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Dow Jones Newswires

An Estate Plan Designed For A Reversal

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--Adviser creates a flexible estate plan for a young family

--Taking advantage of 529s and a trust

--Building in access to funds, if business turns bad

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By Peter McDougall
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Waiting too long to plan an estate can mean paying Uncle Sam more than is necessary. "It's too late to think about it when you're 90 and on your deathbed," says N. Perry Moore, director of wealth planning at Evansville, Ind.-based Payne Wealth Partners.

That said, funneling your assets into an estate plan too early creates its own problem: What if you end up needing the money?

That issue arose, for example, when an affluent couple in their early 40s approached Moore a few years ago. They wanted to set aside some money for their children, ages two and six, but also wanted some flexibility for the future.

More than half of the couple's $25 million net worth was tied up in the family business, which saw its fortunes rise and fall with the economy. A big fall in the value of the business could pose problems for their own financial security.

Moore developed a plan to take that into account. First, he suggested the couple fund 529 plans with a one-time contribution of five years' worth of annual exclusion gifting. At $13,000 per child, per year, per parent, the couple was able to put $260,000 into the 529s. That money will grow tax-free, as long as the proceeds are used for qualified educational expenses. At the very least, the money gets to grow tax-deferred.

More importantly, the move placed $260,000 outside of the estate, thus saving it and any resulting growth from the 35% federal estate tax and Indiana's 10% state inheritance tax.

Moore titled the 529 accounts in the couple's names, with the children named as beneficiaries. That way, they could pull the funds back if that their business took a nosedive. "It's essentially like a custodial 529 account," says Moore. "They can turn it over to the children at the age of maturity."

If the savings grew substantially and the children had leftover funds in their 529 accounts after college, they would have to pay regular income tax on the funds' earnings, in addition to a 10% penalty. Still, that was likely to leave them better off than paying the estate and inheritance taxes. Moreover, the children can retitle the accounts and pass them on to their children, thus creating a multi-generational legacy.

Next, Moore suggested that the couple place $1.5 million, or a little over a tenth of their liquid net worth, into an intentionally defective irrevocable trust, or IDIT. The trust signs a note to pay the $1.5 million plus interest back to the couple over 20 years, at the current market rate. At any point, the couple has the right to call the full value of the note--again, in the event that their business takes a turn for the worse. And from a planning point of view, growth in excess of the principal plus interest remains in the trust and is passed on to the children outside of the estate.

The IDIT strategy benefited from some fortuitous timing. Moore's clients set up their trust in May 2009, just more than a month from the market bottom. As a result, the trust's value, beyond the principal and interest, has grown by $500,000. That growth is free and clear of estate and inheritance taxes.

Moore saw the timing as an opportunity, but his clients were wary. "The last thing that someone wants to do is push part of their balance sheet into a trust when that balance sheet just got beat up by a recession," says Moore. "But we were able to get them to seize the opportunity."

It was a tough sell, but Moore succeeded by proving to his clients they were dealing with excess assets. "Using really conservative estimates, we showed them what they needed to preserve and fund their lifestyle goals," says Moore. "Then we showed them that they really didn't need this other money, which will just be going to the kids anyway."

(Practice Management is a column that looks at ways financial advisers can build and improve their business. Peter McDougall can be reached at 212-416-2245.)

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