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ESTATE PLANNING FOR MARRIED COUPLES

HAVE CREDIT SHELTER TRUSTS BECOME OBSOLETE?

If you're married, a couple of estate planning objectives likely loom large in your mind. First, you probably want to ensure your spouse will have sufficient assets to maintain his or her lifestyle after your death. Second, you no doubt wish to protect your wealth from estate taxes so that as much as possible ultimately goes to your children (or other heirs).

One way to accomplish both goals is to set up a credit shelter trust (also sometimes referred to as a "bypass" trust). Essentially, it preserves your estate tax exemption for eventual tax-free disposition of assets to your children while first benefiting your spouse for the remainder of his or her life.

But have the increase in the estate tax exemption and the availability of exemption "portability" under last year's tax relief legislation made these trusts obsolete? For many taxpayers, the answer is a resounding "no!"

It's about the exemption

Whether you and your spouse should consider a credit shelter trust rests largely on how the size of your estates together compares with the estate tax exemption. Generally, if your and your spouse's estates will total less than the estate tax exemption, a credit shelter trust won't be necessary for estate-tax-saving purposes.

With the exemption now at $5 million, if your current net worth is lower, you may feel safe from estate tax. But keep in mind that the exemption is scheduled to drop back down to $1 million in 2013. Also, what matters isn't what your estate is worth *now* but what it will be worth at your death. So there may be a good chance that, by the time of your death, your estate will exceed the estate tax exemption — even if it doesn't now.

How the trust works

Let's say you and your spouse both have $5 million estates and you leave your entire estate to your spouse. No federal estate tax will be due on your death because of the marital deduction,

Already have a credit shelter trust?

If so, you need to review your estate planning documents in light of the current $5 million estate tax exemption and the scheduled 2013 return of the $1 million exemption. You'll want to make sure the document language is written in a way that you can make the most of your estate tax exemption, regardless of the amount.

If your estate plan language calls for a fixed dollar amount to go to the credit shelter trust, that language may need to be revised. Otherwise, if you die in 2011 or 2012, you might not be able to protect your full $5 million exemption.

For example, the language might say that $3.5 million (the 2009 estate tax exemption) will go into your credit shelter trust and the rest of your estate will go directly to your spouse. If your total estate is $5 million, then $1.5 million will go to your spouse outright.

If your spouse dies with a $1.5 million estate after 2012 — when the lifetime exemption is only $1 million — $500,000 will be subject to estate tax, which would be $210,000. Had the full $5 million gone instead to the credit shelter trust, no estate tax would be due on your spouse's death.

which allows you to transfer an unlimited amount to your spouse free of estate tax (unless your spouse isn't a U.S. citizen, in which case special rules apply).

But, if your spouse later dies with an estate of $10 million and the exemption is still $5 million, his or her estate will owe $1.75 million in estate taxes (assuming the current 35% estate tax rate and that your spouse doesn't remarry and bequeath assets to the new spouse tax-free under the marital deduction). And if he or she dies after 2012 and, as scheduled, the exemption amount drops to $1 million and the top estate tax rate returns to 55%, the tax will be $4.795 million.

In other words, leaving all of your estate to your spouse can waste your exemption, resulting in unnecessary estate tax and a smaller (perhaps significantly smaller) inheritance for your children. The simple solution is to bequeath assets up to the estate tax exemption amount directly to your children. But "disinheriting" your spouse in this way may not be desirable. This is where a credit shelter trust can serve a purpose.

Your estate plan can direct assets up to the exemption amount to be transferred on your death to the trust. The trust provides an income stream for your spouse and certain rights to the principal for life, and what remains at your spouse's death goes to your children or other beneficiaries — estate-tax-free under *your* exemption.

Essentially, the credit shelter trust allows you to make full use of your estate tax exemption without jeopardizing your spouse's financial well-being. The assets basically "bypass" his or her estate — thus the alternate name for the trust. One important caveat: You can't use assets held in joint tenancy for the trust.

Problems with portability

On the surface, estate tax exemption portability may seem to eliminate the need for a credit shelter trust. It allows any remaining estate tax exemption available at one spouse's death to be used by the surviving spouse. While it may sound simpler than setting up a credit shelter trust, portability generally isn't a better alternative.

First, portability is scheduled to expire after 2012. So you can't depend on it being available. Even if you or your spouse dies before it expires, the survivor would have to use up the deceased spouse's remaining exemption by the end of 2012.

Second, portability can't be used to leverage the estate tax exemption in the same way that a credit shelter trust can if assets appreciate. Let's consider our previous example and say that the credit shelter trust assets appreciate to a value of $7 million by your spouse's death. The entire $7 million trust balance will pass estate-tax-free to your children. But without the trust, only $5 million could be protected from estate tax under exemption portability, if still available.

Still valuable

Although the increase in the estate tax exemption to $5 million and the availability of exemption portability may make credit shelter trusts seem less important, these arrangements can still serve a useful purpose for many married couples. After all, the estate tax "certainty" under current rules is only temporary. Therefore, the benefits of these trusts should be valuable for years to come. ❒

BUSINESS OWNERS SHOULD CONSIDER A ROTH 401(K)

If you walked around your company's offices and asked employees what comes after "Roth," many would probably say "IRA." Indeed, the Roth IRA has become a well-known type of retirement plan. But you can put "Roth" and "401(k)" together, too, and have a benefits option worth considering.

Value added

Like a Roth IRA, a Roth 401(k) offers tax-free withdrawals but contributions are after-tax. As a result, many employees may find a Roth 401(k) option to be an attractive benefit.

A Roth 401(k) is an add-on to the traditional 401(k) plan. You can't establish a Roth-only 401(k) plan — your plan must also allow for pretax elective contributions. Employer matching and profit-sharing contributions can be made only to the traditional 401(k) accounts.

Except in certain limited circumstances, participants can't roll over traditional 401(k) assets into a Roth 401(k) account. Nor can they roll over Roth 401(k) assets into a traditional 401(k) account.

Keep in mind that adding a Roth 401(k) to your retirement plan doesn't increase the total amount that employees can contribute. The contribution limits are the same for traditional and Roth 401(k) contributions, or the two combined. Roth 401(k)

contributions, like employees' contributions to traditional 401(k)s, are always 100% vested.

About distributions

A Roth 401(k) distribution can occur on a qualifying event. Examples include termination of employment, death, disability and retirement. Your plan document may also permit distributions on reaching age 59½ or for certain hardship situations.

Even though distributions are allowed for any of these qualifying events, the entire distribution — including earnings — may not be tax-free. Distributions of *contributions* are always tax-free, but a distribution of *earnings* is tax-free only if it's a "qualified distribution." To be a qualified distribution:

The participant must meet the five-year rule. He or she must have held the Roth 401(k) account for five years. The holding period begins on the first day of the calendar year in which a participant makes his or her first Roth 401(k) contribution and ends on the completion of five consecutive calendar years. This is a one-time requirement, not a rolling requirement that separately applies to each year's Roth 401(k) contributions.

The distribution must have a qualified purpose. This means it must be made after the participant reaches age 59½ or due to his or her disability or death, if earlier.

Employee questions

Employees may ask how a Roth 401(k) will affect their taxes. By forgoing the pretax treatment of the contributions, participants can generally avoid having to pay taxes on distributions. Doing so benefits participants who'll be subject to a marginal tax rate in retirement that's at least as high as their rate when they made the contributions. With traditional 401(k) contributions, the taxes are deferred until distributions are taken. This benefits participants who'll be taxed at a significantly lower rate during retirement.

Because it's hard to predict what the future will bring, participants sometimes split the amount they contribute between a Roth 401(k) and a traditional 401(k). If you choose to offer a Roth 401(k), advise your employees to consult with their financial advisors to determine whether this type of plan suits their financial profile.

Employees may also ask about the difference between a Roth 401(k) and a Roth IRA. For starters, married couples filing jointly with adjusted gross incomes (AGIs) exceeding $169,000 per year or singles with AGIs exceeding $122,000 can't contribute to a Roth IRA, and taxpayers with AGIs nearing those amounts are subject to a contribution phaseout. On the other hand, there are no AGI limits on Roth 401(k) contributions.

Roth 401(k)s also permit much higher contributions than Roth IRAs. For 2011, the limits are $16,500

vs. $5,000, respectively ($22,000 vs. $6,000 for taxpayers age 50 and older).

The five-year holding rule applies to both. However, Roth IRAs aren't subject to required minimum distributions (RMDs) after age 70½, while Roth 401(k)s are. And, on a qualifying event, participants can roll over a Roth 401(k) into a Roth IRA to eliminate RMDs.

Your call

A Roth 401(k) could give a boost to your benefits package that helps you attract or retain key employees who may not be eligible to contribute to a Roth IRA. But, as an add-on benefit, it may "add on" some administrative time and expense. It's your call. ❒

Moneylines: News Briefs for Businesses

How are your workers feeling? Not so good, say the results of the Thomson Reuters Workforce Wellness Index, released earlier this year. The information specialists used six behavioral risk factors to assess the collective health of U.S. workers with employer-sponsored health care insurance from 2005 to 2009. The index found that there was an overall decline in employee health during that time, and unhealthy behaviors were costing employers, on average, $670 per worker annually. Don't forget to promote wellness while keeping your employees informed about your health care plan's offerings.

The IRS is doing more audits — especially of the wealthy. As a business owner or executive, your odds of getting audited could depend on your compensation level. The 2010 *IRS Data Book* indicates that the agency audited 18.4% of very wealthy taxpayers (incomes exceeding $10 million) in 2010 compared with 10.6% in 2009. Audits of taxpayers with incomes between $5 million and $10 million rose a whopping 55% from the number of such audits in 2009. Overall, there was an uptick of about 11% in audits in 2010. Whatever your income level, be sure to approach personal tax planning with as much care as you take with business planning.

Owners of midsize businesses went into the year optimistic. How is your 2011 progressing? A number of business owners were expecting good things from this calendar year. Specifically, of 527 managers of midsize (between $50 million and $1 billion in revenue) companies surveyed by Deloitte earlier this year, approximately 80% predicted revenue and profit growth. Almost 70% planned to hire new employees. Check your company's growth projections and see whether you need to make a big push this fall to accomplish your objectives.

LIFE SETTLEMENT PIQUES CURIOSITY OF WELL-READ RETIREE

Donald is a 72-year-old retiree who enjoys his morning newspapers. While reading the *Wall Street Journal* recently, he came across an article describing how an arbitration panel had ordered insurance conglomerate AIG to pay millions for its involvement with life settlements.

Donald's curiosity was piqued by the article's brief description of a life settlement because he had a $3 million permanent life insurance policy he might be willing to part with if he could get something for his years of investment. He contacted his financial advisor to learn more.

Donald's advisor said that arranging a life settlement is certainly an option available to him. But Donald needed to carefully study the details before committing to the idea.

How it works

Under a life settlement, a third party would buy Donald's life insurance policy for more than its cash surrender value but less than its net death benefit. The third party would take over the premium payments and either sell the policy on the secondary market or collect the death benefit when Donald died.

A third-party buyer would calculate the value of Donald's life insurance policy based on his age and medical condition (the policyholder generally must be over age 65), the policy type (commonly universal life, whole life or convertible term insurance), his insurer's rating, and the premiums needed to keep the policy in force.

In most cases, the sale proceeds from a life settlement are tax-free (at the federal level) up to the amount of total premiums paid on the policy. But Donald's advisor said they should review his state's tax treatment of the transaction.

In Donald's case ...

Donald's $3 million life insurance policy had a cash surrender value of $725,000 and his tax basis in the policy, based on his paid premiums, was $400,000.

His advisor said that a life settlement may indeed be beneficial because Donald had enough other insurance in place and could use the payout — as well as the cash that would be freed up from no longer having to pay premiums — to cover other expenses. Plus the policy's cash surrender value was only a fraction of its face amount.

A word of caution

Life settlements are controversial to some, partly because the third-party buyers are essentially making money when someone dies. There are also fraud and abuse risks that warrant close scrutiny of any buyer. Donald appreciated his financial advisor's input and decided to sleep on the decision and, of course, read up on it further. ❒

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