INSIGHT ON ESTATE PLANNING

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Flexible postmortem planning a plus when markets are volatile

If you're like many people, you may assume that filing a federal estate tax return is pretty cut-and-dried. The executor or professional representative completes the return, pays the requisite amount of tax, if any, and that's the end of the matter. But there's more to this than meets the eye. In fact, a savvy move by an executor might save a wealthy family hundreds of thousands of estate tax dollars, or even more, by making a timely election to use the "alternate valuation date" for assets.

A silver lining to a down market

This election is especially beneficial when the value of the deceased's securities or other assets plummets soon after death. It can allow the family to avoid estate tax on value that has essentially disappeared.

One noteworthy opportunity involved estates of individuals who died just before the economic downturn of 2008. Similarly, if a family member died before the stock market plunged this past January, the alternate valuation election may reduce estate tax liability.

Estate planning 101

The top federal estate tax rate of 40% applies to the entire taxable estate after the unlimited marital deduction and the available estate tax exemption are taken into account. The unlimited marital deduction completely shields from tax assets transferred from one spouse to another. In addition, assets passing to non-spouse beneficiaries may be covered by the $5.45 million estate tax exemption.

Normally, assets are included in the taxable estate based on their value on the date of death. For instance, if you own stocks valued at $1 million on the day you die, the stocks are included in your estate at a value of $1 million.

Alternate valuation date in action

Despite available deductions and exemptions, a small percentage of families still must contend with an onerous federal estate tax.

However, tax law provides relief to estates negatively affected by fluctuating market conditions. Instead of the value of assets on the date of death, the alternate valuation date of six months after the date of death may be elected. This could effectively lower the federal estate tax bill.

For example, let's say Burt, a widower, died on January 1, 2016, leaving his entire estate to his two children, John and Bridget. On the date of his death, Burt owned securities valued at $10.45 million. Following his death, the stock holdings declined in value to $7.45 million at the end of January. By July 1, 2016, the value had recovered to $8.45 million.

Using the regular date of death to value the assets, the estate would owe tax on $5 million after the $5.45 million exemption is applied, resulting in an estate tax of $2 million (40% of the remaining $5 million). Conversely, if the alternate valuation date of July 1 is elected, the estate tax is reduced to $1.2 million (40% of $3 million). Ultimately, the strategy saves the family $800,000 in estate tax. In reality, other factors will likely come into play, but this simplified example provides a rough idea of the potential tax savings.

Qualifications

To qualify for an alternate valuation date, the following requirements must be met:

- The total value of the gross estate must be lower on the alternate valuation date than it was on the date of death. (Of course, the election generally wouldn't be made otherwise.) If assets are sold after death and before the alternate valuation date, the asset is valued at the amount equal to the sales price.

- The amount of estate tax must be lower using the alternate valuation date than it would be on the date of death. This would seem to always be true if the first requirement is met, but that's not necessarily so for estates passing under the unlimited marital deduction or times when the estate tax is equal to zero on the date of death.

- Any assets that decline in value solely due to the passage of time (for instance, a vehicle that depreciates) must still be valued as of the date of death.

- The election to use the alternate valuation date must be made within one year of the estate tax filing date. That is, even if the return is filed late, you still have a way to make the election. Once made, the election is irrevocable.

An estate tax return is due within nine months of the date of death. Thus, when the value of assets has declined, there is a small window of opportunity for electing the alternate valuation date.

An alternate valuation date election is especially beneficial when the value of the deceased's securities or other assets plummets soon after death.

Election covers the entire estate

Be aware that the alternate valuation election must be made for the entire estate. In other words, you can't cherry-pick stocks to be valued six months after the date of death and keep the original valuation date for others. Therefore, if other assets such as real estate have substantially increased in value since the date of death, electing the alternate valuation date might not be the best approach.

Consult with your estate planning advisor regarding your family's situation. Also, be aware of varying rules for state estate taxes. •

The write stuff: A letter of instructions

When you draft an estate plan, the centerpiece is your will or living trust. Such a document determines who gets what, where, when and how, as well as tying up the loose ends of your estate. A valid will or living trust can be supplemented by other legally binding documents, such as trusts (or additional trusts), powers of attorney and health care directives.

But there's still a place at the table for a document that has absolutely no legal authority: a "letter of instructions" to your heirs. This informal letter can provide valuable guidance and act as a road map to the rest of your estate.

Taking inventory

Begin your letter of instructions by stating the location of your will or living trust. Then create an inventory of all your assets and include their location, any account numbers and relevant contact information. This may include, but isn't necessarily limited to, the following items:

- Checking and savings accounts,
- Retirement plans and IRAs,
- Health and accident insurance plans,
- Business insurance,
- Life and disability income insurance,
- Records of Social Security and VA benefits,
- Stocks, bonds, mutual funds and other investments,
- Safe deposit boxes and vaults and their contents,
- Information on real estate holdings,
- Information on credit cards, loans and debts,
- Social Security number and birth certificate,
- Passports and other identification papers,
- Copies of tax returns,
- Any divorce or citizenship papers, and
- Any tangible assets not readily found.

The contact information should include the names, phone numbers and addresses

Make it your mission (statement)

Many people today are moving away from a rules-based approach to estate planning and embracing a principles-based approach. Rather than conditioning a child's inheritance on a rigid list of "acceptable" behaviors, for example, a principles-based approach allows greater flexibility for trustees and others to make decisions based on the values you wish to promote.

A family mission statement can be an invaluable tool for defining and communicating these principles and values. Because each family is different, there's no cookie-cutter formula for drafting a family mission statement. The most important thing is for the statement to clearly articulate your family's shared values, whatever they may be.

Ideally, the mission statement will also create mechanisms for intrafamily communication and for putting the statement's ideas into action. For example, the statement might call for regular family meetings and create a governance structure for managing the family's wealth and making decisions about charitable giving and other endeavors.

(including emails) of the professionals handling your financial accounts and paperwork, such as an attorney, CPA, banker, life insurance agent and stockbroker. Also, list the beneficiaries of retirement plans, IRAs and insurance policies and their contact information.

Although your heirs aren't bound to follow your instructions, you can state some of your personal preferences.

And don't forget the location of the items and any passwords, PINs or other information needed: Your heirs can't access a safe without the key or combination, nor will they be able to access your information online.

Guidance for personal preferences

Remember that a letter of instructions is more than just a listing of assets and their locations. Typically, it will include other items of a personal nature, such as funeral, burial or cremation arrangements, accounting of fees paid for cemetery plots or mausoleums, the names, addresses and telephone numbers of people and organizations to be notified upon death, and specific instructions for handling personal and financial affairs after you're gone.

The letter can also expand on instructions in a living will or other health care directive. For example, it might provide additional details about the decision for being taken off life support systems. It may also cover charitable contributions you wish to be made after death or the manner in which property should be donated to charity.

Putting pen to paper

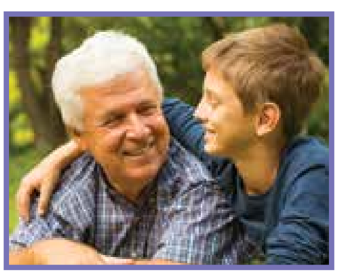
As you're writing your letter, bear in mind that there are no legal requirements backing it. And just like a will or living trust, the letter should be updated periodically to reflect significant changes in your life. Finally, keep the letter in a safe place where the people whom you want to read it can easily find it. •

Making the most of your GST tax exemption

If you want to share some of your wealth with your grandchildren, great-grandchildren or even more remote generations, special planning may be required to keep generation-skipping transfer (GST) taxes to a minimum. This 40% tax applies — *in addition* to gift or estate taxes — to transfers that skip one or more generations.

When it comes to GST tax planning, the good news is that a significant GST tax exemption is available. It's the same as the gift and estate tax exemption — $5.45 million for 2016. But in some cases, automatic allocation rules that apply to the exemption can lead to undesirable results if you don't opt out of them.

When the GST tax applies



The GST tax applies, in general, to direct gifts to a skip person. A skip person is a family member more than one generation below you, subject to certain exceptions, or a nonfamily member more than 37½ years younger than you. Importantly, the GST tax doesn't apply to direct gifts that are covered by the annual gift tax exclusion (currently, $14,000 per recipient; $28,000 for "split" gifts by married couples). But the GST tax does, potentially, apply to two types of transfers involving trusts:

Taxable terminations. Trust assets pass to a skip person (such as your grandchild) when a nonskip person (such as your child) no longer has an interest in the trust — which may, for instance, happen upon the death of the nonskip person — and the trust terminates.

Taxable distributions. Trust income or principal is distributed to a skip person.

Allocating the exemption

In some cases, in order to qualify for the GST tax exemption, you must allocate it to particular assets via an affirmative election on a timely filed gift tax return. In other cases, the exemption is allocated automatically (unless you opt out), which can lead to unwanted results if you prefer to allocate your exemption elsewhere.

The automatic allocation rules are intended to protect you against inadvertent loss of GST tax exemptions. So, for example, if you make a direct gift in excess of the annual gift tax exclusion to a grandchild or other skip person, your unused GST tax exemption is automatically applied to the gift, without the need to make an allocation on a gift tax return.

The exemption is also allocated automatically to "GST trusts." The rules are complex, but in general a trust is considered a GST trust if there's a possibility it will benefit your grandchildren or other skip persons in the future.

Unintended results

In many cases, the automatic allocation rules work well, ensuring that the GST tax exemption is used where it's needed most. But in some cases the rules lead to unintended — and potentially costly — results. Here are two examples:

Example 1. You set up a trust primarily for the benefit of your children, although your grandchildren are named as contingent beneficiaries. This may be enough to trigger the automatic allocation rules, even if the possibility that your grandchildren will receive any trust assets is remote. Depending on the size of your estate, you may be better off opting out of automatic allocation and directing your exemption to gifts that are more likely to trigger GST taxes.

Example 2. You set up a trust for the benefit of your daughter during her lifetime, with the remainder passing to your grandson. You assume that the trust is a GST trust and that your exemption will automatically be allocated to it. To minimize gift taxes, however, you set up the trust to grant your daughter certain withdrawal rights. These rights cause it to not qualify as a GST trust. Unless you proactively allocate your exemption to the trust in a timely filed gift tax return, the transfer to your grandson will be subject to GST taxes.

Work with your advisor

If you wish to provide for your grandchildren or other skip persons after you're gone, beware of GST tax traps. The rules regarding allocation of the GST tax exemption are complex, and mistakes can be costly. To avoid an unexpected tax bill, consult your estate planning advisor. •

ESTATE PLANNING PITFALL

You're transferring your home to your children

Frequently, parents choose to transfer ownership of a home to their adult children to remove it from their taxable estates. But before taking such action, consider the potential estate tax implications.

If you give away your home, the transfer is subject to gift tax. After exhausting the $14,000 annual gift exclusion ($28,000 for a married couple), your $5.45 million gift tax exemption is triggered, eroding the available estate tax exemption at your death.

In addition, when you give a home to your children, their basis for income tax purposes is your cost. This increases the likelihood that they'll owe substantial income tax on the subsequent sale of the home, assuming it has appreciated and will continue to do so.

Contrast this with the fact that, if you hold on to the house until your death, your children can receive a step-up in basis and their cost will be equal to the home's value as of your death. Alternatively, if you sell the home to them at a below-market price, the IRS treats the difference between fair market value and the sell price as a taxable gift. Either way, it may not be a desired tax result.

Instead, consider using a qualified personal residence trust with a reduced gift tax cost or an intentionally defective grantor trust that freezes the home's value for estate tax purposes. Bear in mind that there are myriad ways to transfer your home to your children, so explore all of your options.

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Life Insurance: Understanding a Key Part of Your Estate Plan, Part 3

An *irrevocable life insurance trust* ("ILIT") is a trust that is created for the purpose of owning one or more life insurance policies. The primary purpose of using an ILIT is to achieve estate tax savings by placing ownership of the policy in an entity other than the insured, so that the death benefits are excluded from the insured's estate. In a typical situation, an insured person transfers a policy (or the money to purchase a policy) to an ILIT and then makes continuing gifts of cash to the trust so the trustee can pay the policy premiums. After the insured's death, the trustee manages the insurance proceeds for the benefit of the trust beneficiaries.

An ILIT must be irrevocable, meaning that the terms of the trust (such as the beneficiaries and when and for what purpose distributions can be made) aren't generally subject to change. Thus, before creating an ILIT, an insured must be comfortable with the loss of control over the policy. The insured should also carefully consider selection of a Trustee. This is critical because the Trustee is responsible for maintaining the policies owned by the ILIT, and for managing the money according to the trust's terms after the insured's death. The owner-insured may even give the Trustee some measure of discretion over when, how, and for what purposes the benefits can be made available to the beneficiaries.

If a person owns a policy insuring his or her life, then the full value of death benefits are included in his or her estate. If the death benefits, along with the rest of the decedent's estate, exceed the estate tax exemption amounts (currently, $2,079,000 per person for Washington decedents, and $5,450,000 per person federally), the death benefits may be subject to state and federal estate tax. If, however, an entity separate from the insured owns the insurance, then the full amount of death benefits may pass to the beneficiaries free from both income and estate taxes. An ILIT often serves as that separate entity.

Creating an ILIT involves a team of advisors: (1) an attorney to draft the trust document to achieve the client's goals, to assist the trustee with the beneficiary designation, and to oversee the ongoing contributions to the trust; (2) a life insurance professional to communicate with the trustee to make sure premiums are paid year to year and assist the Trustee with other policy maintenance issues; and (3) an accountant to monitors the trust determine each year whether an income tax return must be filed by the trustee and whether a gift tax return must be filed by the insured.