personal property to be divided.

2. Take advantage of Michigan law, which allows you to leave a separate statement or list disposing of specified items of tangible personal property to designated recipients. This list should be signed and dated to ensure that it reflects your intent and so that the most recent list can be followed if more than one list is discovered after your death. This list need not be witnessed, which allows you to revise the list from time to time without incurring additional expense.

3. To the extent possible, talk to your children to obtain their input on the division of your tangible personal property. This input may help you identify potential conflicts and avoid them through discussion with your children or modification of your estate plan.

4. If necessary, develop a clear procedure for the distribution of tangible personal property when your children are unable to agree. This could involve a direction that your children choose items in a specified order with or without taking into account the value of each item selected, or designating a third party to determine the distribution of items.

Tangible personal property does not usually constitute a significant percentage of the overall value of a decedent's estate. However, dealing with issues regarding the division and distribution of a decedent's tangible personal property can constitute a significant expense. Proper planning can minimize this possibility.

Our Attorneys

The Trusts and Estates Group at Foster Swift is dedicated to meeting your estate planning and estate administration needs. We continue to add new professionals and offices to ensure our commitment to serving you --- today and in the future. We have recently added several estate planning attorneys and a new office in Holland, Michigan. For more information on our estate planning attorneys (listed in the left margin) go to www.fosterswift.com/professionals.html.

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