Insight on Estate Planning

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Adapting to the times

Estate planning focus shifts to income taxes

Until recently, estate planning strategies typically focused on minimizing federal gift and estate taxes, with less regard for income taxes. Today, however, the estate and income tax law landscape is far different. What does this mean for estate planning? For many people — particularly those who expect to have little or no estate tax liability — it means shifting their focus to strategies for reducing income taxes.

Changing estate tax law

For many years, the combination of relatively low estate tax exemption amounts and high marginal rates could easily devour more than half of an estate's value. Popular estate planning techniques often had income tax implications, but in general any income tax consequences were eclipsed by the estate tax savings.

Now that has changed. For one thing, since 2001, the federal exemption has grown from $675,000 to $5.34 million. And, unlike before 2013, the exemption isn't scheduled to drop in the future. In fact, it will continue to gradually increase via annual inflation adjustments. Estate tax rates have also decreased significantly, from 55% to 40%. And the 40% rate has no expiration date.

For many people, this new gift and estate tax law regime means federal gift and estate taxes are no longer an issue.

Income tax matters

At the same time that potential gift and estate tax liability has disappeared for many, individual income tax rates have increased. In 2001, the top federal income tax rate was 39.1%, substantially lower than the top federal estate tax rate of 55%. Now the top income tax rate has grown to nearly as high as the current top estate tax rate.

Taxpayers with taxable income of more than certain annually adjusted levels (for 2014, $406,750 for single filers, $432,200 for heads of households, $457,600 for joint filers and $228,800 for separate filers) are now subject to a 39.6% marginal rate.

Have your cake and eat it

Intentionally defective grantor trusts — also known as income defective trusts (IDTs) — have long been a popular tool for reducing estate taxes. These trusts ensure that assets are removed from your estate while the trust income remains taxable to you. If, however, your estate is well within the $5.34 million gift and estate tax exemption — so that you're more concerned with reducing *income* taxes — you might consider an *estate* defective trust (EDT).

An EDT is essentially the opposite of an IDT. It's designed so that the trust income is taxable to your beneficiaries while the assets remain in your taxable estate. From an income tax perspective, an EDT provides two significant benefits. First, you can use it to shift income to beneficiaries in lower tax brackets, reducing your family's overall tax burden. Second, it allows you to share some wealth with your beneficiaries now without losing the benefits of the stepped-up basis at death.

Capital gains rates also have increased. Currently, the top rate is 20% (up from 15%) — 23.8% for taxpayers subject to the Affordable Care Act's 3.8% net investment income tax (NIIT). It applies to certain net investment income — including dividends, taxable interest and capital gains — earned by taxpayers whose modified adjusted gross income tops $200,000 ($250,000 for joint filers, $125,000 for separate filers). The NIIT thresholds aren't annually adjusted.

Fortunately, many estate planning strategies are available that can help reduce income taxes. Consider the family limited partnership (FLP). A properly structured and operated FLP allows parents to shift income to children or other family members in lower tax brackets by giving them limited partnership interests. But watch out for the kiddie tax, which can undo the benefits of income shifting if you transfer FLP interests to dependent children under the age of 19 (age 24 for certain full-time students).

Tax basis planning

The heightened importance of income taxes also means that there may be an advantage to holding assets until death rather than giving them away during your life. If you give away an appreciated asset, the recipient takes over your tax basis in the asset, triggering capital gains taxes should he or she turn around and sell it.

When an appreciated asset is inherited, on the other hand, the recipient's basis is "stepped up" to the asset's fair market value on the date of death, erasing the built-in capital gain. So, from an income tax perspective, there's an advantage to retaining appreciating assets until death rather than giving them away during your lifetime.

For those with large taxable estates, however, this advantage may be outweighed by estate tax concerns. From an estate tax perspective, it's preferable to remove appreciating assets from your estate — through outright gifts or contributions to irrevocable trusts — as early as possible. That way, all future appreciation in their value will be shielded from estate tax.

If your net worth is safely within the estate tax exemption, retaining assets until death will minimize the impact of built-in capital gains on your heirs. Alternatively, if you want to share your wealth with your children or other family members, consider using an estate defective trust, which provides current income to your beneficiaries without removing the trust assets from your estate. (See "Have your cake and eat it" on page 2.)

Charitable planning

Higher income taxes can also have a big effect on charitable giving strategies. If your estate plan includes charitable bequests, for example, it makes sense to fund those bequests with assets that otherwise would generate "income in respect of a decedent" (IRD).

IRD is income that a deceased person earned but never received, such as IRA or qualified retirement plan distributions. Unlike other inherited assets, which are income-tax-free to the recipient, IRD assets can trigger a significant tax bill. But you can avoid these taxes by donating the assets to charity.

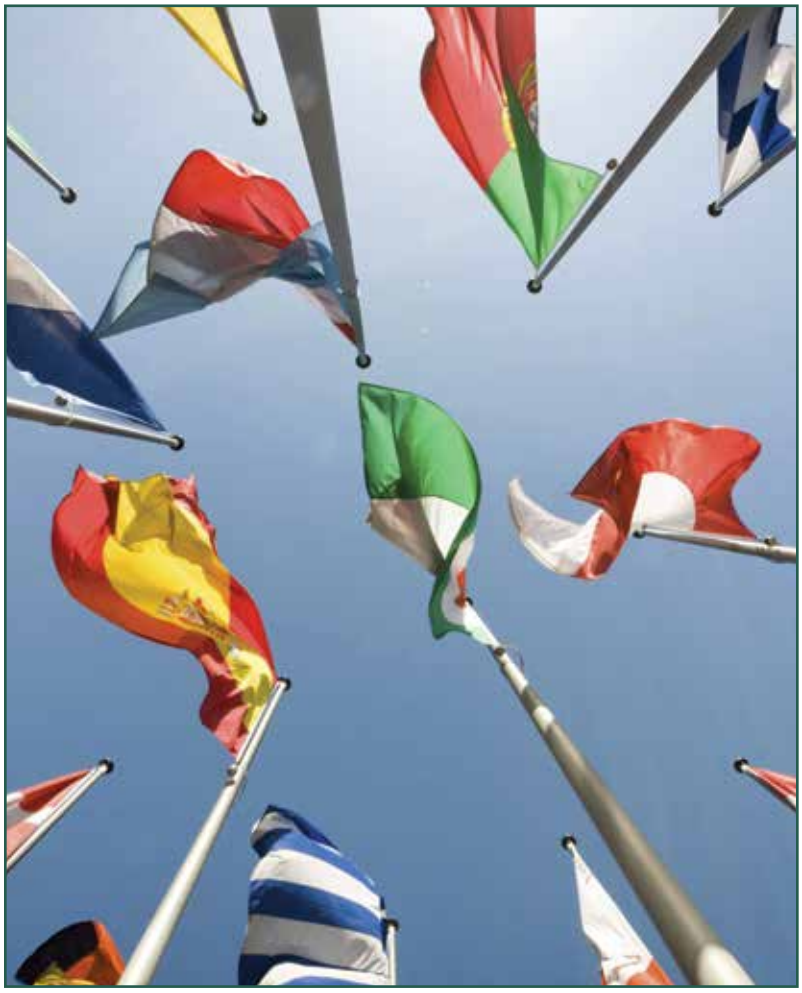
If your estate is within the exemption, it's preferable to make charitable gifts during your lifetime. This is because, if you have no estate tax liability, charitable bequests won't yield any tax benefits. But lifetime donations can generate valuable income tax deductions.

Do the math

Identifying the right estate planning strategies for you and your family is in part a matter of running the numbers. Projecting your income and estate tax liabilities — including state as well as federal taxes — will help you determine whether it's better to focus on reducing estate taxes or income taxes.

International estate planning 101

Many traditional estate planning strategies are based on the assumption that everyone involved is a U.S. citizen. But if you or your spouse is a noncitizen, special rules apply that require additional planning.



Generally, U.S. citizens are subject to federal gift and estate taxes on all of their assets, wherever located. But they're also entitled to various exemptions, exclusions and deductions. These include the gift and estate tax exemption (currently $5.34 million), the annual gift tax exclusion (currently $14,000 per year per recipient), and the unlimited marital deduction, which permits one spouse to transfer tax-free any amount of property to the other spouse during life or at death.

Let's take a look at how things change when one or more noncitizens are involved.

General rules

If you're a U.S. resident, but not a citizen, you're treated similarly to a U.S. citizen by the IRS. You're subject to federal gift and estate taxes on your worldwide assets, but you also enjoy the benefits of the $5.34 million exemption and the $14,000 annual exclusion. And you can double the annual exclusion to $28,000 through gift-splitting with your spouse, so long as your spouse is a U.S. citizen or resident. Special rules apply to the marital deduction, however, as discussed on page 5.

Residency is a complicated subject. IRS regulations define a U.S. resident for federal estate tax purposes as someone who had his or her *domicile* in the United States at the time of death. One acquires a domicile in a place by living there, even briefly, with a present intention of making that place a permanent home. Whether you have your domicile in the United States depends on an analysis of several factors, including the relative time you spend in the United States and abroad, the locations and relative values of your residences and business interests, visa status, community ties, and the location of family members.

Tax traps for nonresident aliens

If you're a nonresident alien — that is, if you're neither a U.S. citizen nor a U.S. resident — there's good news and bad news in regard to

estate tax law. The good news is that you're subject to U.S. gift and estate taxes only on property that's "situated" in the United States. Also, you can take advantage of the $14,000 annual exclusion (although you can't split gifts with your spouse).

The bad news is that your estate tax exemption drops from $5.34 million to a miniscule $60,000, so substantial U.S. property holdings can result in a big estate tax bill. Taxable property includes U.S. real estate as well as tangible personal property — such as cars, boats and artwork — located in the United States.

Determining the location of intangible property — such as stocks, bonds, partnership interests or other equity or debt interests — is more complicated. For example, if a nonresident alien makes a gift of stock in a U.S. corporation, the gift is exempt from U.S. gift tax. But a bequest of that same stock at death is subject to estate tax. On the other hand, a gift of cash on deposit in a U.S. bank is subject to gift tax, while a bequest of the same cash would be exempt from estate tax.

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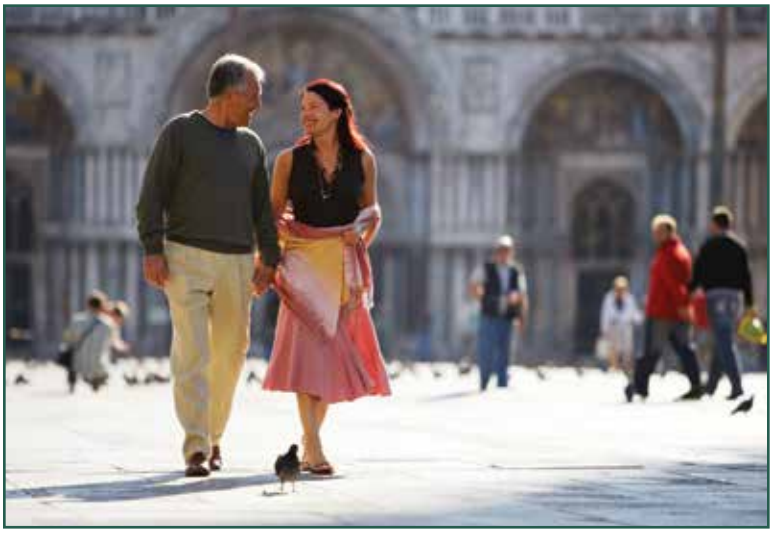
Your estate planning advisor can help you determine which property is situated in the United States and explore strategies for minimizing your tax exposure. For example, it may be possible to avoid U.S. estate taxes by setting up a foreign corporation to hold U.S. property.



No marital deduction for noncitizens

The unlimited marital deduction isn't available for gifts or bequests to noncitizens. However, there are three options for making tax-free transfers to a noncitizen spouse:

1. Use the transferor's $5.34 million exemption (provided the transferor is a U.S. citizen or resident).
2. Make annual exclusion gifts (currently, the limit for gifts to a noncitizen spouse is $145,000).
3. Bequeath assets to a qualified domestic trust, which contains provisions designed to ensure that the assets are ultimately taxed as part of the recipient's estate.

Know that the marital deduction *is* available for transfers *from* a noncitizen spouse *to* a citizen spouse.

Understand your international rights

If you, your spouse or both are noncitizens, traditional estate planning tools and strategies may not protect you against unnecessary gift and estate taxes. Your advisors can help you understand your options and identify strategies for minimizing your tax liability.

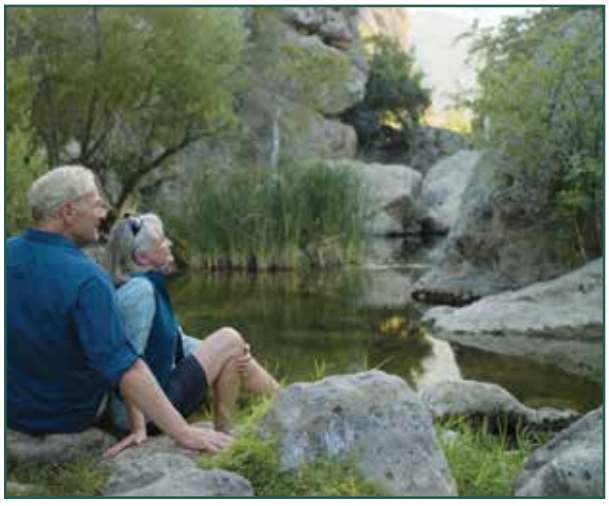
When is the optimal time to begin receiving Social Security?

Your estate plan is (or should be) closely connected to your wealth and retirement plans. Why? Your wealth plan can influence the amount of funds available during your retirement, and your retirement plan will affect how much of your estate will be left to pass on to your family after death. A factor to consider among all of this planning is when to begin receiving Social Security benefits.

Understand the impact

You can begin receiving Social Security benefits as early as age 62 or as late as age 70. The longer you wait, the higher the monthly benefit. This is because the system is designed to provide you with roughly the same total benefit (based on government life expectancy tables) regardless of when you begin receiving payments.

If you start benefits before your "normal" retirement age, you'll receive a smaller check over a greater number of years. If you start later, you'll receive a larger check over a smaller number of years.



Determine the breakeven point

A useful tool for choosing the right starting age is to calculate your breakeven point. For example, Scott, who is retired, is about to turn 62. He's trying to decide between taking a reduced Social Security benefit right away or waiting until his normal retirement age of 66. Let's say Scott's full monthly benefit at 66 would be $2,000 and his reduced benefit at 62 would be $1,500.

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Ignoring cost of living adjustments for simplicity, Scott's breakeven point is just before his 78th birthday. At that point, his total benefits will be about the same whether he starts at age 62 (192 months × $1,500 = $288,000) or at age 66 (144 months × $2,000 = $288,000). If Scott lives to at least age 78, waiting until age 66 to start collecting will provide him with greater lifetime benefits. If he doesn't reach that age, he's better off starting at age 62.

Let's suppose that Scott's father and grandfather both lived to be 90. If Scott follows suit, he'll receive $72,000 of additional Social Security benefits by waiting until his normal retirement age of 66.

After determining your breakeven point, the right choice for you depends on several factors, including your actuarial life expectancy, your health and your family history. Also, keep in mind that the above example doesn't consider potential earnings on Social Security benefits. If you plan to invest your benefits, you may need to adjust your breakeven point upward or downward, depending on your expected rate of return.

Ask questions

There are many variables to considering the question of when to begin receiving Social Security benefits. Your wealth, retirement and estate plans will affect the answer. Your estate planning advisor can be a valuable resource in this process.

Estate Planning Pitfall

You don't have a buy-sell agreement for your business

If you own an interest in a closely held business, it's critical to have a well-designed, properly funded buy-sell agreement. Without one, an owner's death can have a negative effect on the surviving owners.

If one of your co-owners dies, for example, you may be forced to go into business with his or her family or other heirs. And if you die, your family's financial security may depend on your co-owners' ability to continue operating the business successfully.

There's also the question of estate taxes. With the federal gift and estate tax exemption currently at $5.34 million, estate taxes affect fewer people than they once did. But estate taxes can bring about a forced sale of the business if your estate is large enough and your family lacks liquid assets to satisfy the tax liability.

A buy-sell agreement requires (or permits) the company or the remaining owners to buy the interest of an owner who dies, becomes disabled, retires or otherwise leaves the business. It also establishes a valuation mechanism for setting the price and payment terms. In the case of death, the buyout typically is funded by life insurance, which provides a source of liquid funds to purchase the deceased owner's shares and cover any estate taxes or other expenses.

There are two basic types of a buy-sell agreement: a redemption agreement, under which the business buys back a departing owner's interest, and a cross-purchase agreement, under which the remaining owners buy the interest.

Depending on the structure of your business and other factors, the type of agreement you choose may have significant income tax implications. Your advisor can help you design a buy-sell agreement that's right for your business.

Planning for the Care of Minor Children

Many parents have concerns about who will make decisions for their children if neither parent is able to do so. Most Wills contain provisions for the appointment of a guardian in the event that both parents of a minor child are deceased. However, a Will is not effective until death and therefore is not effective to designate a guardian for a child whose sole parent is alive but mentally or physically incapacitated. What can you do protect your children if you are unable to care for them?

Under Washington law, a **Durable Power of Attorney** can include a provision in which a parent nominates a particular individual (or individuals) to serve as guardian for a minor child if a situation arises where no parent is capable of caring for a child. The guardian is legally appointed by the local court and the parent's nomination is given substantial weight when the court is determining who should be appointed. Parents should consider naming a temporary guardian if their choice for primary guardian is a friend or family member who lives far away or may not be immediately available to care for the child.

A parent also can authorize a caregiver to seek and consent to medical treatment for a child if neither parent is available. This authorization can be in the form of a **Medical Consent Authorization** or a **Special Power of Attorney**. A Medical Consent Authorization is executed by the parents prior to leaving their child in someone else's care and typically has an expiration date. If the child then needs medical attention, the Medical Consent Authorization allows the caregiver to seek and consent to whatever medical treatment may be necessary in the parent's absence during the defined period of time. A Special Power of Attorney appoints a person to act on the parent's behalf for a limited purpose such as consenting to and authorizing medical care for a minor child. The person appointed has the same power as the parent with regard to medical care for the child. This document is not typically limited to a specific period of time.

If you would like to discuss your children's needs and how to protect them in the event of your absence or disability, please contact a member of the Stokes Lawrence Estate Planning Group at (206) 626-6000 in Seattle or (509) 853-3000 in Yakima.

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