Estate Planning
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Legal Matters®

How an LLC could help protect the family cottage

Does your family have warm memories of gathering at a lake house? Sitting by a cabin campfire? Hunting on grandpa's acreage? A vacation home often holds a special place in a family, sometimes enjoyed generation after generation.

Unfortunately, if left unprotected the family cabin can fall victim to nursing home costs. If you require long-term care under Medicaid, you will be required to spend down your assets first, including the value of that beloved cabin.

There are a variety of options available, but the best protection comes when people act proactively, well ahead of the time they need care. Medicaid uses a five-year look back period for "countable assets," and you can be penalized for gifts within that timeframe.

An LLC is one flexible option that allows a parent to retain some measure of control over property while transferring the equity to an adult child.

Under one scenario, parents could gift a 49% interest to one child and a 49% interest to another and retain 2% for themselves. That works well if a parent can ensure that at least one child will consistently vote with them over property management issues.

In this option, the parent retains just 2% interest in the property that could be considered a countable asset for Medicaid. If that value needed to be liquidated, the other LLC members could purchase those shares at fair market value.

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In another scenario, a parent could give majority interest to an adult child, for example 90%, while still maintaining management control. That requires a carefully drafted operating agreement that could include classes of membership interest or restrictive management rights.

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Congress may be closing the backdoor Roth

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A backdoor Roth is a way for high-income earners to put money into a Roth IRA, despite Roth income limits. The backdoor Roth and the "mega-backdoor" Roth have become increasingly popular ways to build tax-free retirement accounts. But now those tools may be going away.

As part of government funding measures built into the Build Back Better Act, the House Ways and Means Committee has recommended eliminating backdoor Roth conversions after December 31, 2021. This prohibition would include both after-tax IRA conversions and after-tax 401(k) conversions — the so-called "mega backdoor" Roth.

The plan includes eliminating pre-tax conversions for certain high-income taxpayers a decade from now, starting January 1, 2032. These conversions would be eliminated for taxpayers with adjusted gross income over $400,000 (single) or $450,000 (married filing jointly).

According to one analyst quoted in the *Wall Street Journal*, the change is expected to "sail right through" because it's predicted to raise around $750 million in the first decade.

Political opposition to Roth conversions grew when it was revealed that some wealthy Americans had amassed multi-million or even multi-billion Roth accounts, such as the case of PayPal founder Peter Thiel, who had $5 billion in assets as of 2019. Thiel reportedly invested in PayPal shares worth less than a penny each and then enjoyed tax-free growth of those assets. (Current law allows IRAs and Roth IRAs to be invested in a wide range of assets.)

Other limits could be coming

Legislators may have giant retirement accounts in their crosshairs. Other proposals have been made to impose limits on large IRAs. Senator Ron Wyden (D-OR), for example, has proposed disallowing contributions to Roth IRAs once they reach $5 million in assets. In addition, Wyden's proposals would force payouts from Roth IRAs that exceed $5 million and curb undervaluation and other abuses of alternative-asset IRAs.

The Obama administration had previously proposed halting contributions to tax-favored vehicles like IRAs, 401(k)s and 403(b) plans once they hit a specific multi-million dollar cap.

A primer on backdoor Roths

Contributions to a Roth IRA are made after you pay income tax, and then those dollars grow tax-free. However, income restrictions limit who can contribute to a Roth and cap your annual contributions at $6,000 in 2021 ($7,000 for those 50+).

When you contribute to a traditional IRA, you get an immediate tax break and money grows tax deferred, but you will pay income tax when you pull your money out in retirement. Some advisors recommend conversion strategies that move some traditional IRA funds into a Roth as a hedge against increased tax rates in the future.

In 2021, income restrictions limit direct Roth IRA contributions to people with modified adjusted gross incomes of $140,000 (single) or $208,000 (married filing jointly). However, savers who earn above that limit can make a traditional IRA contribution and then roll that money over into a Roth, i.e., the backdoor Roth.

The mega backdoor Roth takes things up a notch. People with 401(k) plans that allow after-tax contributions can do the same thing. In 2021, savers can put up to $38,500 of after-tax money into 401(k) plans and then roll those over into a Roth IRA or Roth 401(k), if certain plan provisions are in place.

Legislators may have giant retirement accounts in their crosshairs.

What to do now

Find out if your employer's 401(k) plan offers after-tax contributions and allows you to move that money into the Roth part of the plan, because that option would still be available to you for at least the next 10 years.

Maxing out contributions into a heath savings account (HSA) may be another way for you to realize the tax-free growth advantages of a Roth. Once you turn 65, distributions from an HSA are no longer limited to health expenses and HSAs do not have required minimum distributions like a traditional IRA.

Spendthrift trusts and DAPTs

Want to create a trust for your grandson but worry he'll squander it away in a few short years?

A spendthrift trust contains provisions aimed at preventing a beneficiary from profligately spending their inheritance.

Spendthrift trusts are used when people want to leave substantial sums to an heir but don't trust that person to use the money wisely. The trust prevents the beneficiary from spending or borrowing against trust funds. Language is also used to prevent the beneficiary's creditors from reaching into the trust.

The settlor (the person originating the trust) appoints a trustee to manage distributions and administer the trust. The trustee, then, has discretion to determine how funds would benefit the beneficiary, typically per terms laid out in the trust.

A provision in most trusts. Most trusts contain a "spendthrift provision" that prevents the funds from being available to creditors, even when the beneficiary is the trustee him or herself. Such a provision might state that the beneficiary cannot assign or voluntarily transfer income or principal and that neither income nor principal is subject to attachment, bankruptcy proceedings or control of creditors, etc.

Spendthrift trusts provide protection from a judgment creditor (e.g., for negligence in an auto accident), a property settlement in a divorce or a personal debt. Some states will, however, allow the trust to be breached for unpaid spousal maintenance or child support.

Self-settled spendthrift trusts. Some states have laws that allow someone to set up a self-settled spendthrift trust, which is a spendthrift trust set up for their own benefit. These trusts are also known as Domestic Asset Protection Trusts (DAPT).

These trusts can name the settlor, their spouse and their descendants as beneficiaries, while placing the trust beyond the reach of any creditor. State laws vary, but generally laws are designed to prevent use of a DAPT as an intentional tool to defraud known creditors. Creditors, however, have a limited timeframe to pursue trust funds after a qualified disposition has been made.

Spendthrift trusts are accepted in most states while DAPTs are available in less than 20. Some states recognize that the DAPT can be a way to protect personal estates and aid estate planning, without fraudulent intent.

An estate planning lawyer can help you create a trust that protects your beneficiaries from creditors and from themselves.

How an LLC could protect the family cottage

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Transferring the family cottage via an LLC can offer estate planning and tax benefits that are not available with outright gifts and other vehicles. LLCs can use flexible operating agreements that govern member duties, access, and financial responsibilities. When one member dies, membership interests can be easily transferred outside of probate.

Other advantages of holding the family vacation home in an LLC include liability protection and creditor protection. When compared to joint ownership, an LLC also prevents a property owner from using a divorce or right of partition to force a sale.

Trusts are another common option to protect the family cottage.

Planning for your family vacation property is a critical part of estate planning. There are pros and cons to each option and your attorney can help you decide what's best in your situation.

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Whether you're worried about long-term care protections or not, advance planning can ensure the asset transitions to family members securely and tax-efficiently, according to the owners' intent.

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Should you consider survivorship insurance?

Survivorship insurance is a joint insurance policy that covers two people and pays out after the second person has died. As an estate planning tool, it can cover estate taxes, provide for a child with special needs or otherwise help leave a legacy for your heirs.

Because survivorship insurance doesn't pay out until the second partner dies, the premiums are typically cheaper than what you'd get with two individual policies. These so-called "second-to-die" policies can also make sense when one person has a medical condition that would make it prohibitive for that partner to receive coverage on their own.

Preserving assets: For married couples, estate taxes are due after the death of the second spouse when the estate exceeds exemption amounts. This is currently $11.7 million per individual, but that is set to decline to $5 million in 2026.

Let's assume the estate exemption is lowered. On a $10 million estate, $5 million would be taxable at what could be a 37% tax rate. That becomes a large federal tax bill your heirs need to pay. Your heirs may need to sell assets (e.g., real estate, stock or art) to cover that cost.

Life insurance benefits can provide immediate liquidity to pay an estate tax bill. Those funds go directly to the beneficiary, without the cost and delay of probate.

Special needs planning: For parents of a child with disabilities, survivorship insurance can be one way to fund a special needs trust. The death benefit can help ensure the child will continue to receive care (beyond the basics provided under Medicaid).

Leaving a legacy: Some people choose survivorship insurance as a financial planning tool to leave an inheritance behind. If you believe you can cover the cost of premiums but will otherwise use up your assets during your lifetime, it can be a way to leave something behind. An estate planning attorney can help you with these decisions.