the Estate Planner

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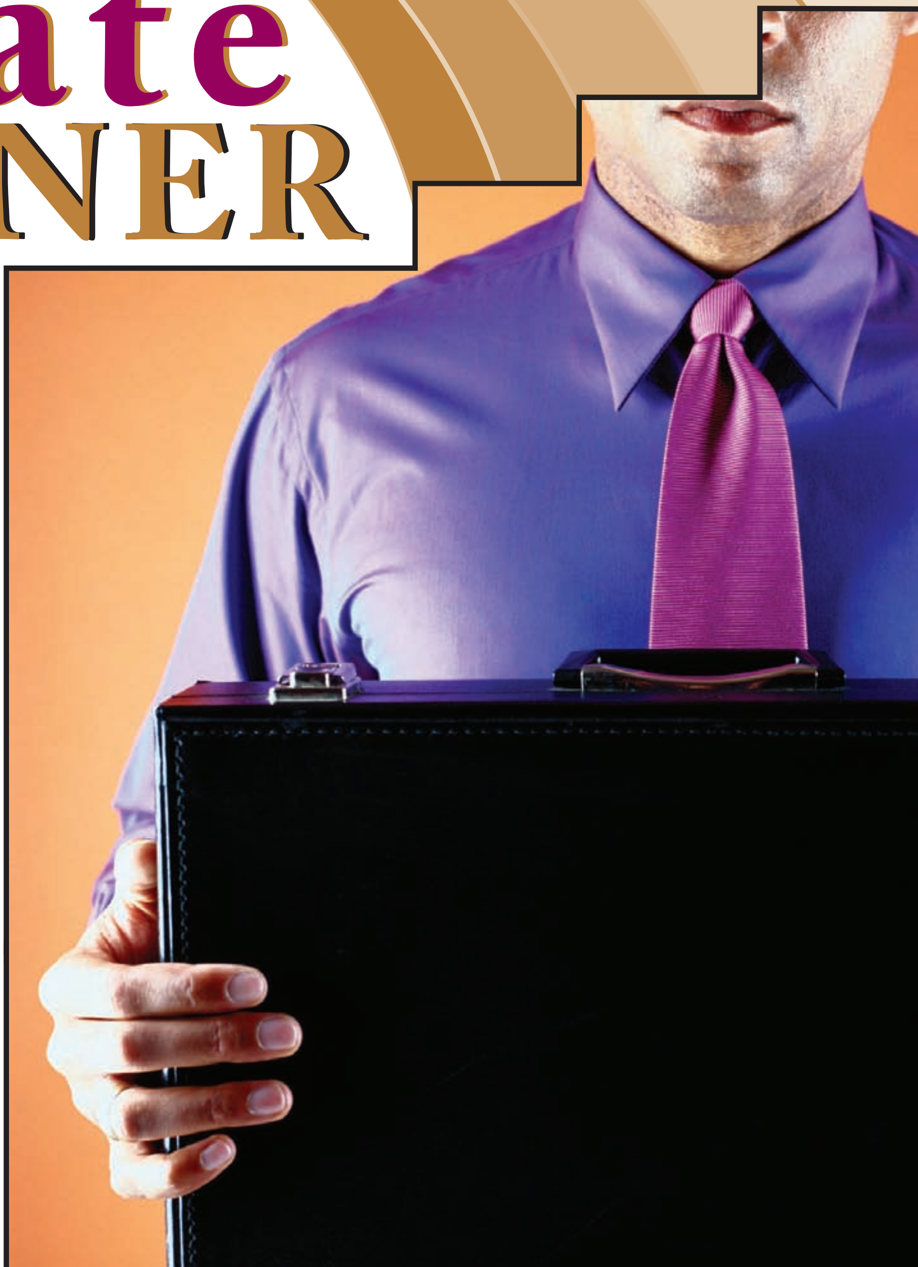

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If a substantial amount of your wealth is tied up in a closely held business, your heirs may be able to stretch out the estate tax payments over 14 years. To qualify for installment payments, you must meet the definition of a "closely held business" and satisfy several other requirements.

But if you own real property, determining whether your real estate activities constitute a closely held business can be problematic. A recent IRS ruling sheds some light on this issue by providing safe harbors and a list of factors to consider.

How does it work?

Under Section 6166 of the tax code, installment payments are available if the value of your interest in a closely held business exceeds 35% of your adjusted gross estate. If you qualify, your executor can elect to pay estate tax attributable to the business in up to 10 annual installments. Your executor also can defer the first installment payment for up to five years and pay only interest during that five-year period.

At first glance, it may appear that the total payment period is 15 years, but because the last interest payment and the first installment payment are both due in Year 5, the total extension is actually 14 years.

A special 2% interest rate applies to deferred taxes on up to $1.2 million in taxable value. (The $1.2 million figure is for 2006 and is adjusted annually for inflation.) The interest rate on tax above that amount is 45% of the rate charged for tax underpayments. In the fourth quarter of 2006, for example, the underpayment rate was 8%, so the interest rate on installment payments would be 3.6%.

Keep in mind that installment payments aren't available for the entire amount of tax owed on your estate. Sec. 6166 applies only to the portion of estate tax attributable to your interest in the closely

held business. So, for example, if the value of your interest is 40% of your adjusted gross estate, 40% of the tax is eligible for installment payments. The remaining 60% must be paid within nine months after you die.

To secure the installment payments, your estate must furnish a bond or allow a tax lien to be filed against the business or other assets.

What's a closely held business?

For purposes of Sec. 6166, a closely held business includes:

- A sole proprietorship,
- A partnership or limited liability company (LLC) — provided either your estate holds 20% or more of the entity's total capital interest, or the entity has 45 or fewer partners or LLC members, or
- A corporation — provided either your estate holds 20% or more of the corporation's voting stock or the corporation has 45 or fewer shareholders.

In addition, for a sole proprietorship, partnership, LLC or corporation to qualify for installment payments, it must conduct an active trade or business — merely managing investment assets isn't enough.

How do you pass the 35% test?

As noted earlier, installment payments are available if the value of the closely held business interest exceeds 35% of your adjusted gross estate. Several special rules apply in determining whether you meet the 35% test. For example, you may count only assets actually used in conducting a trade or business — the value of your interest doesn't include the portion attributable to any passive assets the business holds, such as stocks, bonds, or real estate held for investment purposes.

Also, if you have interests in more than one closely held business, you may combine them to meet the 35% test, provided you own at least 20% of each business.

Real answers for real estate owners

When real estate is involved, the line between conducting an active business and holding investment property can be blurred. But the distinction can make the difference between qualifying for installment payments and having to pay estate taxes upfront.

Sec. 6166 applies only to the portion of estate tax attributable to your interest in the closely held business.

In Revenue Ruling 2006-34, the IRS provided guidance that should help bring the line back into focus. The IRS recognizes that day-to-day real estate activities often are performed by property management companies or other third parties. The ruling makes clear that using independent contractors doesn't prevent a business from qualifying as an active trade or business, so long as third-party activities don't reduce the business's activities "to the level of merely holding investment property."

To determine whether real estate is used in an active trade or business, the IRS will consider all the circumstances, including these factors:

- The amount of time you or your employees (including employees of a partnership, LLC or corporation in which you have an interest) devote to the business,
- Whether an office is maintained for conducting or coordinating business activities and whether you or your employees maintain regular business hours there,
- The extent to which you or your employees provide landscaping, grounds care or other services beyond the mere furnishing of leased premises,
- The extent to which you or your employees arrange, perform or supervise repairs and maintenance, and
- The extent to which you or your employees handle tenant repair requests or complaints.

The ruling also analyzes five situations to determine whether the decedent's real estate interest was part of an active trade or business. In situations where the decedent handled day-to-day operations, either personally or through employees, the active business test was satisfied. This was the case even if the decedent hired independent contractors to perform repairs or maintenance, so long as the decedent was involved in selecting contractors and reviewing and approving their work.

When a third-party management company operated the property, however, the active business test wasn't satisfied — unless the decedent owned a significant interest in the management company. In one example, the IRS held that, when a decedent owned 20% of the management company, the company and the real estate were part of a single active business.

Easing your family's burden

If business interests or real estate makes up a significant portion of your estate, it pays to explore opportunities to defer taxes under Sec. 6166. If you qualify, installment payments can ease the estate tax burden on your family. ■

Don’t lose what’s yours

Asset protection is an essential part of any estate plan

Estate planning is about much more than saving taxes. Protecting your assets against the claims of creditors is equally important, if not more important. After all, the smartest strategies for transferring assets in a tax-efficient manner are worthless if you have no assets left to transfer.

Asset protection doesn’t mean avoiding responsibility for legitimate debts. (See “Understanding fraudulent conveyance laws” on page 5.) But in today’s litigious society, it can help you avoid being held hostage by plaintiffs’ unreasonable demands and maintain control over your wealth.

Building a better defense

Your first line of defense — especially if you’re a doctor, lawyer or other professional exposed to malpractice claims — should be your personal or professional liability insurance. But to shield your wealth against excessive or frivolous claims, also consider strategies for keeping your assets out of reach. These strategies may include:

Gifts. The easiest way to protect assets from your creditors is to give them away to your children or other family members. The downside to this approach, of course, is that you’ll also lose control over — and, in many cases, enjoyment of — the assets you give away.

Titling of property. If you and your spouse live in a state that recognizes “tenancy by the entirety,” holding a home or other real estate in that form protects the property from claims of your and your spouse’s separate creditors. It doesn’t protect you, however, from claims of your joint creditors.

If one spouse — a doctor or other professional, for example — has greater liability exposure, another option is to transfer title to property to the other spouse. Even if you live in a community property state, you may be able to protect assets by partitioning community property into separate property or having one spouse give property to the other spouse. Obviously, this strategy is a viable option only if your marriage is strong.

Trusts. You can protect assets from your heirs’ creditors by placing them in a trust with “spendthrift” provisions, which prohibit beneficiaries from selling or assigning their interests, either voluntarily or involuntarily. But a spendthrift trust won’t avoid claims from *your* creditors unless you relinquish any interest in the trust assets.

The smartest strategies for transferring assets in a tax-efficient manner are worthless if you have no assets left to transfer.

An alternative is a domestic asset protection trust (DAPT), now offered by a handful of states, which purports to allow you to protect assets from your creditors even if you retain a discretionary beneficiary interest. A discretionary beneficiary doesn’t have unrestricted access to

Understanding fraudulent conveyance laws

Asset protection planning is a little like buying homeowner's insurance. You can't insure your house after it has burned down. Nor can you obtain insurance while a neighboring house is ablaze. You probably can't buy insurance during a severe electrical storm. The time to insure your home is well before the appearance of any imminent or potential threats.

Fraudulent conveyance laws work much the same way. Although specifics vary from state to state, these laws are intended to prevent you from transferring property with the intent to hinder, delay or defraud present or future creditors. The reference to "future creditors" doesn't mean that fraudulent conveyance laws protect anyone that could potentially become your creditor some day. But if someone has threatened a claim or if you have reason to believe that a legal problem may arise in the future, the fraudulent conveyance laws may pose an obstacle to asset protection planning.

Like purchasing homeowner's insurance, the time to implement asset protection strategies is when the skies are clear and there are no storm clouds looming on the horizon.

the trust assets, but can receive distributions from the trust in the trustee's discretion. You can take advantage of a DAPT of one state even if you live in another state. But bear in mind that DAPTs have yet to be tested in the courts, so their effectiveness remains uncertain.

An offshore trust established in a debtor-friendly foreign jurisdiction perhaps offers the greatest protection, but such a trust is expensive to set up and maintain.

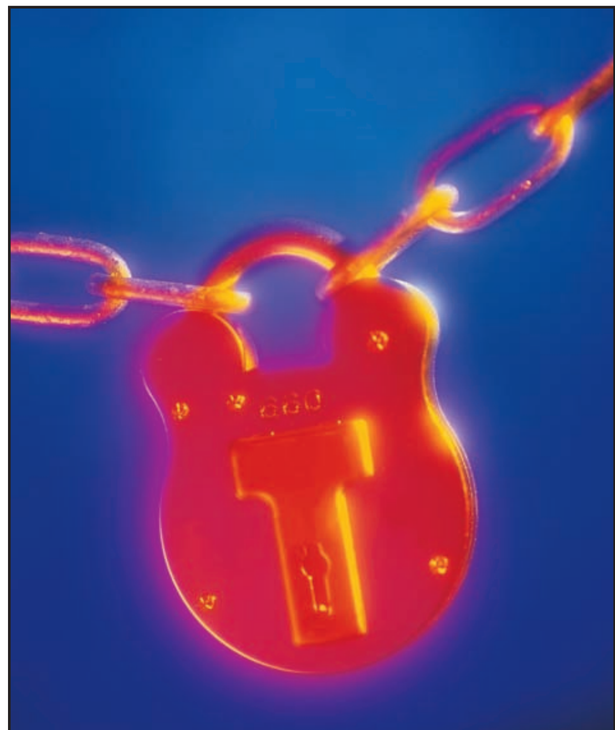
Retirement plans. A qualified retirement plan — such as a 401(k) or 403(b) plan — is one of the best places to safeguard assets. These plans generally are exempt from creditors' claims, at least until the benefits are distributed. IRAs also offer some limited protection against creditors.

Family limited partnerships (FLPs). Another technique for protecting assets is to transfer them to an FLP in exchange for limited partnership interests for you and your family. A properly structured FLP also can be used to reduce gift and estate taxes on transferred assets. In general, a limited partner's creditors cannot reach the FLP's assets — they can only obtain rights to receive any distributions made from the FLP to the limited partner. By retaining a small general partnership interest (1%, for example), you can retain control over the property while keeping your liability exposure to a minimum.

Keep in mind that FLPs must be structured and operated carefully to survive an IRS challenge.

Act now

These are just a few examples of the many asset protection strategies available. The right ones for you will depend on your particular goals and circumstances. But whatever options you choose, the time to protect your assets is now. If you wait until someone brings or threatens to bring a claim, it may be too late. ■



A roll of the dice

Self-canceling installment notes may be a good bet

Some of the most effective estate planning strategies involve a bit of gambling. One example is the self-canceling installment note (SCIN), a sophisticated technique that, if the odds are in your favor, allows you to transfer a business or other assets to family members at the lowest possible tax cost.

SCINs have been around for a long time, but a 2003 decision by the Sixth U.S. Circuit Court of Appeals breathed new life into the technique. The court held that, while intrafamily transfers are presumed to be taxable gifts, you can rebut this presumption by showing that at the time of the transaction there was a "real expectation of repayment and intent to enforce the collection of the indebtedness."

The skinny on SCINs

In a typical SCIN transaction, a parent sells a closely held business interest or other assets to his or her children (or to a trust for their benefit) in exchange for an interest-bearing installment note. Unlike a traditional installment note, however, a SCIN releases the buyer from future payment obligations when the seller dies. For a SCIN to work, the note's term cannot exceed the seller's life actuarial expectancy at the time of the transaction.

A properly structured SCIN provides several tax benefits for both the seller and the buyer:

- It removes future appreciation of the business or other assets from the seller's estate.
- If the seller dies before the note matures, the outstanding principal amount is excluded from the seller's estate.
- The seller can spread the taxable capital gain over the term of the note — though if the seller dies before the note matures, the remaining capital gain is accelerated. Essentially, the seller's estate must recognize capital gain on payments it will never receive, but in most cases the benefits of a SCIN outweigh this tax liability.
- The buyer's tax basis in the property generally is stepped up to the purchase price.
- In most cases, the buyer can deduct the interest portion of the installment payments.

Unlike many other planning techniques, a SCIN doesn't require the seller to use annual gift tax exclusions or any of his or her lifetime gift tax exemption.

The risk premium

The note must include a premium — either on the purchase price or the interest rate — to compensate the seller for the risk that the note will be canceled if he or she doesn't survive the term. Determining the amount of the premium involves some complex calculations, but purchase-price and interest rate premiums could reach the 25% to 30% range.

The type of risk premium selected has significant tax implications for the parties. A purchase-price premium, for example, increases the portion of the installment payments taxed to the seller at favorable capital gains rates. It also increases the buyer's tax basis in the property.

If an interest rate premium is selected, a greater portion of the seller's receipts will be taxable at higher ordinary income rates, but the buyer may enjoy larger income tax deductions. The parties should perform after-tax cash-flow projections to determine which form of risk premium will generate the greatest overall tax benefit.

Improving the odds

Families using SCINs to transfer a business or other assets are betting that the seller will not outlive the installment note's term. If the seller dies during the

term, the unpaid principal plus any appreciation in the business's or assets' value is transferred estate-tax free.

The risk, of course, is that the seller will survive the SCIN's term. If that happens, the buyer will have paid a substantial premium for the business and the seller's estate may actually be *increased* rather than reduced. If the note is paid in full, the parties will be worse off unless the appreciation in the business's or assets' value exceeds the premium.

To minimize this risk, SCINs ideally should be used by older sellers who don't expect to reach their actuarial life expectancies. Sellers who are terminally ill, however, generally can't take advantage of this strategy, because the IRS and the courts would likely conclude that there's no real expectation of repayment.

The risk of default also is a concern. For a SCIN to achieve its objective, the buyers must be able to make the installment payments when they come due. That means either the business or assets likely will generate enough income to fund the payments or the buyers have other resources they can tap to cover the installments.

A calculated gamble

Under the right circumstances, a SCIN can be a good bet, so long as you understand the potential costs and risks involved. If the gamble pays off, your family will enjoy sizable winnings in the form of income, gift and estate tax savings. To improve your odds, it's important to design the SCIN carefully and diligently observe its terms to avoid an IRS claim that the arrangement is a disguised gift. ▮

Estate planning red flag

You don't have a lifetime giving plan

Many people mistakenly believe that lifetime gifts are no longer necessary for estate planning. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) boosted the estate tax exemption, after all, to its current level of $2 million (less any of the $1 million gift tax exemption used during life) and increases it to $3.5 million in 2009. And EGTRRA repeals the estate tax (but not the gift tax) in 2010.

So, why bother giving away assets now? Because, absent further legislation, the estate tax repeal will last only one year: In 2011, the previous gift and estate tax system will be revived — with a top rate of 55% and a combined gift and estate tax exemption of only $1 million. If that happens, those who have neglected to make lifetime gifts will have squandered a valuable planning opportunity.

Although Congress has introduced bills to make the estate tax repeal permanent, most commentators believe that the estate tax will return after 2010 but the exemption amount will be further increased.

Assuming that the estate tax continues to exist in some form, the annual gift tax exclusion (currently $12,000 per recipient) allows you to remove significant amounts of wealth from your taxable estate without using up any of your exemption amounts. You also can avoid gift and estate taxes by paying tuition and medical expenses on behalf of others. Even if the estate tax is repealed, you'll be no worse off for having made these gifts.

And remember, there are plenty of nontax reasons to make lifetime gifts, like the opportunity to watch your family enjoy the fruits of your hard work.

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