Estate Planning Insights

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THERE ARE MORE OPTIONS ON THE MENU NOW: WHAT WILL YOU HAVE?

What Are Your Estate Planning Goals? In order to design an estate plan that is right for you, your estate planning attorney must know what your primary goals are. Note that it is not always possible to accomplish *all* of your estate planning goals, so you have to rank your goals in order from most important to least important. Here is a list of some "testamentary" estate planning goals (we are ignoring lifetime disability planning for purposes of this newsletter):

1. Make sure your spouse has sufficient assets for his/her health, maintenance and support after you die.
2. Make sure that your remaining assets pass to your children when your spouse dies (and not to your spouse's new spouse or to your spouse's children from a prior marriage). This is sometimes called "ultimate control."
3. Make sure that the assets you leave to your children do not get "allocated to" your child's spouse in a divorce (as a result of commingling) or get taken by a tort creditor who obtains a judgment against your child.
4. Make sure that your children (and grandchildren) do not receive too much too soon.
5. Make a final gift (i.e., leave a legacy) to the charities you have supported during your life.
6. Avoid the probate process on your death.
7. Pay as little estate taxes as possible on your death (or, if you are married, on the death of the surviving spouse).
8. Reduce/defer income taxes on your "pre-tax assets" (e.g., IRAs and qualified plans) after your death.
9. Keep everything as simple as possible from an administrative standpoint.
10. Create an asset management structure in case a beneficiary loses his/her mental capacity.
11. Obtain a step up in income tax basis on the death of the surviving spouse, without having to pay estate taxes to get it.

Increasing Importance of Income Tax Considerations. The eleventh item on the above list was infrequently discussed prior to this year. Now, because of several provisions in the American Taxpayer Relief Act of 2012 (ATRA), which became law in January 2013, more people are starting to discuss #11 on the list. Per ATRA, the estate tax exemption amount is now $5,000,000, indexed for inflation (already adjusted to $5,250,000 for 2013), and the portability provisions are now permanent. The estate tax rate is now 40%, while the top income tax rate is 39.6% *plus*: the *plus* is because of the 3.8% Medicare surtax (not part of ATRA), which kicked in this year, and the additional 5% long term capital gains tax rate and additional 5% qualified dividend rate for high income taxpayers.

We believe that, since fewer and fewer estates will be subject to federal estate taxes, there will be an increased focus on the income tax consequences of various estate plans. One important income tax issue is *basis*.

Step Up in Basis at Death. Nothing special has to be done to obtain a step up in the income tax basis of the assets owned by a single person or by the first spouse to die upon his/her death. (Note that, even though we usually refer to a "step up" in basis at death, a "step down" in basis can also occur.) All assets in which a decedent owned an interest at death have to be valued at fair market value as of his/her date of death (or the alternate valuation date, if applicable) to satisfy federal estate tax rules. Those estate tax values then become the new income tax bases of the assets. Further, because the estate plan of most married couples is designed so that no estate taxes are payable on the death of the first spouse, the step up in income tax basis on the first spouse's death, which applies to both halves of the community property and all of the decedent's separate property (if any), is a *tax-free* step up in basis. The step up in basis basically "wipes out" all of the prior appreciation in value and allows the decedent's executor or beneficiaries to sell the assets with little or no capital gain (i.e., gain/loss=sales price of the asset sold minus the new income tax basis of the asset obtained as a result of the decedent's death).

The Bypass Trust and the Basis Issue. Over the past 30+ years, it has been very common for a married couple's estate plan to cause the interest of the first spouse to die in the couple's assets to pass upon his/her death into a Bypass Trust for the benefit of the surviving spouse

(and, often, for children and grandchildren as well). This plan was used primarily to avoid "wasting" the exemption of the first spouse to die and, therefore, to avoid paying too much in estate taxes on the death of the surviving spouse. The Bypass Trust worked beautifully, too. Even in cases where the surviving spouse served as the sole trustee of the trust and even though the trust assets could be used for the spouse's health, maintenance and support, the trust assets were not includable in the surviving spouse's estate at death. In addition, the appreciation in value of the Bypass Trust assets between the first spouse's death and the surviving spouse's death escaped estate tax on the surviving spouse's death. Further, the assets in the trust were protected from creditors' claims and from being diverted to the new spouse of the surviving spouse. With this plan, the first spouse to die could take care of the surviving spouse and also achieve "ultimate control" over the disposition of his assets on the surviving spouse's death. Thus, the Bypass Trust seemed to accomplish multiple estate planning goals for married couples.

Assets in a Bypass Trust do not obtain a second step up in income tax basis on the death of the surviving spouse, however. When the estate tax exemption amount was low (for many years, less than $1 million) and when the estate tax rate was high (for many years, a top rate of 55%), no one cared too much about the fact that the Bypass Trust assets did not obtain a second step up in basis when the surviving spouse died. The estate tax savings of the Bypass Trust more than offset the loss of the second basis step up. Now, that may no longer be true. Yet, focusing solely on the income tax basis issue may be too "narrow-minded." As noted, the Bypass Trust provides significant non-tax benefits, too. Further, in most cases, it is likely that the most significant step up in income tax basis will occur on the death of the first spouse (versus the death of the second spouse) and that is not changed by ATRA.

Reminder. Married couples do not *automatically* get 2 exemptions from the federal estate tax. Married couples have to *do something* to get 2 exemptions. The most common ways for a married couple to get 2 exemptions are (i) to fund a Bypass Trust on the death of the first spouse and (ii) to make the portability election on the death of the first spouse. Either or both methods can be used (of course, the Bypass Trust method is only available with proper pre-death planning). In certain cases, the first spouse to die might leave his exemption amount to his children from his prior marriage, rather than to his spouse. This is another way to avoid "wasting" the first spouse's estate tax exemption amount. However, we will ignore that option in this newsletter since most married couples want most or all of their assets to be available for the support of the surviving spouse.

Let's use an example to make sure that everyone understands how the rules work. If a married couple (both US citizens) with a total community property estate worth $10,500,000 (twice the 2013 estate tax exemption amount) doesn't utilize one of the methods noted above, and if all of the assets pass outright to the surviving spouse on the first spouse's death, ignoring future inflation adjustments to the exemption amount and future changes in the value of the assets, there will be a 40% estate tax on $5,250,000 when the surviving spouse dies, amounting to **$2,100,000** in estate taxes payable at that time! The reason for this result is that the surviving spouse, who is just 1 person, will have an estate worth $10,500,000, but will only be able to use her own $5,250,000 exemption to avoid estate taxes because nothing was done to avoid "wasting" the exemption amount of the first spouse to die. In other words, the couple got 1 exemption from the estate tax, not 2.

If the couple had done *something*, such as either (i) funding a Bypass Trust on the first spouse's death (assuming the Will or Revocable Trust contained appropriate provisions for a Bypass Trust) and/or (ii) filing a Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return ("Form 706"), on the first spouse's death and making the portability election, then they would have been able to obtain 2 exemptions from the estate tax, not just 1, and could have avoided paying $2,100,000 in estate taxes on the second spouse's death.

Portability. One of the advantages of making the portability election–versus funding a Bypass Trust–on the first spouse's death is that all of the assets owned by the surviving spouse will get a second step up in income tax basis on her death. This is because those assets will be includable in the surviving spouse's estate for federal estate tax purposes. Thus, couples who want 2 exemptions from the estate tax and also want a second step up in income tax basis on the death of the surviving spouse can leave all of their assets outright to the surviving spouse on the first spouse's death and, as long as the Executor of the first spouse's estate files a Form 706 to make the portability election (and the surviving spouse doesn't lose the first spouse's exemption as a result of remarriage), the couple will have 2 exemptions on the second spouse's death to shelter their combined assets from estate taxes. The transported unused exemption of the first spouse to die (called the "DSUE amount") can be lost if the surviving spouse remarries and her new spouse predeceases her with no DSUE amount (or with less compared to the first spouse). So, surviving spouses who use this method should consider using the first spouse's DSUE amount to make lifetime (taxable) gifts to children (or trusts for them) before remarrying.

But what if, in addition to obtaining 2 exemptions from the estate tax, the couple also wants to protect the first spouse's assets from creditors' claims and also from being diverted to the new spouse of the surviving spouse (or to

beneficiaries chosen by the surviving spouse, who might not be the ultimate beneficiaries the first spouse wanted to benefit). The way to accomplish those additional goals is to use a Marital Trust as the recipient of the first spouse's assets, rather than leaving the first spouse's assets outright to the surviving spouse.

Remember, however, that whether the first spouse's assets pass outright to, or into a Marital Trust for, the surviving spouse, those assets *will* be includable in the surviving spouse's estate at their fair market value at the time of the surviving spouse's death. Since the DSUE amount is not indexed for inflation, even though the couple may end up getting 2 exemptions from the estate tax, estate taxes may still have to be paid because of the increase in the value of the assets after the first spouse's death. On the other hand, when the first spouse's assets pass into a Bypass Trust, no matter how much those assets appreciate in value after the first spouse's death, they will not be subject to estate taxes when the second spouse dies.

GST Tax Issue. Let's also consider the exemption from the Generation-Skipping Transfer (GST) Tax, which is currently $5,250,000. Many couples use their GST exemptions to create lifetime, divorce and creditor-protected trusts for their children that become effective on the surviving spouse's death. While portability allows the first spouse's DSUE amount to be transported to the surviving spouse, resulting in 2 estate tax exemptions when the second spouse dies (assuming the first spouse's DSUE amount isn't lost due to the surviving spouse's remarriage), there is no portability for the GST exemption. In other words, if assets pass outright to the surviving spouse, the first spouse's GST exemption cannot be transported to the surviving spouse by making the portability election. This means that, if portability is elected instead of funding a Bypass Trust on the first spouse's death, significant assets held in the children's trusts may well be subject to estate taxes upon the children's deaths–taxes that could have been avoided if the couple had used the Bypass Trust method of obtaining 2 estate tax exemptions *and* 2 GST exemptions.

Complicating Factors. The above is a simplistic comparison of *some* of the estate planning options and considerations now that ATRA is in place. If a couple is in a second marriage, or if they own a closely held business, or if the vast majority of a couple's total net worth is in "pre-tax" assets such as qualified retirement plans and IRAs, the estate planning analysis becomes even more complex. There never was a "one size fits all" estate plan and that is now more true than ever.

Based on current Obama administration proposals, additional tax law changes may be made this year that will affect estate planning. We will keep you posted.

A NOTE TO TRUSTEES OF "COMPLEX TRUSTS." If you are the Trustee of a *complex trust*, you should discuss the new 3.8% Medicare surtax with your CPA. In general, a trust will be treated as a "complex trust" for federal income tax purposes if it is *not* treated as a grantor trust and if it does not *require* that all net income of the trust be distributed out of the trust each year (i.e., is not a "simple trust" for federal income tax purposes). Basically, a complex trust is an irrevocable trust in which the Trustee is given *discretion* whether to distribute all or any part of the trust's income out of the trust to one or more permissible current beneficiaries or to retain all or any part of the trust's income in the trust. Trusts that are usually drafted as complex trusts include Bypass Trusts, Child's Trusts, and Descendant's Trusts.

In past years, the Trustee of a complex trust may have exercised her discretion in a "borderline situation" in the direction of retaining trust income in the trust, rather than distributing it, to accomplish certain long-term goals that the trust settlor had in mind when he created the trust. These goals might include protecting the retained income from a creditor (or potential creditor) with a claim against a trust beneficiary (including the beneficiary's spouse in a divorce) and preventing the retained income from being subject to future estate taxes in the beneficiary's estate. In view of the 3.8% Medicare surtax that is applicable to the trust's retained net investment income, starting in 2013, long-term goals need to be weighed against short term income tax consequences. In other words, if you are the Trustee of a complex trust, don't just blindly continue the distribution practices you have followed in past years and, if you do, don't just pay the same quarterly estimated income taxes this year that you paid last year without first consulting with the CPA who helps you with the trust's income tax matters.

For 2013, complex trusts reach the highest income tax bracket once the trust's adjusted gross income (AGI) for the year exceeds $11,950. This is a much lower threshold than those that apply to individual income taxpayers. Thus, AGI above $11,950 is taxed at a "regular" top income tax rate of 39.6% plus the 3.8% Medicare surtax on retained net investment income. Investment income means income such as interest, dividends, rental income, royalties, income from passive activities and short and long-term capital gains. If the trust that you administer receives income from a "pass-through entity," such as a limited partnership (LP) or limited liability company (LLC), then the net investment income from that entity should also be taken into account. We are not going to go into further detail regarding trust income tax matters in this newsletter. Our purpose is simply to give Trustees a "heads up" regarding these income tax issues that apply to complex trusts and to recommend that all Trustees discuss these matters with their CPA.

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A Tip Regarding Your Living Will. Many clients have signed a "Directive to Physicians and Family or Surrogates" ("Living Will"). When you check into the hospital for a medical procedure, they will ask you whether you have a Living Will and will often also ask you to provide them with a copy of it. If you have selected the first option in the Living Will (i.e., "withhold life sustaining treatment"), you may not want to give the hospital a copy of your Living Will when you check in. The reason is that, if something unforseen happens to you during your procedure, you will want your doctors and hospital personnel to speak with the person you have named as your agent in your Medical Power of Attorney (i.e., your medical agent) but, if the hospital already has a copy of your Living Will and they determine that it applies, then it "cuts off" the powers of your medical agent and the hospital's ability to consult with your medical agent. To keep your medical agent "in the loop," you can answer "Yes" to the question regarding whether you have a Living Will, and then, in response to the place on the form where it asks you to provide the hospital with a copy of your Living Will, you can write this: "If it becomes necessary, my medical agent will supply you with a copy of my Living Will." Hopefully, doing it this way will enable your medical agent to find out what happened and discuss the situation with the hospital before the provisions of your Living Will are activated.

Time for an Estate Planning Check Up? If it has been *more than 5 years* since your estate plan was created or last reviewed, you are "due" for a check up. Also, if you want to change your Bypass Trust Wills to "simple" Wills, please make an appointment to come in for an estate planning check up. And, now that we "know what the rules are," if you are ready to take a "second step" up the estate planning ladder, please call for an appointment.

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown above. You can also reach us by email addressed to:

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