

# ESTATE PLANNING *Legal Matters*

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## Making Mistakes With IRAs Can Be Costly

IRAs are an increasingly popular retirement saving device. In fact, Americans have about \$3.5 trillion in IRAs, which is about 27 percent of total retirement savings in the U.S.

But while IRAs offer great tax benefits, they can also be very tricky. You can face substantial tax penalties if you make a mistake in withdrawing money from those accounts, or in rolling over money into them from employer-sponsored retirement plans, such as a 401(k) plan.

For example, you have 60 days to roll assets from one tax-deferred account into another one. But that deadline can be easily missed, either due to the fault of the IRA holder or a financial institution holding the assets. A missed deadline can trigger income tax on the money, as well as penalties.

Another trap: If you want to pass along your Roth IRA to your children (free from estate taxes), you must take careful steps to do so before you die. You can't rely on your children to take care of it after you die.

One area where you can catch a break is related to company stock that you own. You can get a tax break if you withdraw company stock from your 401(k) before rolling over the remainder into an IRA. The big bonus is that any increase in share prices is subject to a long-term capital-gains tax (15 percent) rather than regular income tax (up to 35 percent). But you only get one chance to withdraw the stock before rolling over the money.



Inheriting an IRA comes with its own rules. For instance, if you inherit an IRA from someone other than your spouse, you cannot roll it over into your own IRA. Nor can you withdraw money from it and then deposit it in a new IRA. What you can do is stretch out withdrawals over your lifetime, rather than take the inheritance in one lump sum, and reduce tax payments as a result.

Another area needing careful thought is establishing the beneficiary of your IRA. If you name no beneficiary or designate your estate, your heirs will lose the benefit of stretching out withdrawals over their lifetimes. On the other hand, there can be advantages in naming a trust as the beneficiary.

These are only some of the issues and potential traps related to IRAs. We're here to help you navigate the many rules and regulations so you can get the most benefit from tax-deferred income in your IRA.

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## Family Limited Partnerships May Still Feel the Bite of Estate Taxes

Recent court rulings make it clear that family limited partnerships must have a valid reason to exist other than simply avoiding estate and gift taxes. Otherwise, the partnership assets will likely be included in a parent's estate

The court ruled that assets of a family limited partnership of a deceased Texas businessman should be included in his estate. The court said the man did not relinquish any real control over the assets, even though they were in a

and subject to taxation.

A popular estate planning technique is when a parent transfers business or investment assets – such as a family business, real estate or securities – to a partnership formed with his or her children. Many of the partnership assets are shifted to the children, while the parent often retains significant control over managing the assets as a general partner. The intended result is to allow the parent to continue actively participating in the management of the assets while avoiding estate and gift taxes.

But the Internal Revenue Service claims these partnerships are often nothing more than a tax avoidance scheme, and more and more courts are agreeing.

The most recent decision came from the federal appeals court covering Texas, Louisiana and Mississippi.

partnership, and therefore the partnership was basically a sham with no legitimate business purpose.

For example, the businessman continued to live in a home given to the partnership, which didn't receive rent on the property until he died. And the court found that the man was able to use other partnership assets even after they were transferred to the partnership. The court said the partnership had no substantial purpose other than saving on taxes.

One valid reason for creating a family partnership is managing a family business. And it's important that a parent not regularly use the partnership assets for personal reasons.

A parent may also want to consider appointing a disinterested person as general partner.

The recent court rulings, however, have left open many questions regarding how family limited partnerships should be set up and managed.

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## Choosing Which Assets to Leave Your Children Requires Some Thought

Parents regularly face the question of what assets they should spend in retirement and what they should save and give to their children.

It's important to assess that question carefully, because some assets are worth more to your heirs than others.

Perhaps the most valuable gift to bequeath is a Roth IRA, which, if managed carefully, can provide tax-free income for years to your children. That's because you don't have to draw down on a Roth IRA during your lifetime. And while your children have to pay estate and gift taxes on an inherited Roth IRA, that's becoming less of an issue as

the exemption on the federal estate tax is currently \$1.5 million, and Congress may very well increase it further.

Another strategy is to use up after-tax dollars before dipping into tax-sheltered accounts in order to take full advantage of those accounts, such as IRAs and 401(k) plans.

Another technique is to have your children or an irrevocable trust own your life insurance policies, so they can use the proceeds to pay estate taxes.

You might also want to hold onto real estate because your children will get the step-up in basis, which can help avoid capital gains taxes.

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## You Need to Consider Which Trusts Should Pay Estate Taxes

If your will creates more than one trust, you should carefully consider which one should be tapped to pay estate taxes. In fact, even if you made this decision years ago, changes in the estate tax and other recent decisions might be a good reason to reconsider whether your original plan is still what you want for your estate.

According to one recent decision, estate taxes must be applied against a Qualified Terminable Interest Property (QTIP) trust if the will and trust

documents clearly state otherwise. A federal appeals court and state courts in New Jersey, New York and North Carolina have made similar decisions. But state courts in Alabama, Louisiana and Wisconsin have ruled the opposite.

The Colorado Supreme Court also said federal law on this point is controlling, even if it conflicts with state law.

In the Colorado case, a woman left an estate worth more than \$5 million, which included a QTIP trust of about \$2

documents do not clearly state that other trusts in the estate should be taxed instead.

A QTIP trust provides income to a surviving spouse, but controls ultimate distribution of the trust following the death of the surviving spouse. Taxes on the QTIP trust are deferred until the surviving spouse's death.

The Colorado Supreme Court said that federal law requires apportioning estate taxes among trusts – unless QTIP trust

million. Her estate paid taxes of about \$2 million, with \$323,000 going to the state of Colorado.

The woman's daughters objected to the trustees' plan to apportion taxes and administrative expenses between the QTIP trust and a second trust.

The court said the woman's will did not mention the QTIP trust or refer to the estate's right to recover taxes against property included in the trust. As a result, the woman's estate did not waive the apportionment of taxes among the trusts.

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## How Will My Estate Be Distributed if My Child Dies Before I Do?

While it's certainly painful to consider, sometimes children die before their parents. How their share of an estate is shared with the rest of the family is something to consider in creating a will.

Suppose, for instance, that a couple has three children: Ann, Betty and Carla. Ann and Betty have two children each, and Carla has five. What happens if Ann dies before the couple's estate is distributed?

There are four basic rules to decide this question, and your will can specify one (or you can make up your own). In the past, many people never considered the issue, but it's something you might want to think about. We can help you if you'd like to select a different option.

The four rules are:

"Per stirpes," a Latin term meaning "by roots." Under this system, the one-third share of the inheritance that Ann would have received if she had been alive is given in equal parts to her children.

"Modern" per stirpes. This is the same, except that in the unlikely event that Ann, Betty and Carla all die before their parents, the inheritance will be divided equally among the grandchildren. Carla's five children will each get the same amount as Ann's two children.



Per capita. Under this system, all surviving heirs get the same amount, regardless of generation. Betty, Carla, and the nine grandchildren will each get an equal share.

Per capita by generation. Under this system, Betty and Carla will each get a third of the estate. Ann's third will be divided equally among all the grandchildren, not just her own children.

If your will doesn't say what method to use, generally state law will apply a default method, which you might or might not prefer. Most people would rather make their own decision than let someone else do it for them.

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## Various States Bulking Up Estate Taxes

Federal lawmakers are considering a permanent repeal of estate taxes. In the meantime, though, many states are moving in the opposite direction.

This ebb and flow is creating uncertainties, which means it is important to review your estate plans and update your will if you live in, own property in, or are considering moving to a state that is raising its estate taxes.

taxes, which otherwise would have faded away because of a federal law enacted in 2001.

Further complicating the matter is the fact that different states are employing different approaches to capture the revenue. This can create many issues if you own homes or other property in multiple states.

Current federal law calls for a gradual

Some people are even moving to another state just to take advantage of more favorable estate tax laws.

Fear over loss of billions of dollars in tax revenues recently prompted Connecticut, Washington and North Carolina to take steps to shore up estate taxes. These legislative moves come on the heels of efforts of numerous other states in recent years – including New York, Illinois, New Jersey, Pennsylvania and Massachusetts – to protect these

reduction in the federal tax rate on estates until elimination of the tax in 2010, followed by a reinstatement of the law in 2011. But the House of Representatives earlier this year passed a bill calling for a permanent ban on the tax.

The current federal law will eliminate a “credit” to states based on federal taxes on estates as of the end of this year, which means many states will lose substantial revenues unless they pass new laws to collect the money.

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