Insight on Estate Planning

Year End 2013

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Provide for family members with special needs using an SNT

Estate Planning Pitfall

Your estate plan leaves specific assets to specific heirs

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State death taxes can be hazardous to your estate

Now that the federal gift and estate tax exemption is permanently set at an inflation-adjusted $5 million ($5.25 million in 2013), many people are feeling more relaxed about the need for estate planning. But don't overlook state death taxes. Without planning, these taxes could generate significant tax bills for your family.

Planning after ATRA

In early 2013, the American Taxpayer Relief Act of 2012 (ATRA) made the higher federal exemption amount permanent (it had been scheduled to drop to $1 million) and set the top estate and gift tax rate at 40%. The act also made permanent the concept of "portability," which allows a surviving spouse to take advantage of a deceased spouse's unused exemption. This means that married couples can give or bequeath up to $10.5 million without exposure to gift or estate taxes.

If your estate is under $5.25 million ($10.5 million for married couples), and you don't expect it to grow beyond that threshold during your lifetime, there's less pressure to implement sophisticated estate planning strategies to minimize or eliminate federal gift and estate taxes. But be sure to evaluate the potential impact of state death taxes on your estate. These taxes can be substantial, and in some states, they apply to every dollar of a bequest. (In other words, there's no exemption.)

A state of flux

One challenge in planning for state death taxes is that they're in a constant state of flux. Currently, more than 20 states and the District of Columbia have an estate tax, an inheritance tax or, in at least two cases, both. As the names suggest, estate tax applies to one's estate and inheritance tax is imposed on those who inherit property.

Tax rates and exemption amounts vary from state to state and may change over time. Inheritance taxes often kick in with the first dollar of an inheritance, but some states offer exemptions for inheritances by certain family members (such as children, parents or siblings). In recent years, there's been a trend toward softening the blow of state death taxes by increasing exemption amounts. Still, exemptions in many states are substantially lower than the federal exemption.

Suppose, for example, that you live in a state that imposes estate tax at a flat rate of 16% beyond an allowed $1 million exemption. If you die with $5 million in assets, your estate will escape federal estate tax but will be liable for state estate tax of $640,000 ($5 million less $1 million exemption = $4 million taxable × 16% tax rate = $640,000).

Planning strategies

To avoid surprising your family with an unexpected tax bill, it's important to include state death taxes in your estate planning. Here are some strategies to consider:

Use a credit shelter trust. Traditional estate planning for married couples typically includes a credit shelter (or "bypass") trust to preserve both spouses' exemptions and defer estate taxes as long as possible. With higher exemption amounts and portability, this strategy is less critical today for federal tax purposes. But it still offers significant benefits for estate tax planning in some states.

Here's how it works, assuming you have a $5 million estate and live in a state with a $1 million exemption: When you die, your estate plan transfers $1 million to a credit shelter trust, which is shielded from taxes by your exemption and provides your spouse with income for life (with the remainder going to your children). The other $4 million goes into a marital trust, which escapes taxation in your estate by virtue of the marital deduction. When your spouse dies, $3 million ($4 million less the $1 million exemption) will be subject to state estate taxes, but you will have used both of your exemptions and deferred state taxes until the second spouse's death.

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Give it away. Making gifts to your children or other heirs — either outright or in trust — is a simple but highly effective strategy. For federal tax purposes, you can make gifts up to your unused exemption amount tax-free. You can also use the annual federal gift tax exclusion to give up to $14,000 per person tax-free to any number of recipients. And direct payments of tuition or medical expenses also escape gift taxes.

SLAT lets you have your cake and eat it too

For married couples, a spousal lifetime access trust (SLAT) can be a powerful tool for avoiding state death taxes. Because a SLAT is irrevocable, contributions to the trust are removed from your estate, reducing the amount of wealth exposed to state death taxes.

The trust is designed to benefit your children, but it also authorizes the trustee to make discretionary lifetime distributions to your spouse. So long as your marriage is strong, a SLAT allows you to shelter your contributions and any future appreciation in their value from state death taxes, while retaining indirect access (through your spouse) to the trust assets.

Only two states have gift taxes: Connecticut and Minnesota. Connecticut's tax kicks in after lifetime gifts reach $2 million, while Minnesota's threshold is $1 million. In other states, you can make unlimited gifts to remove assets from your estate and minimize or eliminate state death taxes.

If you're not ready to let go of your wealth, another option is a spousal lifetime access trust (SLAT). (See "SLAT lets you have your cake and eat it too" above.)

Relocate. Consider moving to one of the 20+ states without estate, inheritance or gift taxes (and, in some cases, without income taxes). Many of these states also happen to be attractive retirement destinations, so it's an option worth looking at.

Review state laws

Regardless of your federal tax situation, it's critical to consider the impact of state death taxes on your estate plan. Before you play down the importance of estate planning, review any estate or inheritance tax laws in the state where you live as well as any states in which you own property. ■

Can portability help preserve retirement benefits?

The American Taxpayer Relief Act of 2012 (ATRA) made the estate tax exemption "portability" feature permanent. This allows a surviving spouse to take advantage of a deceased spouse's unused federal gift and estate tax exemption. The main advantage of portability is simplicity. It lets married couples make the most of both of their exemptions without the need for "bypass" trusts or other estate planning maneuvers.

But there are several disadvantages to relying on portability. For example, unlike trust-based strategies, portability doesn't shield future appreciation and income from estate tax or protect assets from creditors. Also, portability doesn't apply to the generation-skipping transfer (GST) tax exemption, so, for couples who wish to preserve the GST tax exemption of the first spouse to die, a bypass trust is the way to go.

One area where portability may provide an advantage, however, is in planning for retirement benefits.

No need for estate equalization

Before portability, married couples who wished to preserve their exemptions and minimize estate taxes generally needed to "equalize" their estates. Here's an example that illustrates why, absent portability, estate equalization is important:

Rich and Samantha are married with two children. They have $10 million in assets, all of which is Rich's separate property. Rich's estate plan can avoid tax in both spouses' estates by transferring the exemption amount (currently $5.25 million) to a bypass trust for the benefit of the kids and the $4.75 million balance to a marital trust (assuming the exemption hasn't been reduced when Samantha dies).

If Samantha dies first, however, there's no estate tax, because she owns no assets. But under the old rules, when Rich died later, his estate would owe $1.9 million in estate taxes — $4.75 million × 40% (assuming the exemption amount and tax rate haven't changed). Samantha's exemption would be wasted.

To avoid this result, preportability estate planning techniques would call for Rich to transfer $5 million to

Samantha to equalize their estates. That way, regardless of who died first, both of their exemptions would be preserved and estate tax would be avoided. But what if Rich's $10 million is in an IRA? To equalize their estates, Rich would have to withdraw $5 million from the IRA — subject to income taxes and, possibly, a 10% penalty — and transfer the funds to Samantha. To determine whether this is a good strategy, they would have to weigh the income tax cost against the potential estate tax benefits.

Portability eliminates this problem, because there's no need to equalize estates. If Samantha dies first (and her estate files a portability election), Rich can combine her unused exemption with his own to shield his entire $10 million estate against tax. And if Rich dies first, the marital deduction allows him to leave his entire estate to Samantha tax-free without using any of his exemption. Portability then allows Samantha to use their combined exemptions to avoid estate tax.

Maximizing tax deferral

Portability provides another important advantage. Generally, leaving retirement benefits to your spouse is the most effective way to maximize their tax-deferral benefits. Why? Because a spouse can roll those benefits over into his or her own IRA, name new beneficiaries, and stretch out the deferral period over many years.

If you leave retirement benefits to a credit shelter trust, however, the funds will have to be distributed sooner and some of the benefits of tax deferral will be lost. Portability allows you to leave retirement benefits to your spouse without wasting any estate tax exemptions.

Weigh your options

If you have significant assets in IRAs or other retirement plans, ask your advisor whether relying on portability is a good strategy. He or she can help you weigh the potential benefits of portability against those of other strategies. ▮

Provide for family members with special needs using an SNT

When John and Emily's daughter was born with a disability that will require lifelong care, the couple decided to set up a special needs trust (SNT). Also known as a supplemental needs trust, an SNT allows you to enhance a family member's quality of life without jeopardizing his or her eligibility for government benefits, such as Medicaid or Supplemental Security Income (SSI). Let's take a closer look at questions to consider when using an SNT.

Will government benefits be preserved?

The costs of extended-term care for a family member with special needs can be enormous and aren't always predictable. These costs can endanger your family's financial security. An SNT can preserve your loved one's access to government benefits that cover health care and other basic needs.

Medicaid and SSI pay for basic medical care, food, clothing and shelter. To qualify for these benefits, however, a person's resources must be limited to no more than $2,000 in "countable assets."

Generally, every asset is countable with just a few exceptions. The exceptions include a principal residence, regardless of value. (But if the recipient is in a nursing home or similar facility, he or she must intend — and be expected — to return to the home.) They also include a car; a small amount of life insurance; burial plots or prepaid burial contracts; furniture, clothing, jewelry and certain other personal belongings.

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An SNT is an irrevocable trust designed to supplement, rather than replace, government assistance. To preserve eligibility for government benefits, the beneficiary can't have access to the funds, and the trust must be prohibited from providing for the beneficiary's "support." That means it can't be used to pay for medical care, food, clothing, shelter or anything else covered by Medicaid or SSI, such as the basic medical care provided by those programs.

Are supplemental expenses covered?

With those limitations in mind, an SNT can be used to pay for virtually anything government benefits don't cover, such as unreimbursed medical expenses, education and training, transportation (including wheelchair-accessible vehicles), insurance, computers, and modifications to the beneficiary's home. It can also pay for "quality-of-life" needs, such as travel, entertainment, recreation and hobbies.

Keep in mind that the trust must not pay any money directly to the beneficiary. Rather, the funds should be distributed directly — on behalf of the beneficiary — to the third parties that provide goods and services to him or her.

Should an SNT include spendthrift language?

Like many trusts, most SNTs contain spendthrift language to protect the trust assets against creditors' claims. Also, in some states, it may be necessary to include specific language providing that the trust is an SNT, that the funds are intended for only nonsupport purposes and that your intention is to preserve the beneficiary's eligibility for government benefits. In other states, simply designing the trust as a discretionary trust may be sufficient, but it can't hurt to include SNT spendthrift language just to be safe.

Communicate your plans

After John and Emily created an SNT, their estate planning advisor stressed the importance of notifying family and friends of the trust. Why? Because well-meaning loved ones might inadvertently undermine the strategy by making gifts or bequests directly to John and Emily's daughter. The couple let loved ones know in advance that the best way for them to help the child is to make gifts or bequests to the SNT. ▮

Estate Planning Pitfall

Your estate plan leaves specific assets to specific heirs

Planning your estate around specific assets is risky and, in most cases, should be avoided. If you leave specific assets — such as homes, cars or stock — to specific people, you may inadvertently disinherit them. Here's an example that illustrates the problem:

George has three children — Michael, Lindsay and Kyle — and wishes to treat them equally in his estate plan. In his will, he leaves a $500,000 mutual fund to Michael and his $500,000 home to Lindsay. He also names Kyle as beneficiary of a $500,000 life insurance policy.

By the time George dies, the mutual fund balance has grown to $750,000. In addition, George has sold the home for $750,000, invested the proceeds in the mutual fund and allowed the life insurance policy to lapse. He didn't revise or revoke his will. The result? Michael receives the mutual fund, with a balance of $1.5 million, and Lindsay and Kyle are disinherited.

To avoid this outcome, it's generally preferable to divide your estate based on dollar values or percentages rather than specific assets. George, for example, could have placed the mutual fund, home and insurance policy in a trust and divided the value of the trust equally between his three children.

If it's important to you that specific assets go to specific heirs — for example, because you want your oldest child to receive the family home or you want your family business to go to a child who works for the company — there are planning techniques you can use to avoid undesired consequences. For example, your trust might provide for your assets to be divided equally but also provide for your children to receive specific assets at fair market value as part of their shares.

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Weinstock Manion
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Comprehensive Estate Planning Services

For over 50 years, the attorneys and staff of Weinstock Manion have focused on providing personalized, high-quality counsel to moderate to high net worth individuals, real estate investors, business owners, charitable organizations, beneficiaries and fiduciaries in the following practice areas:

- Estate Planning
- Wealth Transfer Planning
- Estate and Trust Administration
- Estate and Trust Litigation
- Business Succession Planning
- Charitable Planning and Family Foundations

Working with our client's other trusted advisors, our team of specialized attorneys and paralegals create and implement comprehensive, creative and practical estate plans with the goals of maximizing wealth transfer in accordance with our clients' wishes and reducing taxation.

Estate and trust administration can have significant financial consequences for both current and future beneficiaries. In an effort to minimize income and estate taxes, while maximizing estate and trust income for beneficiaries, our process involves an extensive amount of collaboration between our estate planning, taxation and transactional attorneys.

Weinstock Manion's litigators represent both fiduciaries and beneficiaries in estate and trust disputes. Our litigators are skilled at handling claims for breach of fiduciary duty, beneficiary disputes, disputes regarding the validity of wills and trusts, undue influence and all aspects of conservatorships and guardianships.

For many clients, ensuring the future of their family business through a well-structured succession plan is an essential component of their estate plan. Our team of transactional, tax and estate planning attorneys work with our clients' other trusted advisors to develop plans for retirement, management transition and liquidity events.

Supporting charitable causes is important to many of our clients. We help our clients support the causes they are passionate about in a tax-efficient manner through thoughtful charitable planning, including the creation of family foundations.

At Weinstock Manion, we understand that significant wealth can lead to complex personal and financial issues that may result in family conflict. Our goal is to help implement wealth transfer plans that minimized potential conflicts while promoting enduring legacies for generations to come.

We invite you to explore our team and services, and to contact us to learn more about how we may collaborate to preserve your legacy.

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