Insight on Estate Planning

April/May 2014

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Boosting your estate planning power

How to "supercharge" a credit shelter trust

For years, the credit shelter trust has been a standard weapon in married couples' estate planning arsenals. Today, however, a $5.34 million estate tax exemption amount combined with portability of exemptions between spouses means that traditional estate planning vehicles are less critical than they once were. Nevertheless, credit shelter trusts continue to offer significant benefits, particularly for high-net-worth taxpayers.

Affluent families looking for ways to reduce their gift and estate tax bills should consider a Supercharged Credit Shelter Trust℠ (SCST)*. An SCST enhances the benefits of a conventional credit shelter trust.

Making the most of the exemption

To understand how an SCST works, some background on the credit shelter trust is necessary. A credit shelter trust is designed to take advantage of each spouse's exemption and ensure that neither is wasted. Suppose, for example, that Jane's estate is worth $15 million. If she leaves all of her wealth outright to her husband, Allan, the unlimited marital deduction will shield it from estate taxes. Before portability, if Allan were to die and leave $15 million to the couple's children, his estate would owe $3,864,000 in estate taxes (assuming a $5.34 million exemption and a 40% tax rate).

Had Jane set up a testamentary credit shelter trust, the tax bill would have been substantially smaller. The trust, funded with an amount equal to Jane's estate tax exemption ($5.34 million) would provide Allan with an income interest for life, after which the funds would then go to the couple's children. The trust would take full advantage of Jane's exemption and, by limiting Allan's rights to the trust principal, the funds would bypass his estate. The remaining $9,660,000 in Jane's estate would pass to Allan either outright or in a marital trust. When Allan dies, assuming his estate is worth $9,660,000 (and the exemption amounts and tax rates haven't changed), the estate tax would be $1,728,000, for a $2,136,000 savings.

Portability allows a couple to take advantage of both spouses' exemptions without the need for a credit shelter trust or other sophisticated estate planning tools. Provided certain requirements are met, portability allows a surviving spouse to add a deceased spouse's unused exemption amount to his or her own. So, in the previous example, Jane could have left $15 million to Allan outright, and Allan could have added Jane's exemption to his own, shielding $10.68 million from taxes in his estate. Assuming Allan's estate is still worth $15 million when he dies, the estate tax liability would be $1,728,000 ($15 million – $10.68 million × 40%), the same tax outcome as a credit shelter trust.

There are several disadvantages to relying on portability, though. First, unlike a credit shelter trust, portability doesn't shield future income and appreciation from estate taxes. Suppose, for example, that Jane's estate plan establishes a credit shelter trust funded with $5.34 million in assets. If, when Allan dies, the trust's value has grown to $8.34 million, the $3 million in appreciation will bypass Allan's estate and escape estate taxes. Had Jane relied on portability, that $3 million in growth would end up in Allan's estate, potentially triggering an additional $1.2 million in estate taxes.

Second, portability doesn't apply to the generation-skipping transfer (GST) tax exemption. So, for couples who wish to preserve both spouses' GST tax exemptions to reduce taxes on gifts to their grandchildren, a credit shelter trust is the best option.

Finally, credit shelter trusts offer some protection from creditors' claims against the trust assets. Outright gifts offer no such protection.

Enhancing the benefits

One drawback of a conventional credit shelter trust is that taxes on the trust's income hamper its ability to grow and compound for the benefit of the trust beneficiaries. Under the complex distributable net income rules, trust income is taxed to the trust or to the beneficiaries (or both), depending on the amount of distributions the trust makes each year. Either way, these taxes erode the trust assets, leaving less for the beneficiaries.

An SCST "supercharges" the credit shelter trust by ensuring that it's treated as a grantor trust with respect to the surviving spouse. As grantor, the surviving spouse pays the taxes on the trust's income, allowing the trust assets to grow tax-free for the beneficiaries.

Under the grantor trust rules, the grantor's tax payments don't constitute taxable gifts to the beneficiaries. Essentially, by paying taxes that would otherwise come out of the trust's income, the grantor makes an additional, tax-free gift to the beneficiaries.

How do you ensure grantor trust treatment? After all, credit shelter trusts ordinarily are established by bequest according to the deceased spouse's will or revocable trust, so the deceased spouse is the grantor.

One way is to give the surviving spouse the right to withdraw trust principal, but this would cause the trust assets to be included in his or her estate. The key to an SCST is for the spouse who ultimately will be the *surviving* spouse to set up a lifetime qualified terminable interest property (QTIP) trust to fund a credit shelter trust of the first spouse to die. The QTIP trust assets will be included in the deceased spouse's estate, and the surviving spouse will be treated as the grantor (for income tax purposes) of the credit shelter

Watch out for reciprocal trusts

Typically, a couple who wish to take advantage of a Supercharged Credit Shelter Trust[SM] (SCST) each establishes a lifetime qualified terminable interest property (QTIP) trust for the benefit of the other, designed to fund a credit shelter trust for the benefit of the surviving spouse. A couple who create identical trusts at the same time risk running afoul of the reciprocal trust doctrine, which can unravel an SCST's tax benefits. The doctrine prohibits a couple from avoiding taxes by using trusts that 1) are interrelated, and 2) place each grantor in the same economic position as if they'd each created trusts naming themselves as beneficiaries.

For SCSTs, the biggest risk is that the IRS will invalidate the QTIP trusts, causing the entire amount contributed to the trusts to be taxable gifts. There are several ways to avoid the reciprocal trust doctrine, including giving each QTIP trust beneficiary a special power of appointment, varying the terms of the trusts so they're not identical or establishing the trusts at different times.

trust created from the QTIP trust. (Be aware that, for this strategy to work, the beneficiary spouse must be a U.S. citizen. Otherwise, the QTIP trust won't qualify for the marital deduction, exposing the trust to gift tax.)

Careful drafting required

To make an SCST work, you need to consider a number of complex gift and estate tax rules, including the reciprocal trust doctrine. (See "Watch out for reciprocal trusts" on page 3.) Careful drafting is required to avoid triggering unnecessary gift, estate or income taxes. ▮

* *"Supercharged Credit Shelter Trust℠" is a service mark of Mitchell M. Gans, Jonathan G. Blattmachr, and Diana S. C. Zeydel, whose article on this subject appears in the July/August 2007 issue of* Probate & Property *magazine.*

ABCs of HSAs

Learn how an HSA can benefit your estate plan

With the Affordable Care Act being a hot topic in the news, you may be thinking about various health care insurance plans. One arrangement that has been soaring in popularity in recent years has been the pairing of a high-deductible health plan (HDHP) with a Health Savings Account (HSA). The good news is that not only is an HSA a viable option to reduce health care costs, but it also can be beneficial to your estate plan because HSA funds grow on a tax-deferred basis.

How does it work?

An HSA is a tax-exempt account funded with pretax dollars. Like an IRA or 401(k) plan, contributions may be made by employers, employees or both.

An HSA must be coupled with a high-deductible health plan (HDHP), however. For 2014, to qualify as an HDHP, a plan must have a minimum deductible of $1,250 ($2,500 for family coverage) and a $6,350 cap on out-of-pocket expenses ($12,700 for family coverage).

Even if you have HDHP coverage, you generally won't be eligible to contribute to an HSA if you're also covered by any non-HDHP health insurance (such as a spouse's plan) or if you're enrolled in Medicare.

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For 2014, the maximum HSA contribution is $3,300 ($6,550 for family coverage). If you're age 55 or older, you can make additional "catch-up" contributions of up to $1,000.

What are the benefits?

HSAs provide several important benefits. First, contributions you make can reduce your income tax liability.

Second, they allow you to withdraw funds tax-free to pay for qualified medical expenses.

Withdrawals for other purposes are subject to income tax and, if made before age 65, a 20% penalty.

Third, unused funds may be carried over from year to year, continuing to grow tax-deferred. Essentially, to the extent you don't need the funds for medical expenses or for other expenses before age 65, an HSA serves as a supplemental IRA.

How can an HSA benefit an estate plan?

Like an IRA or a 401(k) account, unused HSA balances can supplement your retirement income or continue growing on a tax-deferred basis for your family. Unlike most other retirement savings vehicles, however, there are no required minimum distributions from HSAs.

It's important to carefully consider an HSA's beneficiary designation. When you die, any remaining HSA balance becomes the beneficiary's property. If the beneficiary is your spouse, your HSA becomes his or her HSA and is taxable only to the extent he or she makes nonqualified withdrawals.

If the beneficiary is someone other than your spouse, however, the account no longer will qualify as an HSA, and the beneficiary must include the account's fair market value in his or her gross income. (However, the beneficiary will be able to deduct any of your qualified medical expenses paid with the funds from your HSA within one year after your death.)

This differs from an IRA, where a nonspouse beneficiary can spread RMDs over his or her lifetime. So, if you're age 65 or older and need to take distributions to pay *non*medical expenses (or for other purposes), you may want to consider whether it makes more sense to withdraw from:

- Your IRA — preserving your HSA so tax-free funds will be available for your own (or your spouse's or dependents') future medical expenses, or
- Your HSA — preserving your IRA's ability to generate tax-deferred growth for your heirs.

The answer will depend on a variety of factors, such as your age and health, the size of each account, and the beneficiary's age, health and relationship to you.

Ask your advisor

HSAs can be a beneficial option for many people, especially for young and healthy individuals. In addition to the savings on health care, HSAs offer a tax-advantaged option that provides estate planning benefits. Your advisor can help you determine if an HSA is right for you.

A family bank professionalizes intrafamily lending

If you're interested in lending money to your children or other family members, consider establishing a "family bank." These entities enhance the benefits of intrafamily loans, while minimizing unintended consequences.

Lending can be an effective way to provide your family with financial assistance without triggering unwanted gift taxes. So long as a loan is structured in a manner similar to an arm's-length loan between unrelated parties, it won't be treated as a taxable gift. This means, among other things, documenting the loan with a promissory note, charging interest at or above the applicable federal rate, establishing a fixed repayment schedule, and ensuring that the borrower has a reasonable prospect of repaying the loan.

Even if taxes aren't a concern, intrafamily loans offer important benefits. For example, they allow you to help your family financially without depleting your wealth or creating a sense of entitlement. Done right, these loans can encourage responsible financial behavior, promote accountability and help cultivate the younger generation's entrepreneurial capabilities by providing financing to start a business.

Too often, however, people lend money to family members with little planning and regard for potential unintended consequences. Rash lending decisions can lead to misunderstandings, hurt feelings, conflicts among family members and false expectations. That's where the family bank comes into play.

A family bank is a family-owned, family-funded entity — such as a dynasty trust, a family limited partnership or a combination of the two — designed for the sole purpose of making intrafamily loans. Often, family banks are able to make financing available to family members who might have difficulty obtaining a loan from a bank or other traditional funding sources or to lend at more favorable terms.

By "professionalizing" family lending activities, a family bank can preserve the tax-saving power of intrafamily loans while minimizing negative consequences. The key to avoiding family conflicts and resentment is to build a strong family governance structure that promotes communication, group decision making and transparency. Establishing clear guidelines regarding the types of loans the family bank is authorized to make, and allowing all family members to participate in the decision-making process, ensures that family members are treated fairly and avoids false expectations.

To ensure fairness and objectivity, and minimize emotional factors, it's a good idea to involve one or more outside advisors in the management of a family bank. ∎

Estate Planning Pitfall
Your documents are hard to find

No matter how much time you invest in designing an estate plan that reflects your wishes, your efforts will be for naught if your family can't find your documents. Here are several tips for ensuring that critical documents are readily accessible when needed:

Wills and trusts. Ask your accountant, attorney or other trusted advisor to keep your original will, living trust and other trust documents; and provide your family with his or her contact information. Be aware that it's not advisable to place your will or living trust in a safe deposit box, however, as state law and bank policy will likely require that you present the original document or a court order to obtain access.

Financial documents. Make it easy for your family or other representatives to find life insurance policies; tax documents; deeds to real property; bank, brokerage, retirement account and credit card statements; stock certificates; and other important documents. Also provide contact information for key advisors, such as real estate attorneys, accountants, brokers and financial advisors.

There are many options for providing your loved ones with access to this information, including:

- Renting a safe deposit box and instructing your family on how to obtain access,
- Storing documents in a fireproof lockbox and providing your family with the location and the key or combination, and
- Uploading digital backups of key documents to an online storage system. These systems provide family members or other representatives with access in the event you die or become disabled.

Health care documents. Consider providing "duplicate originals" or copies of powers of attorney, living wills or health care directives to the people authorized to make decisions on your behalf. You might also ask your physicians to keep duplicate originals or copies with your medical records.

IRS Extends Deadline for Certain Estates to Elect Portability: Could You Benefit?

The 2011 changes to the federal estate tax created a new concept - that of the ability to transfer any unused estate tax exemption from a deceased person to his or her surviving spouse. This concept, known as "portability" provides opportunities for greater flexibility in planning for, and minimizing, federal estate taxes. Portability does not automatically occur and must be elected as part of the probate of the deceased spouse's estate. To elect portability, the deceased spouse's estate must timely file a federal estate tax return (IRS form 706) which makes the portability election. There is no exception to this method of electing portability, even if the deceased spouse's estate would otherwise have no obligation to file a federal estate tax return. Once made, the election transfers any unused federal estate tax exemption from the deceased spouse to the surviving spouse for use in protecting future gifts (made during the surviving spouse's life or at death) from federal estate and gift taxes.

Though a federal estate tax return is due within 9 months of the date of death, the executors of many estates did not understand the importance of timely filing this return in order to elect portability. As a result the IRS recently released a new rule (Rev. Proc. 2014-18) which allows certain estates a retroactive extension of time to file the form 706. To be eligible for this retroactive extension of time the deceased person must have been a U.S. citizen who died between January 1, 2011 and December 31, 2013, leaving a surviving spouse. Also, it only applies if the estate was not required to file a federal estate tax return because the gross estate was less than the amount of the federal estate tax exemption in the year of death ($5,000,000 in 2011; $5,120,000 in 2012 and $5,250,000 in 2013). In other words, this retroactive extension only applies if the sole reason for filing the federal estate tax return was to make the portability election.

The revenue procedure is not available for estates of decedents for whom an estate tax return was already filed. Executors of estates for which this extension does apply, must carefully follow the procedural requirements and submit the federal estate tax return by December 31, 2014. If you would like to discuss whether portability planning is right for you and how to properly file a form 706 on behalf of a qualifying decedent's estate, 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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