INSIGHT ON ESTATE PLANNING

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ESTATE PLANNING PITFALL

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JUNE/JULY 2016

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Portability is a thoroughly modern estate tax break

Computers and phones aren't the only things that are portable today. The gift and estate tax exemption is also "portable" for married couples. Portability simplifies estate planning by allowing a surviving spouse to use the deceased spouse's unused portion of the $5.45 million gift and estate tax exemption amount. This means that married couples can maximize the benefits of their combined exemptions without the need for sophisticated estate planning involving multiple trusts.

Anatomy of an estate tax break

Let's trace the history of this modern phenomenon. After a decade of gradual increases in the federal estate tax exemption — with a one-year moratorium on estate taxes in 2010 — the changes climaxed in 2011 with a generous $5 million exemption (indexed for inflation) authorized by the Taxpayer Relief Act of 2010. At the same time, the top estate tax rate dropped from a high of 55% to 40%.

But the 2010 tax law change did more than solidify the estate tax exemption and tax rate. Among other things, it created a portability provision allowing a surviving spouse's estate to use any remaining portion of the exemption available from the deceased spouse's estate. This amount is referred to as the deceased spousal unused exemption (DSUE) amount.

Although the portability provision technically expired after 2012, it was quickly reinstated (and extended on a permanent basis) by the American Taxpayer Relief Act. The tax law change also permanently preserved the inflation-indexed $5 million exemption and the top 40% rate.

A timely tax election this year

This could be an election year of a different sort for some affluent families. For portability to apply, it must be elected by the executor of the surviving spouse's estate.

The executor must make the election of the deceased spousal unused exemption (DSUE) amount on Form 706, "United States Estate (and Generation-Skipping Transfer) Tax Return," as well as include a computation of the DSUE amount. The election is effective only if made in a timely fashion. Thus, it must be made on an estate tax return filed within nine months of death, plus any allowable extension. There is, however, an exception to allow for late elections in certain situations.

On the timely filing of a valid estate tax return, the executor of an estate of the deceased survived by a spouse will be treated as having elected portability of the DSUE amount, unless the executor opts out based on prevailing regulations.

The portability provision provides a "safety net" for couples with joint assets exceeding the exemption amount for the estate of the first spouse to die. It can be especially effective when combined with the unlimited marital deduction.

Portability in action

Suppose that Kevin and Debbie, who have two children, each own $3 million individually and $4 million jointly with rights of survivorship, for a total of $10 million in assets. Under their wills, all assets pass first to the surviving spouse and then to the children.

If Kevin dies in 2016, the $3 million in assets he owns individually is covered by the unlimited marital deduction. His entire $5.45 million exemption is unused. When Debbie dies, her estate can use Kevin's unused exemption, plus the exemption for the year in which she dies, to shelter the remaining assets of $10 million from tax, with plenty of room to spare for some appreciation in value.

Here's what could have happened without the portability provision: Let's assume that Debbie dies later in 2016. Without being able to benefit from the unused portion of Kevin's exemption, the $5.45 million exemption for Debbie in 2016 would leave $4.55 million still subject to estate tax. At the 40% rate, that's a staggering federal estate tax bill of $1.82 million.

Although techniques such as a traditional bypass trust may be used to avoid or reduce estate tax liability, this simplified example demonstrates the potential impact of the portability provision. It's important to know that portability isn't automatic. The estate of the surviving spouse must make a valid election to realize the benefits. (See "A timely tax election this year" on page 2.)

Also be aware that this discussion covers only federal estate taxes. State estate taxes on inheritances may also have a significant impact, particularly in states where the estate tax exemption is low as compared to the $5.45 million federal exemption.

Does this mean that portability is always the best option? Absolutely not. All the relevant factors should be taken into account, including nontax reasons that might affect distribution of assets under a will. For instance, a wealthy individual may want to divide assets in a way that doesn't maximize portability benefits, including bequests complicated by divorces, second marriages or other circumstances. Also, portability is less of a concern for state death tax purposes in community property states.

Determining the right path

Portability has the benefit of simplicity, but carefully review your situation before taking action. Your estate planning advisor can help you determine if portability is your best course of action. •

Should life insurance be a part of your estate plan?

Today, the federal gift and estate tax exemption stands at $5.45 million ($10.90 million for married couples filing jointly). Because of this, fewer families are facing estate tax liability.

This begs the question: Can life insurance continue to play an important role in estate planning? The answer is: Yes. Because, even though a policy's proceeds may no longer be necessary to provide liquidity to pay estate taxes, even nontaxable estates may have a need for its various other potential estate planning benefits.

Preserve wealth for future generations

If you die unexpectedly, life insurance can protect your family by replacing your lost income. It can also be used to replace wealth in a variety of contexts. For example, suppose you own highly appreciated real estate or other assets and wish to dispose of them without generating current capital gains tax liability. One option is to contribute the assets to a charitable remainder trust (CRT).

As a tax-exempt entity, the CRT can sell the assets and reinvest the proceeds without triggering capital gains tax. In addition, you and your spouse will enjoy an income stream and charitable income tax deductions. Typically, distributions you receive from the CRT are treated as a combination of ordinary taxable income, capital gains, tax-exempt income and tax-free return of principal.

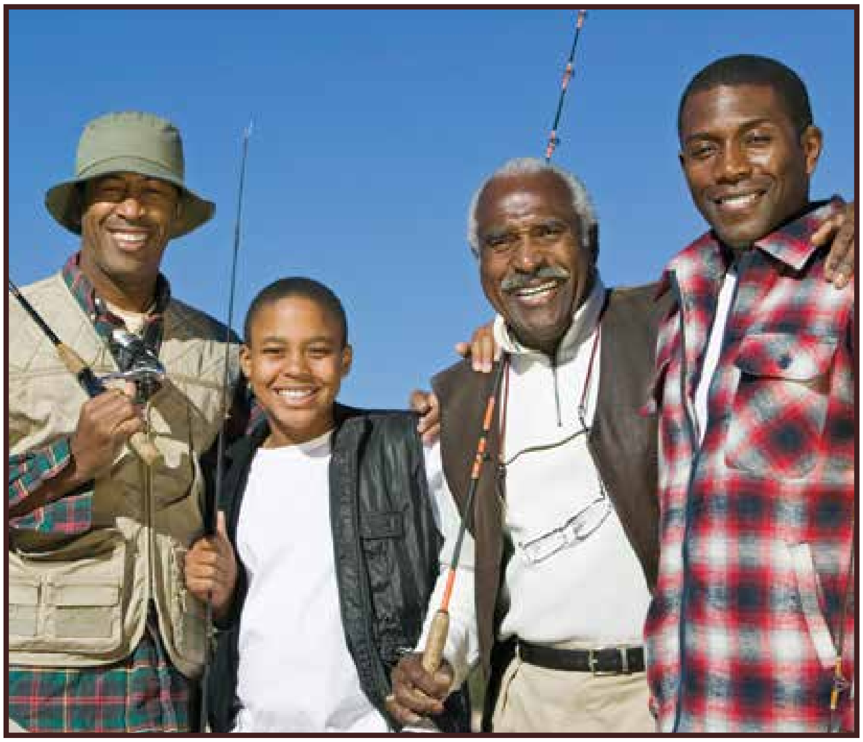
After you and your spouse die, the remaining trust assets pass to charity, reducing the amount of wealth available to your children or other heirs. But you can use life insurance (a cost-effective second-to-die policy, for example) to replace that lost wealth.

If you're philanthropically inclined, life insurance can help you support your favorite charities in a cost-effective manner.

You can also use life insurance to replace wealth that's lost to long term care (LTC) expenses, such as nursing home costs, for you or your spouse. Although LTC insurance is available, it can be expensive, especially if you're already beyond retirement age. For many people, a better option is to use personal savings and investments to fund their LTC needs and to purchase life insurance to replace the money that's spent on such care. One advantage of this approach is that, if neither you nor your spouse needs LTC, your heirs will enjoy a windfall.

Fund philanthropic endeavors

If you're philanthropically inclined, life insurance can help you support your favorite charities in a cost-effective manner. One strategy is to donate life insurance to charity. If you transfer a policy to a charitable organization, so that the organization becomes both owner and beneficiary, you'll enjoy a charitable income tax deduction (subject to certain limitations), plus additional deductions if you continue to pay the premiums. Or, you can simply name a charity as beneficiary. You won't be entitled to any charitable income tax deductions, but you'll retain control over the policy, including the right to tap its cash value or change beneficiaries. When you die, your estate will be entitled to an estate tax charitable deduction.



Another strategy is to use other assets to fund charitable gifts and purchase life insurance to replace the wealth donated to charity. This strategy is particularly valuable if you have a significant amount in traditional IRAs or retirement plans. If you leave these assets to your heirs, they'll be subject to income tax on any distributions they receive. But if you leave the assets to charity and purchase a life insurance policy for your heirs' benefit, both the charity and your heirs will receive the funds tax-free. You can even withdraw funds from an IRA or retirement plan and use the after-tax proceeds to pay the premiums.

Maintain family peace

If much of your wealth is tied up in a family business, treating your children fairly can be a challenge. It makes sense to leave the business to those children who work in it, but what if your remaining assets are insufficient to provide an equal inheritance to children who *don't* work in the business? For many families, the answer is to purchase a life insurance policy to make up the difference.

Protect assets from creditors

Depending on applicable state law, a life insurance policy's cash surrender value and death benefit may be shielded from creditors' claims. For additional protection, consider setting up an irrevocable life insurance trust (ILIT) to hold your policy.

Build the better plan

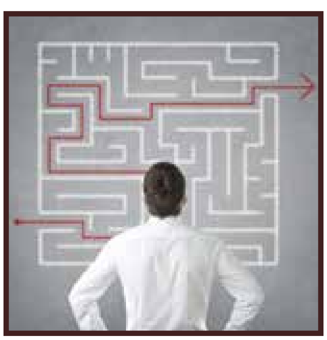
Life insurance can remain an important element of a well-designed estate plan. Even if your estate's worth is firmly within the $5.45 million gift and estate tax exemption, owning a policy may benefit you and your heirs. Your estate planning advisor can help answer your questions regarding your estate plan and life insurance. •

Social Security loopholes close, but options remain open

The Bipartisan Budget Act of 2015 (BBA) closed two popular loopholes for future Social Security benefits. As a result, certain retirees may now realize less in the way of benefits during their lifetime and leave a smaller nest egg for their heirs. But astute planning can still maximize the Social Security benefits you're entitled to receive during your retirement years.

Social Security 101

Generally, you may receive monthly benefits based on your earnings history or your spouse's earnings history, whichever produces the higher amount of benefits, and the age when you apply for benefits. You're entitled to 100% of the allowable benefits if you wait until your "full retirement age" (FRA) before applying for benefits. Alternatively, you can opt for a reduced monthly benefit if you apply early or a greater monthly benefit if you wait to apply after your FRA.



The FRA, established by the Social Security Administration (SSA), is based on your date of birth. For example, the FRA for someone who was born before 1938 is age 65, the "traditional" retirement age. But it gradually increases to age 66 for those born between 1937 and 1943, reaching a plateau at 66 for those born after 1942 and before 1955 — encompassing the majority of the "Baby Boomer" generation. And for younger people, the FRA stretches even further for those born after 1954 until it reaches a maximum of age 67 for those born after 1959.

If you're a Baby Boomer and opt for an early retirement, you can start claiming Social Security benefits as soon as age 62, although your monthly benefits will be reduced by about 30%. The reduction gradually decreases as you near your FRA. Conversely, if you delay retirement past your FRA, your monthly benefit will increase by about 8% a year until maxing out at age 70.

Congress tightens the rules

The new law ends two loopholes that enabled savvy retirees to increase their monthly benefits in the past:

File-and-suspend strategy. The SSA allowed an individual worker to initially claim benefits and then suspend them, thereby continuing to earn Social Security credits until age 70. Typically, a higher-earning spouse would apply for benefits at FRA and then suspend them until age 70. In the meantime, the lower-earning spouse could claim benefits based on the higher-earning spouse's earnings history.

Under the new law, this file-and-suspend strategy became unavailable as of April 30. Now, if you suspend your benefits, your spouse's benefits will likewise be suspended. However, if you were already using this method, the benefits are "grandfathered in" under the BBA and you'll still receive the higher amount.

Restricted application strategy. Using this technique, a spouse who's approaching FRA and is eligible for benefits based on both his or her earnings history and the other spouse's earnings history files a restricted application for spousal benefits only. Then the spouse waits until age 70 to apply for benefits based on his or her own history. This enables the spouse's Social Security credits to continue to grow.

The BBA eliminated the option to file a restricted application for only spousal benefits. If you turned age 62 after 2015, you must claim all of your benefits upon filing, based on the higher amount of your own or spousal benefits. For those who were already 62 at the beginning of this year, however, the restricted application is still a possibility.

Work with your advisor

These two strategies were able to produce thousands of dollars in extra benefits to retirees. Unfortunately, you won't be able to save as much as you could before the new law. But there's still plenty of flexibility within the rules if you intend to retire early or wait until a later age to stake your claim. Consult your advisor to coordinate your Social Security strategies with other aspects of your estate plan to deliver the optimal results for your situation. •

ESTATE PLANNING PITFALL

You're blindsided by tax on intrafamily loans

What's worse than being taxed on income you receive? Having to pay tax on income you never actually collect. That can happen if a family member borrows money from you on an interest-free basis. If you're not careful, you could owe tax on "phantom income."

Fortunately, this harsh tax result can be avoided by staying within the tax law boundaries. The basic rule is that, if the borrower in an intrafamily loan pays no interest, or interest at a below-market rate, interest income is imputed to the lender. In effect, the lender is first treated as having charged interest and then gifting the interest to the borrower. The borrower is then considered to have used the gifted interest to pay the lender. This results in tax on the imputed interest.

Fortunately, there are two key exceptions in the tax law:

- Under a "de minimis rule," there's no tax due if the loan totals $10,000 or less as long as the funds aren't used to purchase income-producing assets.

- If the loan totals $100,000 or less, the amount of interest imputed to the lender annually for tax purposes is limited to the borrower's net investment income for the year. And, if the borrower's net investment income doesn't exceed $1,000, the lender needn't declare any imputed income at all.

Finally, you can avoid the entire issue by simply charging a reasonable interest rate. Use the Applicable Federal Rate (AFR) published by the IRS for the month of the loan.

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Life Insurance: Understanding a Key Part of Your Estate Plan, Part 2

Universal Whole Life

Universal life insurance was designed to provide policyholders with more flexibility than traditional whole life insurance by offering the ability to shift investments between the insurance and savings components of the policy. Unlike traditional whole life insurance, universal life insurance allows for the contribution of additional funds. Those additional funds are attributed interest at a fixed interest rate. The interest from accumulated savings can then be used to help pay premiums. Because of this additional cash reserve, after the policy is established, the policyholder has some flexibility in deciding how much to contribute to the policy in the future which can impact the amount of ultimate death benefit.

Variable Universal Life

The major difference between ***variable universal life*** and standard universal life is that a portion of the cash-value in a variable policy can be invested in a variety of investments. This may provide enhanced returns; however, as with any investment, there is also a risk of poor performance, and when the investment options are performing below expectations or assumptions, the policyholder may have to add funds to keep the premiums paid and the policy in force. Poor investment performance can also lead to a decline in the level of death benefits, though generally not below a stated level unique to each policy.

Survivorship Life Insurance

Sometimes called second-to-die insurance, a ***survivorship life insurance*** policy is designed to insure two lives under one policy and one premium. Sometimes a component of a married couples' estate plan, a survivorship policy generally offers lower overall cost for the same total death benefits than two separate policies insuring the same couple. Death benefits are only paid after the death of the second person to die.
When estate taxes are a consideration, many couples will plan to defer payment of the taxes until the death of the second spouse. Survivorship insurance can therefore provide liquidity to pay estate taxes at the precise time when the funds are needed. When a survivorship policy is considered primarily in anticipation of paying federal or state estate tax, the potential insureds, along with their legal and insurance advisors, must carefully consider who should own the policy. Often, a trust, sometimes termed an *irrevocable life insurance trust (or "ILIT")*, is the most appropriate vehicle to ensure that the death benefits are available for their intended purpose and that estate and income tax consequences are minimized or avoided.

The final article in this three-part series will discuss the use of trusts to own life insurance and the considerations relevant when creating and funding a such a trust.