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Guide...Protect...Preserve

SLATs Fit Through The Cracks In Estate Plans

Although the American Taxpayer Relief Act of 2012 (ATRA) provides some much-needed clarity about tax rules for estate planning, developing an estate plan remains complex. However, one relatively simple technique may be beneficial for some high-income married couples. It's called the "spousal lifetime access trust"—or SLAT, for short.

SLATs are especially popular in situations involving a second marriage in which you want to provide protection for a new spouse while also making sure that children from your prior marriage ultimately will get their fair share of family wealth.

A SLAT is an irrevocable trust established by one spouse for the benefit of the other as well as for children and grandchildren. (Often, both new spouses will establish a SLAT.) The transfer of assets to the trust is treated as a taxable gift, but it can be sheltered from tax by the lifetime gift tax exemption. Assuming a SLAT is structured properly, the value of the assets, plus any appreciation, will go to your heirs free of estate tax. The trust also shields the assets from claims by creditors or ex-spouses.

Under the terms of the trust, lifetime distributions may be made to meet the needs of a current spouse—although generally, if there's money available outside the trust, it's preferable to use those funds first before making regular distributions from the trust to the spouse. Taking assets from the trust to benefit the spouse will reduce the long-term effectiveness of the SLAT.

Now, let's examine the tax consequences of a SLAT on three fronts:

1. Gift taxes. The taxable gift to the trust can be covered by the lifetime gift tax exemption. Now that ATRA has established permanent limits, you can rely on a generous exemption with greater certainty. The unified estate and gift tax exemption now can shelter up to $5.25 million from tax. (That's how much is exempt in 2013, and the figure, indexed annually for inflation, is likely to rise in future years.) The only catch is that because this is a unified exemption, whatever part of it you use to avoid taxes on gifts won't be available to reduce estate taxes later.

2. Estate taxes. The assets you transfer to a SLAT are removed from your taxable estate. Thus, estate taxes aren't a concern for the trust, and that frees up any remaining estate tax exemption for other assets.

3. Income taxes. A spousal limited access trust is considered to be a "grantor trust" for income tax purposes. This means that if you establish a SLAT for the benefit of your spouse, you must report the trust's taxable income on your personal tax return. But the trust itself pays no tax; assets can grow and compound inside it without being eroded by income taxes. The trust will be required to pay income tax only after

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Signs Of The Time Can Be Found In The Underwear Drawer

Are you looking for signs that the economy is turning around? Check the dresser drawers of the man of the house. If old underwear and socks have been replaced with brand-new items, better times may have arrived.

According to a report by market researcher NPD Group, reported in the *Wall Street Journal*, American men's apparel sales rose only 1% to $57 billion in 2012. But NPD noted that sales of underwear and socks were up 13% and 12%, respectively. This could signal a boost in consumer confidence.

The thinking is that men will continue wearing their old undergarments and socks when times are tough. Those items aren't as visible as other clothing. But when economic fortunes rebound, it's time to break out the new boxers or briefs and socks.

Consumers still were spending cautiously during the first few months of 2013. The NPD report explained that many men made undergarment purchases at off-price retailers and online, while fewer shopped at national chain outlets. Nevertheless, consumer expert Adam Ferrier is upbeat. "Post-recession, we are told the economy is improving and that people are spending again," he told the *Journal.* "The first to go—items like men's underwear—is often the first back on the shopping list."

Are there any holes in this economic theory? Maybe, but you have to admit there's logic to it.

Mary Jane Callaghan &
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Saving For Retirement At All Ages

Financial planners often are asked, “When should I start saving for retirement?” Although everyone’s circumstances differ, the answer usually is a variation on this theme: As soon as possible. But that doesn’t mean it’s ever too late to begin, or that you’ll have the same financial priorities at every age. When you’re embarking on a career, you may not have much extra income to set aside, but you can work on establishing sound financial habits. Later, though you’ll likely earn more, you’ll also likely have greater obligations—supporting your family, paying a mortgage note, and, yes, saving for retirement. Still other factors may come into play as you approach your golden years.

Consider these basic approaches during different financial stages of your life.

In your 20s. Retirement may seem several lifetimes away. What’s more, the salary you earn during your early working years likely won’t provide much cushion for savings. But you may be surprised by how much you can accumulate if you’re dedicated, thanks largely to the power of tax-deferred compounding. For instance, if you save $1,000 a month and earn 8% on your savings compounded annually for 40 years until retirement, you will amass a staggering $3,271,022.95. (These figures are hypothetical and not indicative of any particular investment.)

The easiest way for most people to sustain tax-deferred growth is through a 401(k) or another tax-advantaged retirement plan. If your employer provides matching contributions, try to contribute at least as much as you need to qualify for the maximum match.

In your 30s and 40s. These are prime earning years, but you also might incur substantial expenses raising the kids, buying and maintaining a home, and paying for college. Nevertheless, you should do your best to stay disciplined and contribute as much as you can to your retirement plans. For 2013, you can defer up to $17,500 of salary to your 401(k). In addition, if you establish an IRA, the annual contribution limit is $5,500. Meanwhile, although contributions to a Roth IRA are never tax-deductible, future payouts may be tax-free. ï€†

In your 50s and 60s. This may be when you earn the highest salary of your career. If the kids are out of college and the mortgage is paid off, it’s truly time to make hay while the sun shines. Although you might not have been as diligent at retirement saving in the past as you would have hoped to be, you can recover lost ground quickly by socking away more in your retirement plans at this point in your life. For 2013, you can contribute an extra $5,500 to a 401(k) and an additional $1,000 to an IRA, above the limits already discussed. And you can save still more in taxable accounts outside your retirement plans. ●

3.8% Surtax Hits Passive Investors

If you own a sizable interest in a business, you no doubt already pay close attention to the federal income taxes that your stake in the company generates. But now there’s a new tax wrinkle to contend with: the 3.8% Medicare surtax on investment income. Depending on your level of business activity, you might have to pay this new tax in addition to any other federal income tax you owe.

Beginning with the 2013 tax year, the 3.8% Medicare surtax applies to the lesser of (1) net investment income (NII) or (2) the amount by which your modified adjusted gross income (MAGI) exceeds a threshold amount. That threshold is $200,000 for single filers and $250,000 for joint filers.

NII includes items such as interest, dividends, annuity distributions, rents, royalties, and net capital gains on property you sell. Significantly for business owners, it also includes income derived from passive activities. Net investment income doesn’t include salaries, wages, or bonuses; distributions from IRAs or qualified plans; income used to calculate self-employment tax; gains from selling an active interest in a partnership or S corporation; and income from tax-exempt bonds and other items not subject to income tax.

As you can see, it makes a big difference for tax purposes whether you’re characterized as an “active” or “passive” investor in a business. As a passive investor, the income you receive counts as NII for purposes of the 3.8% surtax.

The tax law provides some basic rules governing passive activities. Generally, a passive activity is a business activity in which you do not “materially participate.” Material participation occurs when you’re involved in the activity’s operation on a regular, continuous, and substantial basis. Rental activities—including renting out real estate—are generally

The Renaissance In Life Insurance Trusts

An age-old estate planning technique is enjoying a revival of sorts due to recent tax law developments. If you don't already have an irrevocable life insurance trust (ILIT) in place, you might consider creating one, or you might add a policy to an existing trust. Despite some cracks in the foundation, this remains one of the top tax shelters available to upper-income individuals.

Start with the premise that life insurance proceeds paid from a policy on your life are exempt from estate tax only if you don't possess any "incidents of ownership" in the policy. Naturally, that applies if you own the policy outright, but that's not all. For instance, you will be treated as having incidents of ownership in life insurance if you retain the legal right to:

- Change or name the beneficiaries of the policy;
- Borrow against the policy or pledge any cash reserve it has;
- Surrender, convert, or cancel the policy, or;
- Choose a payment option for beneficiaries (that is, you determine whether payments will be made in a lump sum or installments).

Be aware that these rules apply if you have *the right* to do any of these things regardless of whether you actually do them. If you have a policy with a large death benefit and the proceeds end up being part of your estate, this could have tax consequences for your heirs.

Fortunately, it's relatively easy to avoid problems. All you have to do is establish an ILIT and transfer ownership of the policy, including all of the legal rights discussed above, to the trust. You'll also need to designate someone—a professional, family member, or friend—to serve as trustee. If you acquire additional life insurance protection, you can designate the ILIT as the owner of your new policies.

An ILIT can be "funded" or "unfunded." If it's funded, not only do you transfer ownership of the life insurance policy to the trust, you also transfer other assets that may be used to pay the premiums. The additional property may be in the form of cash, securities, or some other asset. The major drawback of this approach is that the income the trust generates is generally taxable to you.

Unfunded trusts are more typical. In this case, you don't transfer assets to the trust to pay for the premiums, but rather you make annual gifts to the ILIT for this purpose.

The ILIT technique provides some other benefits that may appeal to wealthy taxpayers. With the appropriate wording of trust documents, you can protect the money from spendthrift children or grandchildren (or spouses of your heirs). Furthermore, the proceeds may be used to cover estate tax liability without diluting other assets intended for the family.

How much estate tax flexibility do you have under current law? Plenty. Thanks to the American Taxpayer Relief Act of 2012 (ATRA), an exemption of $5 million (indexed to $5.25 million in 2013) effectively shelters bequests to non-spousal beneficiaries like your children and grandchildren. In other words, if you remove life insurance proceeds from your estate through an ILIT, you can still leave another $5.25 million to your heirs free of estate tax. ATRA also establishes a top federal estate tax rate of 40%.

For example, consider the implications if you have a policy with a $1 million death benefit. Without an ILIT, your family might have to forfeit $400,000 of the proceeds to Uncle Sam.

Keep in mind that to qualify for this estate tax break, the life insurance trust must be "irrevocable"—you can't change your mind once you pull the trigger on the deal. Also, if it's a policy on your life, you can't be the trustee. If you don't observe those rules, the life insurance proceeds could end up back in your taxable estate.

Finally, when you set up an ILIT, the proceeds don't have to go through the probate process, and your heirs should have access to the cash in a relatively short time. But there's one last wrinkle to consider: Under a little-known tax rule, the proceeds still will be subject to federal estate tax if you die within three years of transferring ownership to the trust. Because of this three-year rule, don't delay if you think an ILIT is advantageous for your situation. Set up the trust now to start the clock running.

Tax law crackdowns have eliminated some traditional tax shelters—and Congress has its eye on others—but the benefits of life insurance trusts remain intact. We can help you determine whether an ILIT would be helpful in your situation. ●

treated as passive activities, even if you materially participate. However, rental real estate activity isn't passive if you qualify as a real estate professional.

There are several tests for qualifying as a material participant. For instance, you are treated as materially participating if you're involved in the activity for more than 500 hours during the year; your participation accounts for virtually all of the participation of anyone involved in the activity for the tax year; or if you participated in the activity for more than 100 hours during the tax year and participated at least as much as any other person (including those who don't own any interest in the activity) for the year.

The rules for real estate professionals are even more stringent. Typically, to qualify as materially participating you have to log more than 750 hours.

If it's a close call, put in the extra time to qualify as an active investor. It may help you avoid the 3.8% surtax. ●

Straight Talk About Living Trusts

Ask two financial experts about the benefits of using a revocable living trust and you might well get precisely opposite reactions, especially on a regional basis. One might say that it's the greatest thing since sliced bread, while the other could argue that it should be avoided like the plague. The truth probably lies somewhere in between.

How does a living trust work? You set up the trust, transfer assets to it, and name a trustee to handle matters. If you designate yourself as the "initial beneficiary," you're entitled to receive income from the trust for the rest of your life. At the same time, you designate "secondary beneficiaries"—perhaps your spouse, your children, or both spouse and kids—who will receive the remaining assets when the trust terminates.

Significantly, you can still retain some control of assets in a living trust while you're alive. For instance, depending on the trust terms, you may be able to sell assets and keep the proceeds, amend terms of the trust (for example, change secondary beneficiaries), or revoke it entirely. The assets in the trust become irrevocable upon your death.

The main advantage is that assets in a living trust are exempt from probate, a process that may be required for assets bequeathed through a will.

Proponents of living trusts note that the probate process can be costly and time-consuming. Also, if you face physical or mental limitations in your old age, with a living trust, a trustee for your assets is already in place.

However, detractors point out there are less expensive ways of avoiding probate, such as acquiring property jointly with rights of survivorship (although this may not be the best option in community property states). Also, the cost and complexity of probate is often exaggerated and can vary greatly from state to state. Finally, despite a common perception to the contrary, there's no estate tax advantage to using a living trust if you retain the right to revoke it, as is typically provided. And even die-hard supporters of living trusts acknowledge you'll still need a will to tie up the loose ends of your estate.

So when does a living trust make sense? Consider these four key factors:

1. Age. Younger people in good health have less incentive to use a living trust than do retirees. Remember, a living trust will provide little benefit during your life.

2. Financial status. The more wealth you have, the more you're likely to benefit from a living trust. It will make things easier on your heirs if some or all of your assets bypass probate.

3. Marital status. If you're married and you own a house or other main assets jointly with your spouse, there's less need for a living trust. Furthermore, many states allow surviving spouses to use expedited probate procedures.

4. Confidentiality. One of the main arguments for a living trust is that your testamentary disposition remains confidential. This could be important for some families.

Don't be swayed by the hype of either point of view. Make an assessment of whether a living trust is right for you. ●

Cracks In Estate Plans

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the grantor's death.

Is that all there is to a SLAT? Not quite. There are a few other planning considerations that merit your attention. For instance, if your spouse dies first or if you get divorced, you won't have access to the funds in the SLAT, regardless of your needs. Due to this possible scenario, it is usually best to transfer only those assets that you can reasonably afford to live without. That way, you'll be protecting yourself without harming your spouse.

As mentioned above, it is common for each spouse to set up a SLAT for the benefit of the other. However, under a special tax law doctrine for reciprocal trusts, the two trusts need to be different in a meaningful way—if they're identical, the assets will be included in the taxable estate of the person who established the trust. Typically, this harsh result can be avoided if the SLATs are set up at different times with varying provisions and are funded separately.

Finally, the transfer of assets to a SLAT is a gift, so the person who creates it must file a federal gift tax return. Because your spouse is a beneficiary of the trust, gifts generally are not eligible for gift-splitting—an approach that calls for each spouse to report one-half of the gift. For this reason, you'll want to take care not to exceed your lifetime gift tax exemption when funding the trust. Because that exemption is now so generous, however, most people still will find plenty of room to maneuver.

Also keep in mind that estate planning is about more than just taxes. You'll need to factor in a wide range of financial and personal factors before committing to a SLAT. We can work with your estate planning advisors to help you decide whether this technique makes sense in your situation. ●

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