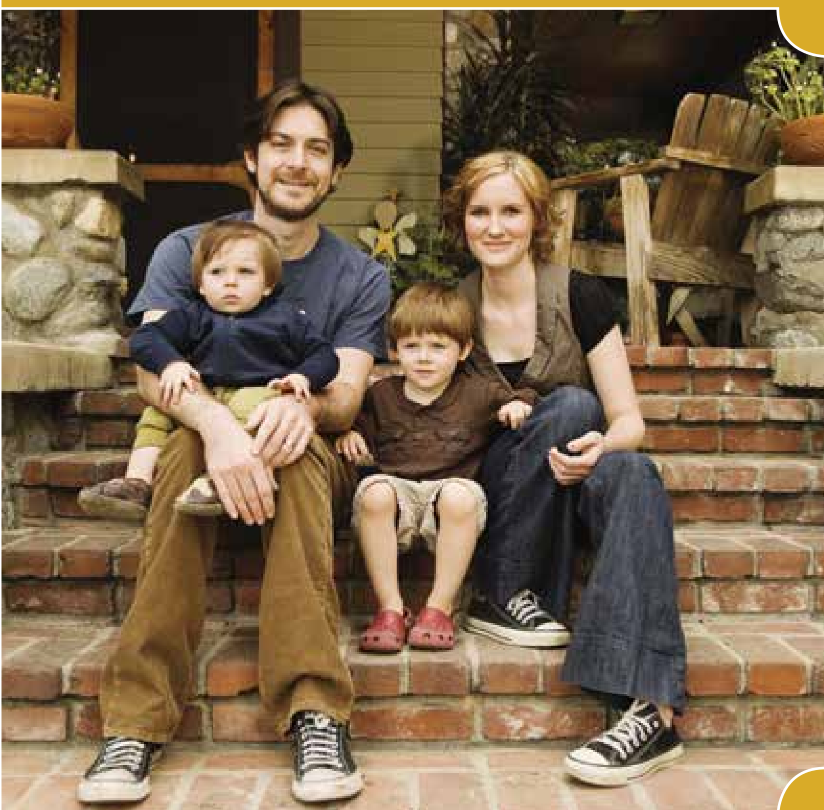
Insight on Estate Planning

February/March 2015



Estate planning for young families

Flexibility is the key

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Estate Planning Pitfall

You're planning to retire abroad

STOKES LAWRENCE, P.S.

Seattle | Yakima

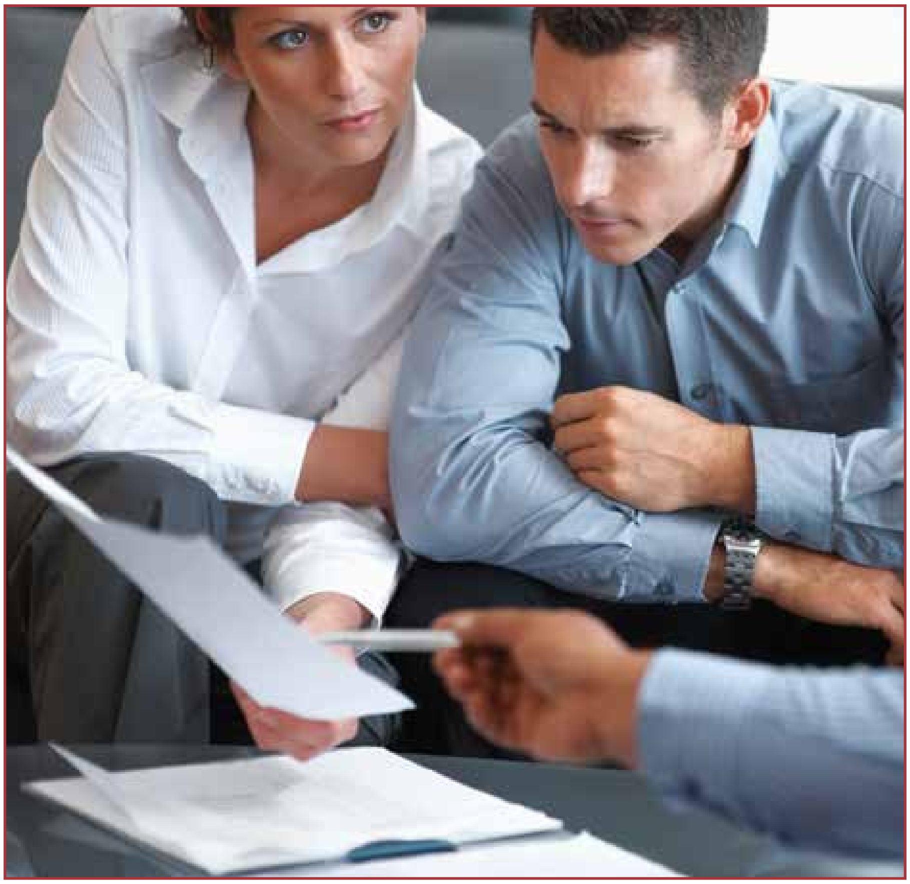
Stokes Lawrence | 1420 Fifth Avenue, Suite 3000 | Seattle, Washington 98101-2393 | 206.626.6000 reception 206.464.1496 facsimile

Stokes Lawrence Velikanje Moore & Shore | 120 N. Naches Avenue | Yakima, Washington 98901-2757 | 509.853.3000 reception 509.895.0060 facsimile

www.stokeslaw.com

Estate planning for young families

Flexibility is the key



Younger taxpayers are faced with a dilemma: Should they minimize gift and estate taxes through lifetime gifts? Or, should they keep assets in their estates to help ease the potential income tax burden on their heirs? The right strategy depends on which taxes will have the biggest impact. If your remaining life expectancy is 30 years or more, however, this is nearly impossible to predict.

Today, your net worth may be well within the federal gift and estate tax exemption of \$5.43 million (\$10.86 million for married couples). But if your wealth grows substantially during the next 30 years — or if Congress decides to lower the exemption threshold — you may end up with a significant estate tax bill. Fortunately, a carefully designed trust can provide you the flexibility to take a wait-and-see approach.

It's all about basis

When you transfer assets at death, your tax basis is "stepped up" to the assets' current fair market value, allowing your heirs to sell the assets without recognizing capital gains. When you transfer assets via gifts, however, they retain *your* basis, so recipients who sell appreciated assets may face a big tax bill. From an income tax perspective, it's usually best to keep assets in your estate and transfer them at death.

Estate tax planning, on the other hand, generally favors lifetime gifts. By transferring assets to the younger generation as early as possible — either in trust or outright — you remove those assets from your estate while asset values are low, thus minimizing gift taxes, while shielding future appreciation from estate taxes.

The best strategy is the one that will produce the greatest tax savings for your family. But if you wait until you know the answer, it may be too late. Let's look at an example.

Frank, age 40, has a net worth of \$5 million. In 2015, he transfers \$1 million in stock (with a \$500,000 tax basis) to an irrevocable trust for the benefit of his daughter, Margaret. When Frank dies 30 years later, the stock's value has grown to $6.5 million. By giving the stock to Margaret in 2015, Frank avoided estate tax on $5.5 million in appreciation. However, because the stock retains Frank's $500,000 basis, Margaret will incur a $1.2 million capital gains tax (assuming a 20% rate) if she sells it.

Assume that, when Frank dies, his net worth remains at $5 million and the inflation-adjusted estate tax exemption is $12 million. Even if Frank had kept the stock, his estate would have been exempt from tax, so there was no advantage to giving it away. And, if he had transferred the stock at death, the stepped-up basis would have erased Margaret's capital gains tax liability. Under these circumstances, keeping the stock in Frank's estate would have been the better strategy.

Suppose, instead, that in 2045 Frank's net worth (apart from the stock) has grown to $10 million. Keeping the stock would increase his estate to $16.5 million, generating a $1.8 million estate tax (assuming a 40% tax rate). Given these facts, the estate tax savings are significantly larger than the potential income tax cost. So the family is better off if Frank removes the stock from his estate in 2015.

It's difficult to predict your family's financial situation, and the state of estate and income taxes, decades from now.

Bear in mind that this example is oversimplified for illustration purposes. To determine the right strategy, you also need to consider state income and estate taxes, as well as your beneficiary's future plans. For example, if Margaret plans to hold the stock rather than sell it, income taxes are removed from the equation, so Frank's plan should focus on estate tax avoidance.

How to return assets to your estate

The key to *removing* assets from your estate is to ensure that you retain no control over their use, enjoyment or disposition. Conversely, the trustee can force assets back into your estate by providing you with such control. Typically, this is accomplished by giving your trustee the authority to grant you a general power of appointment or name you as successor trustee.

For this strategy to work, the trust document must give the trustee absolute discretion over whether to invoke this authority. Moreover, you shouldn't have the power to remove and replace the trustee.

Hedging your bets

It's difficult to predict your family's financial situation, and the state of estate and income taxes, decades from now. But with a carefully designed trust, it's possible to hedge your bets, giving the trustee the ability to switch gears when the best course of action reveals itself.

Here's how it works: You transfer assets to an irrevocable trust for the benefit of your heirs, relinquishing control over the assets and giving the trustee absolute discretion over distributions. The assets are removed from your estate, minimizing gift and estate taxes. If, however, it becomes clear that estate tax *inclusion* is the better tax strategy, the trustee has the power to force the assets back into your estate. (See "How to return assets to your estate" above.)

Handle with care

Even though the strategies discussed allow you to build some flexibility into your estate plan, it's important to know the risks. For example, if you die before the trustee has had a chance to act, the opportunity for estate tax inclusion will be lost. Discuss the pluses and minuses of these strategies with your advisor before taking action.

Get smart when tackling estate planning for intellectual property

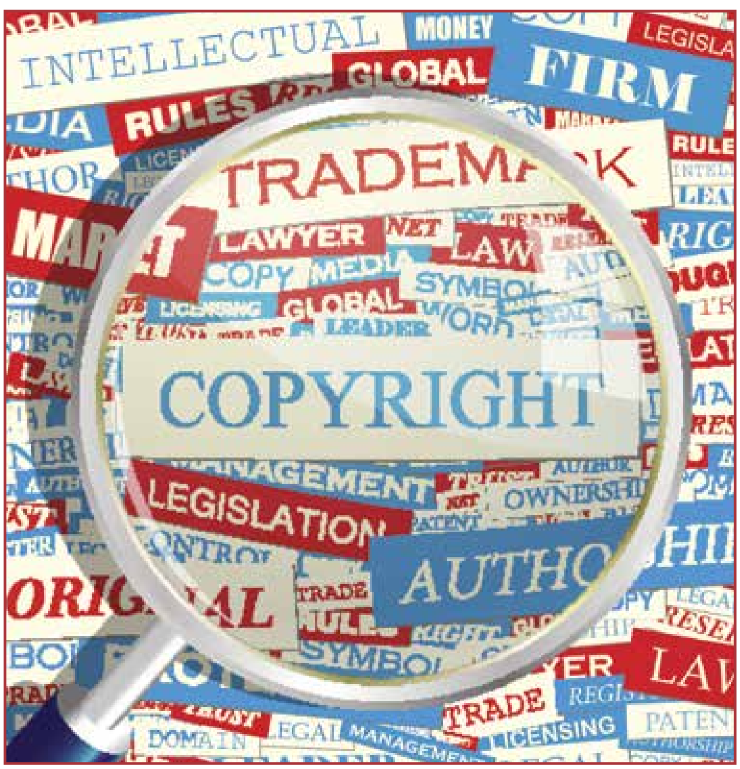
Do you own intellectual property (IP), such as a patent or copyright? If so, do you know how to account for it in your estate plan? These intangible assets can be highly valuable, and you'll want them to be handled according to your wishes after you die. Let's take a closer look at how to address IP in your estate plan.

4 categories of IP

IP generally falls into one of four categories: 1) patents, 2) copyrights, 3) trademarks and 4) trade secrets. Here the focus will be on only patents and copyrights, creatures of federal law intended to promote scientific and creative endeavors by providing inventors and artists with exclusive rights to exploit the economic benefits of their work for a predetermined time period.

In a nutshell, patents protect inventions. There are several types of patents; the two most common are utility and design patents. A utility patent may be granted to someone who "invents or discovers any new and useful process, machine, manufacture or composition of matter, or any new useful improvement thereof." A design patent is available for a "new, original and ornamental design for an article of manufacture." To obtain patent protection, inventions must be novel, "nonobvious" and useful.

Under current law, utility patents protect an invention for 20 years from the patent *application filing* date. Design patents last 15 years (up from 14 years previously allowed for patents issued before December 18, 2013) from the patent *issue* date. For utility patents, it takes at least a year and a half from the date of filing to the date of issue.



When it comes to copyrights, they protect the *original* expression of ideas that are fixed in a "tangible medium of expression," typically in the form of written works, music, paintings, sculptures, photographs, sound recordings, films, computer software, architectural works and other creations. Unlike patents, which must be approved by the U.S. Patent and Trademark Office, copyright protection kicks in as soon as a work is fixed in a tangible medium.

For works created in 1978 and later, an author-owned copyright lasts for the author's lifetime plus 70 years. A "work-for-hire" copyright expires 95 years after the first publication date or 120 years after the date the work is created, whichever is earlier. More complex rules apply to works created before 1978.

Estate planning for IP

For estate planning purposes, IP raises two important questions:

1) What's it worth? and 2) How should it be transferred? Valuing IP is a complex process. So it's best to obtain an appraisal from a professional with experience valuing IP.

After you know the IP's value, it's time to decide whether to transfer the IP to family members, colleagues, charities or others through lifetime gifts or through bequests after your death. The gift and estate tax consequences will affect your decision, but also consider your income needs, as well as who is in the best position to monitor your IP rights and take advantage of their benefits.

If you'll continue to depend on the IP for your livelihood, for example, hold on to it at least until you're ready to retire or you no longer need the income. You also might want to retain ownership of the IP if you feel that your children or other transferees lack the desire or wherewithal to exploit its economic potential and monitor and protect it against infringers.

Whichever strategy you choose, it's important to plan the transaction carefully to ensure your objectives are achieved. There's a common misconception that, when you transfer ownership of the tangible medium on which IP is recorded, you also transfer the IP rights. But IP rights are separate from the work itself and are retained by the creator — even if the work is sold or given away.

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Don't overlook your IP

A primary goal of your estate plan is to ensure your assets are distributed per your wishes after your death. It's easy to remember to include tangible assets, such as primary and vacation homes and vehicles, but don't forget to account for intangible assets, including IP. Your estate planning advisor can help you include your patents and copyrights in your estate plan. ■

Avoiding undue influence claims

A primary purpose of estate planning is to ensure that your wealth is distributed according to your wishes after you die. But if a family member challenges the plan, that purpose may be defeated. If the challenge is successful, a judge will decide who'll inherit your property.

Will contests and similar challenges often occur when one's estate plan operates in an unexpected way. For example, if you favor one child over the others or leave a substantial inheritance to a nonfamily member, those who expected to inherit that wealth may challenge your plan, often on grounds of undue influence. There are steps you can take, however, to avoid these challenges.

Not all influence is undue

It's important to recognize that a certain level of influence is permissible, so long as it doesn't rise to the level of "undue" influence. For example, there's nothing inherently wrong with a daughter who encourages her father to leave her the family vacation home. But if the father is in a vulnerable position — perhaps he's ill or frail and the daughter is his caregiver — a court might find that he's susceptible to undue influence and that the daughter improperly influenced him to change his will.

Protecting your plan

Here are several steps you can take to avoid undue influence claims and ensure that your wishes are carried out:

Use a revocable trust. Rather than relying on a will alone, create a revocable, or "living," trust. These trusts don't go through probate, so they're more difficult and costly to challenge.

Establish competency. Claims of undue influence often go hand in hand with challenges on grounds of lack of testamentary capacity. Establishing that you were "of sound mind and body" at the time you sign your will can go a long way toward combating an undue influence claim. Be sure to create your estate plan while you're in good mental and physical health. Have a physician examine you, at or near the time you execute your will and other estate planning documents, to determine if you're mentally competent.

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Avoid the appearance of undue influence. If you reward someone who's in a position to influence you, take steps to avoid the appearance of undue influence. Suppose, for example, that you plan to leave a substantial sum to a close friend who acts as your primary caregiver. To avoid a challenge, prepare your will independently — that is, under conditions that are free from interference by family members or other beneficiaries. People who'll benefit under your estate plan shouldn't be present when you meet with your attorney. Nor should they be present when you sign your will and other estate planning documents, or serve as witnesses.

Talk to your family. If you plan to disinherit certain family members, give them reduced shares or give substantial sums to nonfamily members. And make sure that you meet with your family as soon as possible to explain your reasoning. If that's not possible, state the reasons in your will or include a separate letter expressing your wishes. Family members are less likely to challenge your plan if they understand the rationale behind it.

To deter challenges to your plan, consider including a no-contest clause, which provides that, if a beneficiary challenges your will or trust unsuccessfully, he or she will receive nothing. Keep in mind, however, that you should leave *something* to people who are likely to challenge your plan; otherwise, they have nothing to lose by contesting it.

No guarantees

If your estate plan leaves any family members less of an inheritance than they expect, there's a risk they'll contest it. Although there's no guaranteed way to protect your plan, the strategies discussed above can minimize the chances that a disgruntled beneficiary will challenge your plan in court.

Estate Planning Pitfall

You're planning to retire abroad

Have you dreamed of spending your golden years in a tropical paradise or a culture-rich European city? If so, discuss your plans with your advisor before making a move. It's important to understand the potential tax and estate planning implications so there are no surprises. These include:

Double taxation. If you're a citizen of the United States, you'll remain subject to U.S. taxes even if you move to another country. So you might be subject to gift and estate taxes in your new country *and* in the United States (possibly including state taxes if you maintain a residence in a U.S. state). In some cases, you can claim a credit against U.S. taxes for taxes you pay to another country, but these credits aren't always available.

One option for avoiding U.S. taxes is to relinquish your U.S. citizenship. But this strategy raises a host of legal and tax issues of its own, including potential liability for a one-time "expatriation tax."

Real estate issues. If you wish to purchase a home in a foreign country, you may discover that your ability to acquire property is restricted. Some countries, for example, prohibit foreigners from owning real estate that's within a certain distance from the coast or even throughout the country. It may be possible to bypass these restrictions by using a corporation or trust to hold property, but this can create burdensome tax issues for U.S. citizens.

Unfamiliar inheritance rules. If you own real estate or other property in a foreign country, you may run up against unusual inheritance rules. In some countries, for example, your children have priority over your spouse, regardless of the terms of your will.

STOKES LAWRENCE, P.S.
Seattle | Yakima

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

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

www.stokeslaw.com

Could your Estate Benefit from an "Intentionally Defective Grantor Trust"?

In simple terms a "grantor trust" is a trust that is treated as being the same as the creator of the trust (the "grantor") for income tax purposes. Put another way, grantor trusts are disregarded entities for income tax purposes and the grantor is taxed on all of the trust's income, even if he or she is not entitled to any trust distributions. As a result, any income tax associated with the trust's income will be paid by the grantor. Although this may not sound appealing initially, it is the equivalent to allowing the grantor to make a tax free addition to the trust in the amount of the income tax liability. It also allows the assets inside the trust to grow tax-free for the beneficiaries; the grantor may sell assets to a grantor trust without recognizing gain on the sale; and the grantor can exchange assets with the trust without adverse income tax consequences. These can be powerful planning tools.

One of the most common grantor trusts is a revocable living trust. People often use revocable living trusts as will substitutes. Irrevocable trusts can also be grantor trusts if the grantor or another person holds one or more of the following powers over the trust:

- a reversionary interest in either the principal or the income of the trust;
- a power to dispose of principal or income without approval from any adverse party;
- a power to deal with trust assets for less than full and adequate consideration;
- a power to borrow trust assets without adequate interest or security;
- a power to substitute assets of equal value; or
- a power to add charitable beneficiaries.

Trusts that are intentionally structured to be grantor trusts are sometimes called "intentionally defective grantor trusts," or IDGTs. Originally grantor trusts were not favored due to former differences in the trust and individual income tax rates. As a result, a trust that triggered the grantor trust rules was considered to be "defective."

Care must be taken when drafting a grantor trust to avoid having the trust included in the grantor's taxable estate for estate tax purposes. This can happen if the wrong power is used, or if a power is improperly drafted. On the other hand, with properly drafted grantor trusts all of the trust's assets can escape estate taxation on the grantor's death.

Grantor trusts are a valuable estate planning tool and can offer significant possibilities for estate and gift tax savings. If you are interested in learning more about grantor trusts, please contact a member of the Stokes Lawrence Estate Planning Group at (206) 626-6000 in Seattle or (509) 853-3000 in Yakima.