

Trust, Estate and Asset Protection Planning After the 2010 Tax Relief Act

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- I. 2010 Tax Relief Act.
 - A. Federal estate tax changes.
 1. Basic exclusion amount is \$5 million.
 2. "Portability" applies for a married person who dies between January 1, 2011, and December 31, 2012, in regard to the decedent's unused "basic exclusion amount."
 - a. Subtract from that figure the sum of the dead spouse's federal taxable estate plus his or her adjusted taxable gifts (taxable gifts made after 12/31/76 not otherwise included in the gross estate).
 - b. Example 1: If a married couple owns all assets as JTWROS or H&W, and if the total value of the assets is \$4 million, when H dies, then H's gross estate would be \$2 million (one-half of \$4 million), under IRC § 2040(b); assuming that H made no post-1976 lifetime taxable gifts, and assuming his taxable estate is \$2 million, his DSUEA (deceased spousal unused exclusion amount) would be \$3 million. If W dies before 2013, then she would be able to exclude up to \$8 million from her gross estate.
 3. The DSUEA may only be taken into account by a surviving spouse if the executor of the estate of the deceased spouse files an estate tax return in which the amount is computed and makes an election on the return that the amount may be taken into account by the surviving spouse.
 - a. The election, once made, is irrevocable.
 - b. No election may be made if the estate tax return is filed after the due date (including extensions).
 - c. Example 2: H dies in 2011, having made taxable transfers of \$3 million and having no taxable estate. An election was made on the estate tax return to permit W to use his DSUEA. W has made no taxable gifts. W's applicable exclusion amount is \$7 million (her \$5 million basic exclusion amount plus \$2 million DSUEA from H), which she may use for lifetime gifts or for transfers at death.

- B. Note the complications and questions that can arise if the surviving spouse remarries, etc. It should be noted that the Joint Committee on Taxation has reported that a technical correction may be needed to correct certain defects in language, particularly in the case of a surviving spouse predeceased by more than one spouse.
- C. Note the options available in regard to capital gains taxes for 2010 estates.
 - 1. Beneficiaries of 2010 estates can elect to avoid the estate tax on assets of any value by electing the modified carryover basis regime with a basis step-up of up to \$1.3 million of value with an additional \$3 million tax break for surviving spouses.
 - a. Consequently, 2010 estates have the option of either total exemption from federal estate taxes, or totally avoiding capital gain taxes by recognizing the \$5 million exception.
 - b. The estate tax rate (above a \$5 million exemption) became 35% for 2010, in contrast to the 15% federal capital gain rate (plus state income taxes), so that larger estates may find it cheaper to choose estate tax avoidance.
 - 2. Heirs who do face large capital gains on bequests might want to consider transferring the assets to a charitable remainder trust or otherwise contributing the low basis assets to charity.
- D. Other Issues.
 - 1. Note that the effect of the 2010 Tax Relief Act is to exempt 99.9% of Americans from federal transfer taxes. However, the transfer tax relief has an expiration date - it expires at midnight, December 31, 2012, to be replaced by a mere \$1 million exemption and a 55% top tax rate. Consequently, we are poised for the same tax muddle that existed immediately prior to the end of 2010.
 - 2. The lack of concern about federal estate taxes may result in a number of unintended consequences.
 - a. Note the uncertainty beginning in 2013.
 - b. 22 states and the District of Columbia impose estate or inheritance taxes, at rates of up to 20% in some states.
 - (1) In Indiana, the maximum rate applicable to a Class A beneficiary is 10% above \$1.5 million, the maximum

rate applicable to a Class B beneficiary is 15% above \$1 million, and the maximum rate applicable to a Class C beneficiary is 20% above \$1 million.

- (2) All states provide deductions or exemptions for charitable bequests.
 - (3) Consequently, lack of planning can reduce an IRA by 50% or more in combined income and inheritance taxes, while proper charitable planning can result in substantially reduced taxes.
- c. Lack of emphasis on planning, or the ignorance of people regarding risks and exposure due to a failure to plan, may result in reduced sales of insurance products, reduced charitable giving, and unanticipated or unintended inheritance results when improper wills are written, or wills are not written at all, or when improper joint ownership or other beneficiary arrangements are utilized.
- (1) Taxes can be reduced substantially overall, including income taxes, if qualified dollars are directed to charitable beneficiaries, rather than to leave a percentage of the total estate to charities.
 - (2) If significant assets pass to beneficiaries by non-probate transfers (joint ownership, POD or TOD arrangements, beneficiary designation, etc.), and inheritance taxes are not allocated or apportioned properly, the residue may end up bearing all or a significant part of the inheritance taxes, thus eroding the residue or consuming it entirely for the purpose of paying inheritance taxes.
- d. Other tax-burdened assets can give rise to unanticipated income taxes in the hands of a beneficiary, such as investment build-up in an annuity, or accumulated interest in the case of savings bonds.

II. Why bother to plan?

- A. Because of lessening concern about federal estate and generation-skipping transfer (GST) taxes, many people feel that planning is no longer necessary or are otherwise failing to plan.

1. However, federal estate and GST taxes represent only a minuscule part of the framework of issues that people should be encouraged to consider as they deal with estate, lifetime and asset preservation planning.
 2. As a consequence, people are failing to plan in circumstances when, with a little basic planning, significant beneficial results can be obtained, or significant tax or other costs avoided.
- B. A person's last will and testament or trust will not assure that his or her estate and personal assets will pass in the desired manner.
1. A last will and testament controls only assets titled in the decedent's sole name, and a trust controls only assets actually titled in the trust at the time of death.
 2. Certain non-probate transfers will frequently comprise a substantial part of a person's estate, or even perhaps the bulk of his or her estate.
- C. I.e., your last will and testament or trust will not control your life insurance, your IRA, your 401(k), annuities, or accounts which are established to be payable on death ("POD") or transfer on death ("TOD").
1. Consequently, a person's last will and testament or trust may be very detailed, and yet the bulk of a person's assets may pass in an unanticipated or undesirable manner at the time of the person's death because the beneficiary arrangements are not coordinated with the provisions of the will.
 2. It is absolutely necessary to coordinate ownership and beneficiary arrangements in order to accomplish the desired result.
 3. For example, if you desire for certain assets to pass to a trust for the benefit of a beneficiary, then you should not name that individual as a direct beneficiary of insurance or other contractual payments, nor should that person be named as a joint owner or a surviving POD or TOD designee.
 4. This problem will frequently arise in the context of trusts desired for a disabled or younger beneficiary.
- D. A second marriage creates fertile ground for disputes and misconceptions about inheritances and asset protection. There will frequently exist both "his" children and "her" children, and sometimes "their" children in the case of a second marriage.

1. Although joint ownership and proper POD and TOD designations, as well as beneficiary designations for life insurance and retirement benefits, can assure that certain assets will pass to the surviving spouse, in the absence of a proper last will and testament assets owned individually by the predeceasing spouse will not necessarily pass to the surviving spouse.
 2. Instead, assets owned in the sole name of the predeceasing spouse will pass only one-half in the case of personal property to the surviving spouse, and only one-fourth of the value of real estate will pass to the surviving spouse, with the balance of the estate to pass to the decedent's children.
 3. Such passing of property may or may not be the actual intention of the decedent, and if the children are younger, failing to provide for proper trust or custodial arrangements will result in young children receiving assets, thus creating numerous problems and the complexity of a court-administered guardianship.
 4. It is amazing that most young people, and many older people, will spend significant sums on adoptions, fertility treatments, and the cost of having children, but will invest virtually no money, or even their own personal time and involvement, in planning for the disposition of their estate and providing for the interests of their young children.
- E. Problems often arise in the case of older couples when long-term care is a concern.
1. If the couple has executed a prenuptial agreement, keeping their property separate will not protect assets in the context of Medicaid when one of the spouses may require long-term care.
 2. A prenuptial agreement may be very beneficial in the context of planning for death and divorce, but it will have no impact in the realm of asset protection planning, and such an agreement will be entirely disregarded when the issue is obtaining Medicaid eligibility for an incapacitated spouse.
 3. Consequently, when a prenuptial agreement is considered, consideration also should be given to the implications of long-term care as well as to the eventualities of death and dissolution of marriage.

4. Proper planning in advance with testamentary special needs trusts, or utilizing long-term care insurance, can avoid significant and often unanticipated problems if one of the spouses is later admitted to a long-term care facility.
- F. Couples with grown children often feel that they need nothing more than a simple will providing that their assets will pass to their grown children at the death of the surviving spouse.
1. In fact, even without a will, such a result will occur in most states by the applicable laws of intestate succession.
 2. However, if one or more of the adult children should predecease the parents, consideration should be given to the risk of significant assets passing to the deceased child's children, who may be relatively young beneficiaries, or who may be disabled and receiving public benefits.
 - a. There are relatively simple ways to deal with younger beneficiaries such as a Uniform Transfers to Minors Act account.
 - b. It is also possible to implement special needs or supplemental care trust arrangements for disabled beneficiaries.
 - c. However, in the absence of effective planning, such a result would not occur.
 3. Similarly, if it is the parent's goal that only the living children and not a deceased child's children will benefit, then proper arrangements must be put in place in order to assure that such a result will occur.
 - a. If the parents have used bank or investment accounts which are jointly owned with children or accounts which are established as POD or TOD, then unless those arrangements are set up properly, the funds in those accounts would pass only to the living children and not to the issue of a deceased child.
 - b. Proper coordination of ownership and beneficiary arrangements is essential.
- G. Many other issues should be addressed in the case of younger beneficiaries:
1. Who will raise the children?

2. Who will oversee their finances?
 3. Should the same people oversee not only their person, but also their money?
 4. Should a bank or trust company be involved in the process?
 5. Should a trust be implemented as a means of providing protection beyond the age of majority (or after the age of 18 until the age of 21 under a Uniform Transfers to Minors Act)?
 6. How can ownership and beneficiary arrangements be coordinated so as to minimize the impact of probate as well as the tax consequences of receipt of funds?
 7. Clearly a will is necessary, but are other arrangements appropriate as well?
 8. Should not the parents have powers of attorney and health care advance directives to deal with incapacity and end of life issues?
- H. Particular problems confront single parents, which may occur not only due to the death of the other parent, but also due to divorce or the fact that many people have remained intentionally single.
1. Trust provisions should be considered as well as the appropriateness of "special needs" or "supplemental care" arrangements for disabled children as a means of protecting their public benefits.
 2. The tax implications of having retirement benefits payable either directly to a younger beneficiary or to a trust for the beneficiary must be considered, which may necessitate particular planning arrangements in order to avoid ownership or control and to alleviate the tax consequences of the receipt of retirement distributions.
 3. Special consideration should be given to the younger single parent who may die or become incapacitated while his or her child or children are still very young.
 - a. A trust of one or another type should almost always be considered.
 - b. In some instances, a custodial arrangement under a UTMA may be sufficient, but in that case, the younger beneficiary would be entitled to all assets at the age of 21.

- c. There may be different types of trusts, some of which may be more beneficial in the case of the younger beneficiary. Types of trusts will be addressed next.

I. Types of trusts.

1. Testamentary trusts.

- a. "Pot" trusts which are divided later.
- b. Separate share trusts.

2. Family trusts.

- a. Divided later into "pot" trusts or separate shares.
- b. Can be testamentary or *inter vivos*.

3. *Inter vivos* or "living" trusts.

- a. May be revocable or irrevocable.
- b. May include "pot" provisions or separate shares.
- c. May include "special needs" provisions.
- d. May be a "by-pass" trust.
- e. May be a "contingent" or "empty" trust.

4. The foregoing are not the only types of trusts, and various trusts may include various aspects of many of the foregoing arrangements.

- a. I.e., an empty or contingent trust might receive assets at death by beneficiary designation.
- b. It may establish a "pot" trust for various children, which will be divided into separate shares when the oldest or youngest child attains a certain age.
- c. Such trusts might then provide for periodic distributions at various ages.

- d. Such a trust might also include “special needs” (also called “supplemental care”) provisions.

J. Conclusion.

- 1. Proper planning entails contemporaneously considering numerous issues as well as the implications of various arrangements.
- 2. The goals of estate planning are frequently said to include achieving the wishes of the client, minimizing estate, gift and transfer taxes, and providing for the liquidity needs of the decedent’s estate and family.
 - a. As people age, protecting assets becomes more important.
 - b. Unless various means of passing property are integrated so that all transfer and beneficiary arrangements are coordinated, the client’s goals will many times be frustrated and disharmony created among the various members of his or her family.