page 2
Business owners: Be careful making loans to a company
Divorced couples need to update beneficiary designations
page 3
Have life insurance you don't need? Consider donating it
page 4
Trust could force beneficiaries to arbitrate dispute rather than go to court

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Estate Planning
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Estate planning is still important even if you're not super-wealthy

A year ago, Congress dramatically raised the federal estate tax exemption, which for 2013 was $5.25 million (or $10.5 million for a married couple). And that caused some people to mistakenly believe that they no longer need to think about estate planning if their assets are less than $5 or $10 million.

However, nothing could be further from the truth. And people who don't keep their estate plan up-to-date are making a big mistake that could still be very costly to them and their families.

There are a multitude of reasons for this, but here are just a few:


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Protecting your heirs. Many of the techniques that people have used in the past to avoid estate taxes – such as trusts – have lots of other purposes in addition to saving taxes.

For instance, leaving assets to someone in a trust can protect them over the long term if they're not good at managing money. Trusts can also shield children from losses in the event they get divorced, face a lawsuit, or start their own business. And if you have children from a former marriage, a trust can be a way to care for your new spouse if something happens to you, while still protecting your children.

Trusts can also protect children and grandchildren if they should ever have a problem with gambling or other addictions, or if they have special needs.

All of these benefits still exist regardless of the level of the federal estate tax exemption.

Other kinds of taxes have gone up. While the federal estate tax is less of a problem, other taxes – such as income and capital gains taxes – have increased recently. There's also a new 3.8% surtax on investment income.

So you should know that techniques such as trusts, LLCs, and family limited partnerships, which in the past were used primarily to avoid estate taxes, can also be used to reduce these

continued on page 3

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Business owners: Be careful making loans to a company

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If you own a business and you plan to loan money to the company, be sure to consult an attorney about the paperwork. Otherwise, the IRS could claim the money wasn't a loan after all, and come after you for additional taxes.

Fred Blodgett found this out the hard way. Blodgett owned a small company (an S corporation) that sold architectural glass blocks. When the real estate downturn hit, he supported the company by transferring money to it from a family trust. He called this a loan. In subsequent years, the company paid him about $60,000, which he called a loan repayment.

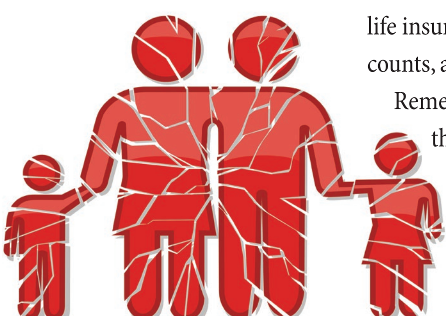
Not so fast, the IRS said. According to the IRS, the "loan" wasn't a loan at all, but a simple contribution of capital. And the "repayment" was actually just ordinary wages for the manager of the business. Therefore, the IRS claimed, the company owed more than $13,000 in employment taxes and penalties.

The U.S. Tax Court sided with the IRS. Although the money that Blodgett transferred to the business *could* have been a loan, the court said, Blodgett blew it because he didn't create a paper trail showing that a bona fide loan was being made. There was no written loan agreement, no interest, no repayment schedule, and no collateral.

Although this case involved an S corporation and employment taxes, the IRS can also reclassify a "loan" in other ways, such as taxable compensation or taxable dividends.

If you're thinking of making a loan to a business, be sure to treat it as a loan. Ideally, a written loan document should specify the repayment terms and schedule, interest, security, and subordination rights. Also, the loan shouldn't be so large in relation to the company's other operating capital that the IRS can argue that it's commercially unreasonable.

Divorced couples need to update beneficiary designations



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One of the most important things people can do after a divorce is to update their beneficiary designations, and indicate who should get the assets in various accounts if they should unexpectedly pass away.

Most married people name their spouse as the beneficiary of their accounts, but in the stress following a divorce, they often forget to update these designations.

And even when people make an effort, they might not remember every account. Pensions, 401(k) plans, life insurance policies, brokerage accounts, bank accounts, and more may all have listed beneficiaries.

Remember that if you die, who gets the money in these accounts usually depends on who is the listed beneficiary – *not* who is named in your will. Even if your will says that "everything" will go to a new spouse or a child or other relative, the will doesn't govern a separate account such as a 401(k) or an insurance policy.

Some states have tried to help divorced people by passing laws that say that a divorce automatically revokes these types of beneficiary designations. But even where that's true, you need to name a *new* beneficiary, or the money might still go to someone who is not your choice.

Also, these laws don't always work. For instance, Warren Hillman was a federal employee in Virginia who had low-cost group life insurance through a special program for federal workers. Warren married Judy in 1996 and named her as his life insurance beneficiary, but he divorced her two years later. In 2002, he married Jacqueline, but for whatever reason he never changed the beneficiary on his life insurance.

In 2008, Warren died. Both his wives claimed his $125,000 life insurance proceeds.

The case went all the way to the U.S. Supreme Court. The court said that, under Virginia law, a divorce revokes beneficiary designations such as on a life insurance policy. However, because the life insurance in this case was arranged under a *federal* program, and federal law trumps state law, the Virginia law didn't apply – and therefore first-wife Judy, not second-wife Jacqueline, got the funds.

Of course, even people who *haven't* been through a divorce should periodically review their beneficiary designations to make sure they're all current, because these designations are an important part of a well-constructed estate plan.

Estate planning is important even if you're not super-wealthy

continued from page 1

kinds of taxes, by giving you the flexibility to funnel income and capital gains to family members in the lowest tax brackets.

Techniques such as charitable remainder trusts can also be used to shift income taxes from current years until post-retirement, lower-bracket years.

And with capital gains taxes going up, it's increasingly important to use estate planning to adjust your heirs' basis in the property they inherit.

Most of the time, if a person dies owning assets that have appreciated in value, his or her heirs receive the assets with a new, "stepped-up" basis as of the date of death. Suppose Martha buys some stock for $50,000, and many years later it's worth $90,000. If Martha sells it, she'll have to pay tax on a $40,000 capital gain. But if she dies and leaves the stock to Lou, then Lou will have a "stepped-up" basis of $90,000, and if he sells it right away, he won't owe any tax.

While capital gains basis is typically stepped up at death, it isn't always, so it's important to engage in estate planning to make sure your heirs aren't stuck with a large and unnecessary tax bill.

Health care costs. If you're not super-wealthy, health care costs in later years can be a bigger destroyer of wealth than the estate tax ever was. It's critical to consider health care in retirement as part of a complete estate plan.

State estate taxes. While the federal estate tax is now a problem only for the very wealthy, many states impose their own estate taxes, and these often kick in at much lower thresholds. New Jersey, for instance, imposes a tax on all estates with assets of more than $675,000. Six other states have estate tax thresholds of $1 million or less. It's still important to plan around avoiding these taxes.

In addition, some states impose inheritance taxes. Inheritance taxes are different from estate taxes, because estate taxes are paid by a dying person's estate, while inheritance taxes are paid by the dying person's *heirs*. Inheritance taxes don't depend on where the heir lives; they're based on where the dying person lived or owned property. So if you live in Florida but you inherit assets from a relative in Arizona who owned property in Iowa, you might owe Iowa inheritance tax.

In some states, the inheritance tax rate varies depending on the heir's relationship to the dying person – so a child might pay one rate, a cousin might pay another, and a lifelong friend might pay yet another.

It's important to plan for this, too, if for no other reason than to compensate your heirs if you're going to saddle them with unexpected taxes after you die.

Family issues. Estate planning has always been about more than just taxes, or even just financial assets. It's about family. What will happen to your family home, or a beloved vacation home? What will happen to a family business? If you have minor children, how will they be taken care of? Who will receive possessions that have sentimental value? Will your children feel that they've been treated fairly, and be encouraged to get along and use their legacy in accordance with your values? All these issues can (and should) be dealt with in a complete estate plan.

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Have life insurance you don't need? Consider donating it

If you have a whole-life or universal-life insurance policy that you don't need, you might want to consider donating it to charity rather than cashing it in.

There are two ways to make such a donation, each of which has its advantages:

(1) *Name the charity as the policy's beneficiary.*

The key advantage to this method is that you retain control of the policy. Thus, you can always change your mind if you decide that your heirs need the money or if your feelings about the charity change. You'll also get an estate tax deduction when the charity receives the money.

(2) *Make the charity the owner of the policy.*

If you make the charity the owner of the policy, you can no longer change your mind. However, you'll get an income tax deduction for the donation (which might be more valuable than the estate tax deduction now that the estate tax exemption is well over $5 million), and you'll be recognized by the charity for having made a donation while you're still alive.

Also, if you continue to pay the premiums on the policy after making the charity the owner, you may be able to take an income tax deduction for these payments as well.

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Trust could force beneficiaries to arbitrate dispute rather than go to court

Andrew Reitz set up a trust to benefit his sons, with an independent trustee. The trust document said that if there was a dispute between his sons and the trustee, it would be decided by a private arbitrator rather than a court.

When John Reitz, one of the sons, became unhappy with the trustee, he sued to have the trustee removed. The trustee argued that the suit should be thrown out of court, and decided by an arbitrator.

The dispute over who should decide the dispute went all the way to the Texas Supreme Court.

That court said the issue should go to an arbitrator. The judges ruled that (1) the trust should be handled according to Andrew's clear intentions, and (2) it would be unfair to let John receive all the benefits of the trust, but ignore the one part of the trust he didn't like.

If you set up a trust and you think there's a chance that there could be disputes among the beneficiaries or between a beneficiary and the trustee, you might consider adding an arbitration requirement. Arbitration can be quicker and cheaper than a lawsuit, so money might be saved that could help the other beneficiaries. Also, arbitration is typically private while lawsuits are public, so arbitration could prevent an unhappy family's internal disputes from being aired for all the world to see.

On the other hand, there can be disadvantages to arbitration as well. There are many procedural safeguards in a court proceeding that simply don't exist when people go to arbitration.

Also, outside of Texas, it's not always clear whether arbitration requirements in trusts are valid. A few courts have suggested that while arbitration requirements are valid in a *contract*, a trust isn't a contract, and beneficiaries can't be barred from going to court by a requirement in a document that they never signed.