INSIGHT ON ESTATE PLANNING

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ESTATE PLANNING PITFALL

A significant portion of your wealth is concentrated in a single stock

OCTOBER / NOVEMBER 2020

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No free lunch for the sandwich generation

Are you part of the sandwich generation? This is the name given to people caught in the middle between caring for elderly parents or in-laws and raising young, and sometimes not-so-young, children. And, of course, you still have to handle your own affairs. You may feel yourself being pulled in several directions — all at the same time.

To further complicate matters, the COVID-19 pandemic has only added to the stress, with some people having to juggle remote teaching responsibilities for their children with tending to parents who reside in facilities or have other restraints. Throw in the great uncertainty for the future.

Practical advice: Don't despair. By developing a comprehensive estate plan that accommodates the needs of all the parties, you can ease some of the pressure. Approach the situation in a logical and organized manner — preferably before any dire situations occur.

A meeting of the minds

The first thing to do, and one of the most important and, quite possibly, the most difficult, is to get everything out in the open. Typically, this will require in-depth discussions with your parents that touch on sensitive matters. They may not be willing to give up control in certain aspects of their lives — for example, the freedom to drive whenever and wherever they want — or even acknowledge the effects of aging.

What to do about the kids

Much of the attention for the sandwich generation is focused on caring for their elderly parents. But you can't overlook the needs of your children, either.

This might include investigating the best day care options for newborns, caregiving for toddlers and tutoring lessons for grade school kids. Of course, you want to give your children your undivided attention, but you can't when emergencies arise.

Practical advice: Find the proper balance for your situation. Consider both short-term solutions and long-term goals, such as saving for college. And simply do the best that you can without remorse.

Be sure to include all the family "stakeholders," such as siblings and close aunts or uncles. Try to present a unified front. If you can't meet in person, you may be able to rely on technology to have a virtual meeting.

Consider also that your parents' advisors will be able to provide valuable input, so you should complement the family sessions with a fact-finding mission about your parents' finances. Frequently, individuals are surprised to find out that their parents have more or fewer assets than they initially thought. These findings can go a long way toward determining the next steps. For instance, do your parents have sufficient funds to ensure an

extended stay in a nursing home or other facility? Do they have long-term care (LTC) insurance that can absorb part or all of the projected cost? Or can they now acquire LTC insurance at a reasonable price?

One of the main objectives of most families is securing the type of care that elderly relatives need. Finding the best solution will depend on the specifics of the situation, and keep in mind that visiting a care facility will likely be a lot more difficult than it would have been a year ago.

Be prepared for some pushback from your parents. While mom and dad may, understandably, prefer to stay at home, doing so may not be practical. Plus, they may not want to cede any control over their assets. So long as a more drastic course of action isn't warranted, it'll probably be best to compromise, or at least phase in changes gradually, so they're not too jarring.

Components of the plan

Usually, a series of meetings will help you formulate a plan that addresses the changing lifestyle needs of your parents. This will likely include some (if not all) of the following components:

Will. First and foremost, virtually everyone needs a will, or documents that act as a substitute for a will, and your parents are no exception. It divides up their assets and designates beneficiaries. An older will may have to be updated or replaced to accommodate recent life events, such as the birth or death of a family member.

Durable power of attorney. With this document, a designated agent — it could be you — is authorized to act on your parents' behalf concerning their financial affairs and health care. It remains in effect if a parent is disabled or declared incompetent.

Health care directives. Certain health directives can be coordinated with a living will that addresses issues if a parent is suffering from a life-threatening illness. This can take some difficult decisions out of your hands.

Trusts. The family may benefit from various types of trusts. For instance, with an irrevocable living trust you may maintain control over assets while protecting the family's privacy and avoiding probate. Another type of trust may provide Medicaid benefits if certain requirements are met.

Although it's not legally binding, a "letter of instruction" is often valuable. Beyond including an inventory of assets, investment and retirement plan account numbers and other important information, it provides a forum for your parents to leave guidance and suggestions for future generations.

Obtain professional assistance

While you may be overwhelmed by the enormity of the task at hand, take comfort in knowing that you don't have to go it alone. Unless you're a legal/financial professional yourself, you will likely benefit from the assistance of professional advisors.

In most cases, you should rely on several professionals — such as an attorney, CPA and investment advisor — to steer you in the right direction. It's especially important to use an attorney to create documents that are legally valid. •

FAQs about QPRTs

Have you considered transferring ownership of your home to a trust? By using a qualified personal residence trust (QPRT), you can avoid potential estate tax pitfalls without drastic changes during your lifetime. Essentially, you can continue to live in the home for a stated term of years. When the trust ends, the remainder interest passes to your designated beneficiaries, such as your children.

But this unique estate planning technique is sometimes misunderstood. Accordingly, here are the answers to several FAQs about QPRTs:

Q: Who operates the trust?

A: For starters, you must appoint a trustee to manage the QPRT. Frequently, a grantor will act as the trustee. Alternatively, it can be another family member, friend or professional.

Q: What are the gift and estate tax consequences?

A: The home is removed from your taxable estate. The gift and estate tax currently is an inflation-indexed $11.58 million, but it's scheduled to revert to $5 million in 2026. Also, the transfer of the remainder interest is subject to gift tax, but tax resulting from this future gift is generally low, especially in the current environment. The IRS uses the Section 7520 rate, which is updated monthly, to calculate the tax. For August 2020, the rate was a record-low 0.4%, compared to the high of 11.6% when the rate was first introduced.

Q: What happens if I die before the end of the trust term?

A: The home is included in your taxable estate. Of course, this defeats the intentions of the trust, but other than the costs involved with creating and maintaining the QPRT, financially your family is no worse off than it was before the QPRT was created.

Q: Do I have to transfer my principal residence?

A: Normally, this is the case, but a QPRT may also be used for a second home, like a vacation home. In fact, you can maintain trusts for both residences.

Q: Does the home include adjoining land?

A: Generally, yes. In most cases, the IRS will treat the land adjacent to a house as being part of the principal residence. But it must be reasonable under the circumstances. The location, size and use of the home are determining factors.

Q: How long should the trust term last?

A: There's no definitive time period. Note that the longer the term, the smaller the value of

the remainder interest for tax purposes. On the flip side, as mentioned above, the home will be included in your estate should you die before the end of the term.

Q: Can I sell the home during the trust term?

A: Yes. But there are caveats. While a comprehensive review of the nuance is beyond the scope of this article, generally you must then reinvest the proceeds in another home that will be owned by the QPRT and subject to the same trust provisions.

Q: Who pays the monthly bills for residence?

A: As long as you're still living in the home, you must foot the bill. Typically, you'll have to pay property taxes, maintenance and repair costs and insurance. Because the QPRT is a grantor trust, you're entitled to deduct qualified expenses on your tax return, within the usual limits.

Q: If I outlive the trust term, will I be kicked out of the home?

A: Not exactly. When the term ends, the remainder beneficiaries become owners of the home, but you can pay them a fair market rental for living there. This may seem strange but it actually coincides with the objective of shifting more assets to the younger generation.

Q: Can I back out of the deal?

A: Unfortunately, no. This type of trust is irrevocable. However, remember that the worst that can happen is that you pay rent to the beneficiaries if you outlive the trust term, or the home goes back into your estate if you don't. Also, note that the beneficiaries will owe income tax on any rental income.

Q: Are there any other drawbacks?

A: Yes. First, there are costs associated with a QPRT, including attorneys' fees, appraisal fees and title expenses. Second, you can't take out a mortgage on a home that has been transferred to a QPRT. (An existing mortgage is permitted but it complicates matters.)

Q: Is this estate planning technique right for you?

A: It's not for everyone, but it may be part of a comprehensive estate plan. Discuss this option with your estate planning advisor so that you can make an informed decision. •

Is now the right time to forgive intrafamily loans?

Whether you made intrafamily loans years ago or perhaps this year in response to a loved one's financial troubles due to the COVID-19 pandemic, consider forgiving those loans. Why? A record-high gift and estate tax exemption amount and a low-interest-rate environment add up to an ideal time to forgive intrafamily loans.

Under the right circumstances, an intrafamily loan can be a powerful estate planning tool because it allows you to transfer wealth

to your loved ones free of gift or generation-skipping transfer (GST) taxes — to the extent the loan proceeds achieve a certain level of returns.

Intrafamily loan wild card: Interest rates

Generally, to ensure the desired tax outcome, an intrafamily loan must have an interest rate that equals or exceeds the applicable federal rate (AFR) at the time the loan is made. The principal and interest are included in the lender's estate, so the key to transferring wealth tax-free is for the borrower to invest the loan proceeds in a business, real estate or another opportunity whose returns outperform the AFR.

The excess of these investment returns over the interest expense is essentially a tax-free gift to the borrower. Intrafamily loans work best in a low-interest-rate environment, when it's easier to outperform the AFR.

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Reasons to forgive a loan

An intrafamily loan is an attractive estate planning tool if you've already used up your gift tax exemption or if you wish to save it for future transfers. But if you have exemption to spare, forgiving an intrafamily loan allows you to transfer the entire loan principal plus any accrued interest tax-free, not just the excess of the borrower's returns over the AFR.

Forgiving a loan can be a strategy for taking advantage of the current $11.58 million ($23.16 million for married couples filing jointly) exemption amount before it's scheduled to disappear at the end of 2025, when the amount reverts to $5 million ($10 million for married couples), indexed for inflation. Of course, if you need the funds for your own living expenses, loan forgiveness may not be an option.

Income tax considerations

Before you forgive an intrafamily loan, consider any potential income tax issues for you and the borrower. In most cases, forgiving a loan to a loved one is considered a gift, which generally has no income tax consequences for either party.

Although forgiveness of a loan sometimes results in cancellation of debt (COD) income to the borrower, the tax code recognizes an exception for debts canceled as a "gift, bequest, devise or inheritance." There's also an exception for a borrower who's insolvent at the time the debt is forgiven. But be careful: If there's evidence that forgiving a loan is not

intended as a gift, the IRS may argue that the borrower has COD income.

One thing you should avoid is forgiving accrued interest on an intrafamily loan *every* year. For one thing, doing so may give the IRS ammunition to argue that the *original* loan was a disguised gift, which can trigger gift taxes, depending on the exemption amount in the year the loan was made.

Turn to your trusted advisor

Forgiving outstanding intrafamily loans in today's low-interest-rate loan environment, coupled with the record-high gift and estate tax exemption and the GST tax exemption, may be a beneficial strategy for you. Your estate planning advisor can help in implementing that strategy without triggering unwanted tax consequences. •

ESTATE PLANNING PITFALL

A significant portion of your wealth is concentrated in a single stock

It's been said repeatedly: Don't put all your eggs in one basket. Yet many individuals often disregard this adage. And it comes back to haunt them or their heirs at a future date.

If you've built up a substantial nest egg over the years, it's likely you feathered it through various investments. This growth may have been fueled by one or two specific stocks. For instance, if you acquired Amazon or Apple before those stocks took off, you may be sitting on a goldmine.

But that doesn't mean you should limit your investment holdings to a handful of prior winners. First, be aware that past performance isn't a guarantee of future results. Second, if you're committed to just one or two stocks, your risk exposure is off the charts. If one were to tumble, it could trigger a financial catastrophe.

This is especially true given the current uncertain economic environment. Investors have already seen wide swings in the stock market thus far in 2020. Depending on how the rest of the year goes — plus the election in November — the rollercoaster may continue or the market might surge. Possibly, though, it will hit a tailspin. And, over time, it could be all three.

Diversification is one of the keys to risk-averse investing. This is the process of keeping different kinds of investments — such as stocks, bonds and cash equivalents — in your portfolio. It also means you should maintain a mix of investments in different sectors and industries as well as thinking globally. This reduces overall risk.

Be aware that even diversification can't protect against losses in a declining market. But you'll want to do all you can to keep as much of your nest egg intact so that you can have more to pass on to loved ones after you're gone.

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A Brief Guide to Year-End Gifting

Every year, the holiday season brings with it a few seasonal estate planning considerations. For reasons both festive and otherwise, this time of year many clients wish to make gifts to family, friends, or charities. The following article touches on a few of the most important things to consider when making gifts this holiday season.

For gifts to family and friends, the most important thing to know is that the 2020 annual federal gift tax exclusion amount is $15,000. This means a person can give $15,000 to as many individual recipients as they want and not have to worry about filing a gift tax return or paying any gift tax. Be aware that the $15,000 limit applies to the total amount gifted to each recipient throughout the year, not to each individual gift. If prior gifts have been made during the tax year, the amount a person can gift without being required to file a gift tax return or pay tax is reduced by the amount of such prior gifts. Also note that the $15,000 limit applies to individuals, so spouses may gift up to $30,0000 a year, per recipient, without worrying about gift tax consequences.

Many clients may wish to make these "annual exclusion" gifts to their young relatives, but may desire that the money be held in trust, if the young relative is not ready to manage their finances. The annual exclusion only applies to gifts of a present interest, so typically gifts to trusts are not eligible. However, a trust can be drafted so that the beneficiary has a temporary right to withdraw the distribution to the trust. If the beneficiary is properly notified of their right to withdraw (commonly referred to as a "Crummey notice") the gift to the trust will qualify for the annual exclusion. A common practice is to set up a trust for the purpose of making yearly annual exclusion gifts to the trust.

Finally, itemizing taxpayers can receive an income tax deduction for gifts to 501(c)(3) (and some 501(c)(4)) charities. Around the end of the year, when taxpayers have a good sense of their yearly income, is a good time to consider whether to take advantage of this charitable deduction. Taxpayers should keep in mind the distinction between 501(c)(3)s and other charitable entities, so the taxpayer does not mistakenly make a gift that will not qualify for the deduction.

Of course, ever since the Tax Cuts and Jobs Act nearly doubled the standard deduction to $12,000 beginning in 2018, far fewer taxpayers are itemizing. For those who typically take the standard deduction, one strategy to take advantage of the charitable deduction is gift bundling. This is the practice of making significant gifts in one year, rather than making smaller gifts over the course of multiple years. For instance, a taxpayer who made gifts of $12,000 in consecutive years may find no benefit to itemizing. However, if the taxpayer instead made one $24,000 gift, itemizing and taking the charitable deduction would provide a benefit over the standard deduction for the year of the gift. Taxpayers should keep in mind that, for most gifts, the charitable deduction is limited based on adjusted gross income ("AGI"), typically to 60% of the taxpayer's AGI.

Finally, those with charitable intent and IRAs should consider directing a distribution from the retirement account directly to charity. These direct distributions can count toward a required minimum distribution, with some restrictions, and by making a qualified charitable distribution, income tax on the distribution can be avoided.

If you are interested in making year end gifts to family, friends, or charities, we at Stokes Lawrence would be happy to assist. Please contact a member of the Stokes Lawrence Estate Planning Group at (509) 853-3000 in Yakima or (206) 626-6000 in Seattle.