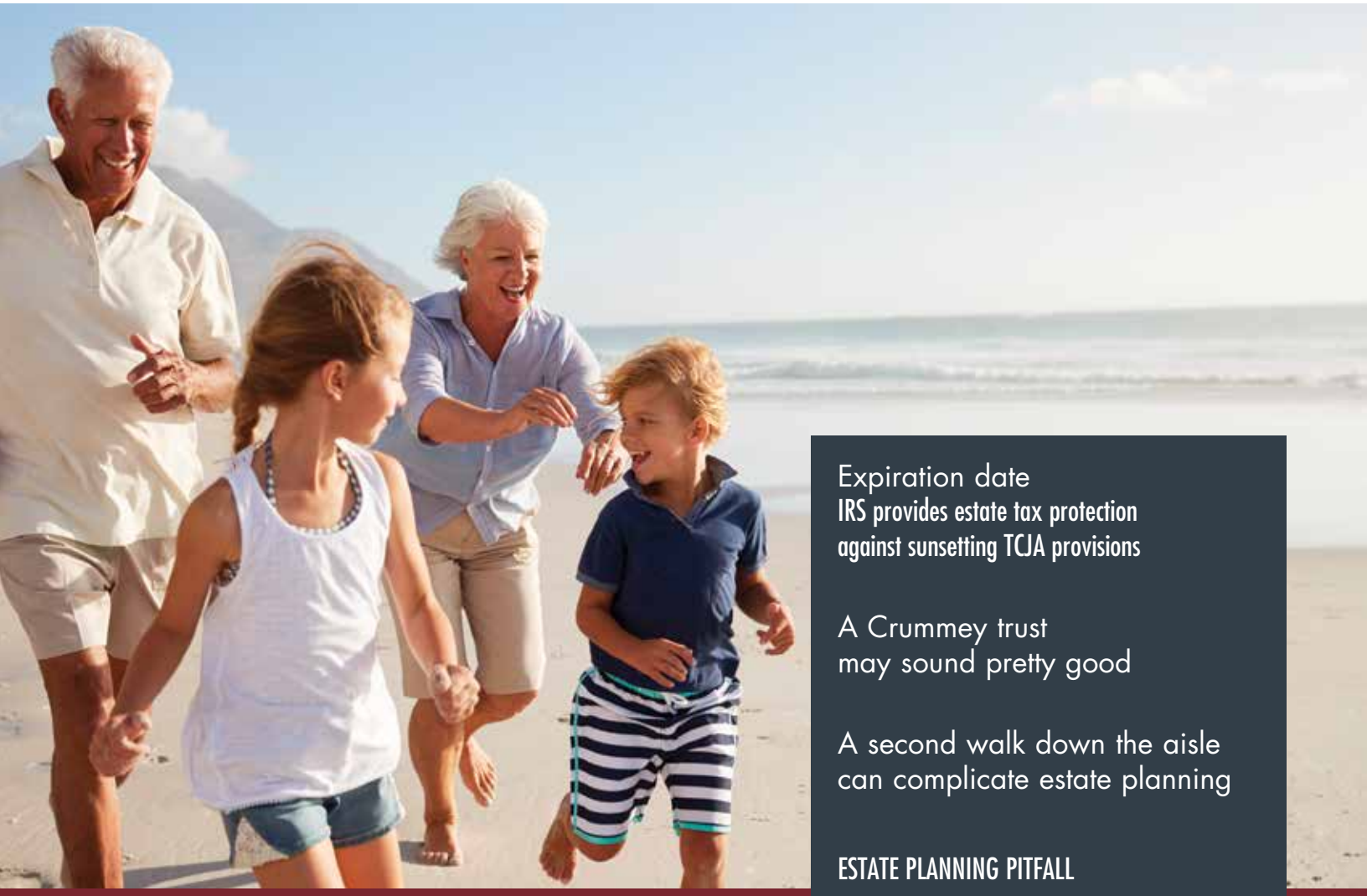
INSIGHT ON ESTATE PLANNING



Expiration date
IRS provides estate tax protection against sunsetting TCJA provisions

A Crummey trust may sound pretty good

A second walk down the aisle can complicate estate planning

ESTATE PLANNING PITFALL
The 60-day IRA rollover deadline has passed

APRIL/MAY 2019

STOKES LAWRENCE

Seattle | Yakima

Stokes Lawrence | 1420 Fifth Avenue, Suite 3000 | Seattle, Washington 98101-2393 | 206.626.6000

Stokes Lawrence Velikanje Moore & Shore | 120 N. Naches Avenue | Yakima, Washington 98901-2757 | 509.853.3000

www.stokeslaw.com

Expiration date

IRS provides estate tax protection against sunsetting TCJA provisions

Beginning in 2018, the Tax Cuts and Jobs Act (TCJA) effectively removed gift and estate tax liability concerns for many families. However, the favorable estate tax changes in the TCJA are currently scheduled to sunset after 2025, unless Congress takes further action. Notably, the TCJA provision that doubled the gift and estate tax exemption from $5 million to $10 million (adjusted annually for inflation) will revert to pre-2018 levels after 2025.

The IRS has announced additional tax relief to families who could be adversely affected by large lifetime gifts during this timeframe. It has issued proposed regulations providing protection if you make large gifts that could erode future estate tax benefits.

Progression of the exemption amount

The gift and estate tax exemption has been increased substantially by several pieces of federal tax legislation since the turn of the century. After it was bumped up from $675,000 to $1 million, relatively small amounts by today's standards, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 gradually increased the exemption to $3.5 million over the course of a decade. During the same period, EGTRRA lowered the top estate tax rate from 55% to 35% and severed the gift and estate exemption.

EGTRRA provided a one-year respite from estate tax — in 2010 — before the 2010 Tax Relief Act reinstated the exemption of $5 million and reunified the gift and estate tax exemptions. This law also introduced the estate planning concept of "portability." With the portability provision, the estate of a surviving spouse can benefit from the unused exemption of a deceased spouse's estate.

Subsequently, the American Taxpayer Relief Act (ATRA) of 2012 retained the $5 million exemption, indexed for inflation. Among other changes, this law also imposed a top 40% tax rate. But many of the gift and estate tax provisions in ATRA were temporary.

At long last, the TCJA provides even more gift and estate tax relief. Under the TCJA, the exemption was doubled from $5 million to $10 million, indexed for inflation, while

retaining the portability provision and the top 40% tax rate. The IRS has announced that the exemption for 2019 is $11.4 million (up from $11.18 million in 2018).

This gives most families plenty of estate planning leeway. For instance, a married couple can effectively shelter up to $22.8 million from gift and estate taxes in 2019. However, in 2026, the exemption is set to return to the 2017 level of $5 million, adjusted for inflation.

New relief provided by the IRS

Generally, the exemption is first used during your lifetime to offset any gift tax. The remaining amount is then used to reduce or eliminate estate tax. But what happens if you make large gifts between 2018 and 2025 that are sheltered by the higher exemption amount but become unsheltered when that amount is reduced beginning in 2026?

To address concerns that estate tax could apply to gifts exempted from gift tax by the increased exemption amount, proposed regulations clarify that individuals who take advantage of the increased exemption won't be harmed after 2025 when this amount is scheduled to drop. Under a special rule in the regs, an estate can effectively compute its estate tax by using the greater of the exemption amount applicable to gifts made during your lifetime or the exemption amount applicable on the date of death.

As a result, if you plan on making large gifts in the next few years, you don't have to worry about losing the tax benefit of the higher exemption amount after it decreases in 2026. For example, let's say that you didn't make any gifts prior to 2018. When the exemption amount was $11.18 million last year, you gave your children $9 million and paid zero gift tax. If you die in 2026 or thereafter, your estate can still base its estate tax calculation on the higher exemption amount that was effective in 2018.

Don't forget the gift tax exclusion

Avoiding gift tax during your lifetime is a major component of estate planning. However, before sheltering gifts using your gift and estate tax exemption, remember to take advantage of the annual gift tax exclusion. This provision is applied before your exemption amount is eroded.

Under the gift tax exclusion, you can give each recipient up to $15,000 in 2019, exempt from any gift tax liability. For instance, if you have two children and four grandchildren, you can give each one $15,000 free of gift tax, for a total of $90,000.

Furthermore, this annual exclusion is effectively doubled for joint gifts made by a married couple. Thus, you and your spouse can give away a total of $180,000 tax-free in 2019. If you continue this gift-giving pattern for five years, you'll have reduced your joint estate by $900,000 — plus any appreciation on the assets transferred — gift-tax-free.

You can rely on these proposed regulations until final regulations are issued. The IRS has requested comments from the public.

Practical approach

Consider both the long-term and short-term gift and estate tax implications of the new regs. This should encompass large gifts contemplated over the next few years as well as the need for eventual estate tax protection. With assistance from your estate planning advisor, you can minimize or eliminate potential estate tax liability. •

A Crummey trust may sound pretty good

The Tax Cuts and Jobs Act (TCJA) has reduced estate tax concerns for many families, but estate tax liability remains a concern for some. Notably, you may implement strategies in the wake of the TCJA that are designed to reduce future exposure to federal and state estate taxes.

One such option, a Crummey trust, remains a viable option. Despite its odd-sounding name, derived from the landmark case authorizing its use, the results are anything but crummy.

"Present interest" vs. "future interest"

Under the annual gift tax exclusion, you can give gifts to each recipient, valued up to a specific limit, without incurring any gift tax. The limit for 2019 is $15,000 per recipient, the same as it was in 2018. (This amount is indexed for inflation, but only in $1,000 increments.) Therefore, if you have, for example, three adult children and seven grandchildren, you can give each one $15,000 this year, for a total of $150,000, and pay zero gift tax. The exclusion is doubled to $30,000 a year for gifts made jointly by a married couple.

If you give outright gifts, however, you run the risk that the money or property could be squandered, especially if the recipient is young or irresponsible. Alternatively, you can transfer assets to a trust and name the child as a beneficiary. With this setup, the designated trustee manages the assets until the child reaches a specified age.

But there's a catch. To qualify for the annual exclusion, a gift must be a transfer of a "present interest." This is defined as an unrestricted right to the immediate use, possession or enjoyment of the property or the income from it. When a gift is placed in a trust and it accumulates income without being distributed to the beneficiary, it doesn't qualify as a gift of a present interest. Instead, it is treated as a gift of a "future interest" that is subject to gift tax.

Crummey trust in action

This is where a Crummey trust can come to the rescue. It satisfies the rules for gifts of a present interest without requiring the trustee to distribute the assets to the beneficiary.

A Crummey trust satisfies the rules for gifts of a present interest without requiring the trustee to distribute the assets to the beneficiary.

Typically, periodic contributions of assets to the trust are coordinated with an immediate power giving the beneficiary the right to withdraw the contribution for a limited time. However, the expectation of the donor is that the power won't be exercised. (The trust document cannot expressly provide this.)

As a result, the beneficiary's limited withdrawal right allows the gift to the trust to be treated as a gift of a present interest. Thus, it qualifies for the annual gift tax exclusion. Note that it's the existence of the legal power — not the exercise of it — that determines the tax outcome.

Potential obstacles

To pass muster with the IRS, the beneficiary must be given actual notice of the withdrawal right, along with a reasonable period to exercise it. Generally, at least 30 days is required.

It's recommended that you spell out the notification in writing. Also, you should obtain a written acknowledgment from the beneficiary or the beneficiary's representative. Furthermore, the trust may limit the withdrawal right to the lesser of the amount of the annual gift tax exclusion or the fair market value of the property contributed to the trust.

Finally, the IRS may challenge arrangements that provide limited withdrawal rights without any other economic interest in the income or principal of the trust. These are sometimes referred to as "naked" Crummey powers. Accordingly, the IRS has ruled that the beneficiaries of a Crummey trust must have an actual economic interest in the trust property to meet the present interest requirement. (For example, the beneficiaries should have a vested right to principal or income.)

Is a Crummey trust right for you?

There are several variations on this theme, but the crux is that a Crummey trust provides a limited withdrawal right for beneficiaries while periodic contributions qualify for the annual gift exclusion. This technique may meet your estate planning objectives. Consult with your estate planning advisor concerning use of a Crummey trust for your situation. •

A second walk down the aisle can complicate estate planning

An estate planning rule of thumb is to review (and, if necessary, revise) your estate plan in light of major life events. Such events include a marriage, birth of a child and a divorce. A second marriage also calls for an estate plan review. You'll want to provide for your current spouse but not inadvertently benefit your former spouse. And if you have children from each marriage, juggling their interests can be a challenge.

Update your will and other documents

It's critical to review your will, trusts, health care directives, powers of attorney and other estate planning documents to ensure that your wishes are carried out. Otherwise, you might unintentionally benefit your former spouse or

his or her family or give them control over your affairs. Check whether your former spouse or members of his or her family are appointed as executor, trustee, guardian, agent or attorney-in-fact in any of your documents.

Consider a prenuptial agreement

If you have children from your previous marriage, you may wish to leave the bulk of your estate to them, particularly if your new spouse is financially independent. The laws in most states, however, make it difficult to "disinherit" your spouse.

For example, many states provide a surviving spouse with an "elective share" — typically between one-third and one-half — of the other spouse's estate, regardless of the terms of his or her will or living trust.

You can use a prenuptial agreement to waive your respective rights to each other's property. These agreements can also be used to serve a variety of other purposes, including retaining control of a business and defining premarital assets and debt.

Determine whether your former spouse is still named as beneficiary of any life insurance policies, annuities or retirement plans.

Review beneficiary designations

Determine whether your former spouse is still named as beneficiary of any life insurance policies, annuities or retirement plans and update the beneficiary designation if appropriate. Also, keep in mind that, if you've named any minor children from your previous marriage as beneficiaries, and you unexpectedly die, your former spouse will likely become their legal guardian and gain control over their property. If this scenario is unacceptable, consider designating a trust as beneficiary for your child's benefit.

Have you established any irrevocable trusts that name your former spouse as a beneficiary? If so, do the trusts provide that his or her rights terminate automatically in the event of divorce?

Also, find out whether your divorce decree grants your former spouse any rights with respect to life insurance, retirement plans or other assets. If the answer is yes, your ability to update certain beneficiary designations may be limited.

As you name new beneficiaries, be aware that your new spouse may have mandatory rights to certain assets, such as qualified retirement plans. If you wish to name someone else as beneficiary — a child from your previous marriage, for example — you'll have to ask your new spouse to waive these rights in writing.

Make the most of trusts

If you leave wealth to your spouse outright, there's no guarantee that he or she won't spend it all or share it with a new spouse, leaving your children from your previous marriage with nothing. The creative use of

trusts can avoid this result and ensure that all your loved ones are provided for.

For example, you might establish a trust for your new spouse (and any children you have together) and a separate trust for your children from your previous marriage. Another option is to set up a trust that provides your new spouse with income for life and preserves the principal for your children.

Avoid unintended consequences

Getting remarried may be a highlight of your life, but doing so can throw a monkey wrench into your estate plan. That's why it's critical to discuss with your estate planning advisor any revisions necessary to ensure you're not surprised by unintended consequences down the road. •

ESTATE PLANNING PITFALL

The 60-day IRA rollover deadline has passed

Obviously, qualified retirement plans such as 401(k) plans and IRAs are meant to provide retirement savings. However, if you're fortunate and don't have to draw heavily, if at all, on plan and IRA assets, you can preserve a tidy nest egg for your heirs.

In fact, if handled correctly, distributions can be stretched over the lifetimes of several generations. Thus, these vehicles become estate planning tools, as well as retirement planning tools.

As part of your planning efforts, you may transfer funds between accounts, depending on your needs and other factors. For instance, after you retire, you might decide to move your 401(k) assets into an IRA. Normally, distributions from qualified plans and IRAs are subject to tax, plus a 10% penalty, if you're under age 59½. But you can avoid any dire tax consequences with a timely rollover.

Essentially, you have 60 days to roll over funds between a qualified plan and an IRA (or other combination) without incurring tax. It's generally recommended that you use a trustee-to-trustee transfer to eliminate any doubt. In

other words, you never touch the money that goes directly from the plan to the IRA.

What happens if you don't meet the 60-day deadline? In that case, the entire distribution is taxable, plus the 10% penalty if applicable.

As a last resort, you can request a waiver from the IRS if you have reasonable cause for missing the deadline. If you qualify, you can self-certify your eligibility for a waiver in certain circumstances (such as an error by the financial institution). But it's far better to be safe than sorry by ensuring that you complete a rollover within 60 days.

STOKES LAWRENCE

Seattle | Yakima

Stokes Lawrence, P.S.
1420 5th Avenue, Suite 3000
Seattle, Washington 98101-2393
206.626.6000

Stokes Lawrence
Velikanje Moore & Shore
120 N. Naches Avenue
Yakima, Washington 98901-2757
509.853.3000

www.stokeslaw.com

What Washington Snowbirds Should Know About Taxes

After this season's harsh February, certain Washington residents may be considering part-time residency in sunnier locales next winter. In addition to improved weather, the possibility of changing domicile to avoid Washington estate tax may make a change of scenery all the more appealing. But before the issue of estate tax becomes a deal-maker (or breaker) in the decision, it is important to consider the complete tax picture, including whether a move will constitute a change of domicile and whether it will improve, or impair, your tax situation overall. Below are some tips on what to think about, from a tax perspective, when considering a move.

What is the estate tax rate in Washington, and when does it apply?

Washington has no income tax, but it imposes an estate tax of 10-20% on estates of deceased Washington-domiciled residents, to the extent an estate exceeds the $2.193 million exemption and does not otherwise pass to a spouse or a charity. Notably, the tax similarly applies against the estate of any deceased person, regardless of domicile, who dies while owning property physically located in Washington. For such estates, the tax is proportionally reduced to capture only that part of the estate that is physically located in Washington. Thus, if you have an estate above the exemption, establishing domicile in a state that does not have estate tax, and reducing your Washington holdings, can significantly benefit your heirs.

What are other potential tax benefits or drawbacks to moving to a new state?

Depending on your personal tax situation, a new state's income tax laws may be of more concern than Washington estate tax. Income tax liability may be based on "residency" rather than "domicile" - two related but different terms defined under a dizzying and sometimes conflicting array of laws across multiple states. Since Washington has no income tax, establishing even a part-time residency in a state with an income tax can yield an unpleasant result.

For example, California has no estate tax but imposes an income tax based on "residency" with the highest bracket just above 13%. On one occasion, California tax authorities reportedly claimed that a frequent visitor to the state was a "resident" of California subject to California income tax on her worldwide income primarily because she had a subscription to the Los Angeles Times on "vacation hold" for several months. California reportedly lost that matter on appeal, but the incident demonstrates the state's expansive view of taxation. Part-time residents may be caught in a double-tax trap and be deemed a California "resident" for income tax but "domiciled" in Washington for estate tax purposes.

Also when contemplating a move it is important to keep in mind that Washington is not the only state with an estate tax. Specifically, twelve other states and the District of Columbia currently impose a state estate tax. Of the Western states, Oregon and Hawaii have an income tax and an estate tax. Arizona, California, Colorado, Idaho, Montana, and Utah have an income tax but no estate tax. Nationwide, the states of Alaska, Nevada, South Dakota, Texas, Wyoming and Florida have no income tax or estate tax.

What is "domicile," and how is it established?

Establishing domicile (i.e., your permanent home) in a state will help ensure you will be taxed under that state's laws. Unlike residency, which can be considered established in multiple states, only one state or location can be your domicile. Keep in mind that moving domicile will not result in complete relief from Washington estate tax liability if any portion of your property remains located in the state.

There are no bright-line rules for establishing domicile, and courts generally look at the totality of circumstances. Some of the factors considered are:

- Location of primary residence
- Other property location and ownership
- Time spent in the state during the year
- Voting place
- Place of employment in the 5 years before death
- Vehicle registration
- Business and social ties

Changing domicile can result in significant tax relief for some taxpayers, but thoughtful planning is an important part of the process. For questions about the effect of domicile in respect to your estate or tax planning, please contact a member of the Stokes Lawrence Estate Planning Group at (509) 853-3000 in Yakima or (206) 626-6000 in Seattle.