Insight on Estate Planning

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Giving: A timeless estate planning strategy

Life's changes beget plan revisions
Disinheriting a child is a difficult, but sometimes necessary, decision

Will health care reform breathe new life into HSAs?

Estate Planning Pitfall
You're planning to name a family member as executor of your estate

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Giving: A timeless estate planning strategy

Like many affluent people, Cynthia faces the question of what to do with the wealth that she's accumulated. She's 65 years old, single and in good health, and she lives a modest lifestyle. She has three children and five grandchildren. Her estate is worth approximately $4.5 million, and she wants to ensure as much of that wealth as possible goes to her family, not taxes.

Although currently there's no federal estate tax, it's scheduled to rear its head again in 2011 with an estate tax exemption amount of only $1 million. Of course, Congress may change that, but as of this writing, it's not yet clear how. A permanent repeal is unlikely, but lawmakers may reinstate the 2009 version of the tax, with a $3.5 million exemption, or they may increase the exemption to, say, $5 million. Check with your estate planning advisor for the latest information.

A structured gifting program can allow you to remove wealth from your estate and minimize the potential impact of estate taxes.

This uncertainty makes Cynthia's estate planning a challenge. A tried and true strategy to reduce potential estate tax liability is making tax-free — or even taxable — gifts.

Benefits of giving

There isn't much Cynthia can do about the estate tax's uncertain future other than build as much flexibility as possible into her estate plan and revisit her plan as the new estate tax regime takes shape.

In the meantime, her estate planning advisor suggests that it's advantageous to make the most of lifetime giving. A structured gifting program can allow Cynthia to remove wealth from her estate and minimize the potential impact of estate taxes.

In addition to reducing the size of her taxable estate, gifting also avoids gift and estate taxes on any future appreciation in the value of gifted assets, and it allows Cynthia to watch her family enjoy her wealth while she's alive.

Here are some of the moves Cynthia and her advisors are considering:

Maxing out annual exclusion gifts. The annual gift tax exclusion allows you to give up to $13,000 per year gift-tax free ($26,000 for married couples who split gifts) to as many people as you want without using up any of your $1 million lifetime gift tax exemption. So, for example, Cynthia

could give $13,000 per year to each of her children and grandchildren, for a total of $104,000 per year. The gifts to her grandchildren would also be exempt from the generation-skipping transfer (GST) tax.

Making direct payments of tuition and medical expenses. Cynthia can pay any amount of tuition or medical expenses on behalf of her children and grandchildren gift-tax free. So long as she pays these expenses *directly* to the school or health care provider, they don't count against Cynthia's annual exclusions or lifetime gift tax exemption.

Using the lifetime gift tax exemption. Ideally, Cynthia would take advantage of annual exclusion gifts and tuition and medical payments to reduce the size of her estate, while preserving her $1 million lifetime gift tax exemption. Preserving the exemption is important because any portion of the exemption used during life reduces the amount of the estate tax exemption available at death.

In some cases, however, it may make sense to use the gift tax exemption. For example, if Cynthia owns assets that she believes will appreciate dramatically in value, her overall tax liability may be lower if she gives away those assets now rather than holding on to them until death.

Making taxable gifts. If Cynthia uses up her annual exclusion *and* $1 million lifetime gift tax exemption, there may still be an advantage to making additional, taxable gifts. But this strategy can be risky. (See "Rolling the dice on taxable gifts" at right.)

Setting up trusts. If Cynthia isn't comfortable giving large sums of money to her grandchildren, she can set up trusts to hold assets until they reach a certain age or meet other requirements she establishes. However, the annual exclusion is available only for gifts of a "present interest."

To qualify for the annual exclusion, therefore, Cynthia must give her grandchildren "Crummey powers" to withdraw trust contributions for a specified period of time after each contribution is made. Cynthia must notify her grandchildren of their right of withdrawal, but there's no reason she can't discuss with them the financial benefits of leaving the funds in the trust.

The gift that keeps on giving

A lifetime giving program is particularly valuable as a hedge against estate tax uncertainty. But even after the estate tax's future is settled, the strategies discussed here will continue to be powerful tax-reduction tools.

Rolling the dice on taxable gifts

Suppose you've maxed out your annual exclusion gifts and used up your $1 million lifetime gift tax exemption. Is it ever a good idea to make additional, taxable gifts? Maybe, but you'll need to get out your crystal ball. If your estate is large and you expect to owe estate taxes, making a gift now will allow you to avoid taxes on future appreciation.

Making gifts now may also allow you to avoid higher tax rates down the road. This year, the top gift tax rate is 35%. Absent new legislation, the top gift and estate tax rates will jump to 55% next year, though it's possible that Congress will choose a lower rate — 45%, for example. Either way, if you expect to be liable for estate taxes, making a gift now at a 35% rate may be preferable to transferring it at death at a higher rate.

This strategy can be a gamble, though. If Congress were to permanently repeal the estate tax or increase the exemption enough to eliminate your estate tax liability, you would have paid a 35% gift tax that you could have avoided.

Life's changes beget plan revisions

Disinheriting a child is a difficult, but sometimes necessary, decision

Because circumstances change over time, an estate plan isn't a static document. It's meant to be revised. For example, perhaps the person you chose to be your minor child's guardian can no longer fulfill that duty because he or she has suffered a physical disability. You can revise your plan to name a different guardian.

What if your relationship with one of your adult children has deteriorated to the point where you wish to disinherit him or her? In this situation, too, you can revise your estate plan.

Consider your options

The short answer to whether you can disinherit your child is "yes." If a child has given you so much grief that you feel leaving him or her an inheritance would only make matters worse or would be unfair to your other children, disinheritance is an option.

Some states allow you to disinherit a child simply by omitting him or her from your estate plan. Other states require you to name each child to make your intentions clear. In that case, you could leave the child $1 or some other nominal amount.

Disinheriting a child is a drastic measure, however, and there may be better alternatives. For example, you could place assets in a trust that pays for basic necessities — like food, shelter and health care — and condition further distributions on the child meeting certain goals, such as finishing college or staying gainfully employed.

Challenge-proof your plan

To successfully challenge your plan, the child would have to prove that you were incapacitated at the time you executed or amended your plan, or that your decision was the result of fraud, duress, mistake or undue influence. To avoid

such a challenge, consider using a living trust rather than a will. Typically, living trusts don't go through probate, so they're more difficult and expensive to contest.

In addition, consider leaving the child a modest inheritance and including a "no contest" clause providing that, if the child contests your will or trust and loses, he or she receives nothing. Bear in mind that some states' laws make any "no contest" provisions in a will or trust void and unenforceable. Check with your estate planning advisor for more details.

Finally, at the time you execute or amend your plan, have a medical professional examine you and provide a written opinion regarding your mental capacity.

Consult your estate planning advisor

If you've come to the conclusion that you need to disinherit your child, you have the option to do so. But before taking action, discuss these arrangements with your estate planning advisor. He or she should check your state's laws regarding disinheritance. ■

Disinheriting your spouse isn't so easy

The laws in most states make it difficult or impossible to disinherit your spouse. A few states still retain the concept of "dower interest." Historically, this term referred to a wife's interest in her husband's real estate or other property at his death, but in some states both spouses have dower interests.

A valid prenuptial or postnuptial agreement, however, generally supersedes state law. If the agreement includes a valid waiver of each spouse's rights to the other spouse's property, it may be possible to give your spouse as much or as little as you wish.

Additionally, in a few states, it's possible to use a revocable living trust to disinherit a spouse. And some states allow you to disinherit your spouse if you're separated at the time of death, or in certain other circumstances that will vary by state.

Will health care reform breathe new life into HSAs?

As the provisions of health care reform law take effect over the next few years, you may be hearing a lot more about Health Savings Accounts (HSAs). HSAs survived the health care overhaul largely intact and may prove to be a valuable tool for reducing health care costs. And because unused HSA balances grow on a tax-deferred basis — similar to an IRA — they can also serve as an additional weapon in your estate planning arsenal.

What's an HSA?

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).

For 2010 and 2011, to qualify as an HDHP, a plan must have a minimum deductible of $1,200

($2,400 for family coverage) and a $5,950 cap on out-of-pocket expenses ($11,900 for family coverage). Because their deductibles are higher, HDHPs generally have significantly lower premiums (often as much as 30% lower).

To be eligible for an HSA, in addition to being covered by an HDHP, you must not be enrolled in Medicare or covered by any non-HDHP insurance (such as a spouse's plan) except for certain dental, vision, disability or long-term care coverage.

What are the benefits?

HSAs provide several important benefits. First, they reduce unreimbursed health care costs by allowing account holders to withdraw funds tax free to pay for qualified medical expenses. These generally include otherwise tax-deductible medical expenses for account holders, their spouses and dependents. (Withdrawals for other purposes are subject to income taxes and, currently, a 10% penalty.)

In addition, unused funds may be carried over from year to year, continuing to grow on a tax-deferred basis. Essentially, to the extent you don't need the funds for medical expenses, an HSA serves as a supplemental IRA. Once you reach age 65, you can make penalty-free withdrawals for any purpose — but withdrawals not used for qualified medical expenses will still be subject to income tax.

What are the contribution limits?

For 2010 and 2011, the maximum annual contribution is $3,050 for account holders with individual coverage or $6,150 for those with family coverage. If you're age 55 or older, you can make additional "catch-up" contributions of up to $1,000 this year ($2,000 for married couples if both spouses are age 55 or older and both have an HSA).

How does health care reform affect HSAs?

The health care reform law made two changes to HSAs that take effect in 2011. First, tax-free withdrawals no longer will be allowed to purchase

over-the-counter drugs that aren't prescribed by a physician. Second, the penalty for nonqualified withdrawals before age 65 will increase to 20%.

What are the estate planning implications?

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 (RMDs) for 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, the account no longer qualifies as an HSA, and the beneficiary must include the account's fair market value in his or her gross income. As long as the beneficiary isn't your estate, however, he or she is eligible to deduct any of his or her own qualified medical expenses paid with your HSA funds within one year after your death.

That differs from an IRA, where a nonspouse beneficiary can spread RMDs over his or her lifetime. So, those age 65 or older who need to take

distributions to pay *non*medical expenses (or for other purposes) may want to consider whether it makes more sense to withdraw from:

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

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

Get ready

Most of the new health coverage requirements take effect in 2014, so you should be aware of any changes that may affect you. But if you're currently eligible for an HSA, opening and contributing to an account now can provide a tax-advantaged way for you to prepare for the potential of additional medical expenses down the road — and perhaps provide estate planning opportunities as well.

Estate Planning Pitfall

You're planning to name a family member as executor of your estate

There's nothing to prevent you from naming your spouse, a child or another family member as executor of your estate. But be sure to consider how this decision may affect your loved ones.

Your executor has several important duties, which may include:

- Filing your will with the local probate court and obtaining court approval to administer your estate,
- Taking inventory of your assets and obtaining necessary values and appraisals,
- Ensuring that life insurance proceeds are collected,
- Preserving and protecting the estate's assets, paying its debts and handling creditors' claims,
- Arranging for the safekeeping of personal property, and
- Filing tax returns on the estate's behalf.

Most family members can't handle all these duties on their own, but they can delegate many duties to accountants, attorneys, investment advisors and other professionals at the estate's expense. Still, serving as executor is a big responsibility involving a substantial time commitment during a difficult period.

This creates a dilemma. On the one hand, you want your executor to be someone you trust and who is familiar with your family dynamics. On the other, you don't want to make an already stressful situation even more difficult.

One solution is to appoint a trusted advisor, such as an accountant or attorney, to serve as executor. Alternatively, you might name a family member and an advisor as co-executors. Another solution is to name a bank trust department or a trust company as executor.

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Personal Legal Services Group

Joseph A. Bonventre has substantial experience advising individuals and business owners on estate planning, business planning, charitable planning and Will and trust contests. He is a Fellow of the American College of Trust and Estate Counsel and a Fellow of the American College of Tax Counsel. Joseph is listed in *The Best Lawyers in America*.

Tel: (313) 965-8293 • Fax: (313) 965-8252
Email: jbonventre@clarkhill.com

Andrea M. Kanski's estate planning background includes analysis and development of tax and estate planning strategies consistent with the objectives of the individual and his/ her family, including closely held, family-owned businesses. She has extensive trust administration experience and probate experience with both supervised and informal proceedings involving deceased estates, guardianships and conservatorships.

Tel: (313) 965-8589 • Fax: (313) 965-8252
Email: akanski@clarkhill.com

Ray J. Koenig III practices in the areas of probate litigation, trust litigation, fiduciary litigation, elder law, estate planning, and estate administration, with an emphasis on will, trust, guardianship, and advance directive contests and other fiduciary litigation. Ray has represented individuals, families, financial institutions, medical institutions, and governmental organizations in all areas of his practice. Ray has extensive trial, appellate and mediation experience in state and federal courts. Ray is frequently appointed Guardian Ad Litem and defense counsel by judges in guardianship cases, and has been appointed Special Administrator in probate matters.

Tel: (312) 985-5938 Fax (312) 985-5999
Email: rkoenig@clarkhill.com

J. Thomas MacFarlane specializes in estate, tax and business succession planning, and in probate matters. He is a Fellow of the American College of Trust and Estate Counsel, and he is listed in *The Best Lawyers in America*.

Tel: (248) 988-5846 • Fax: (248) 642-2174
Email: jmacfarlane@clarkhill.com

Thomas S. Nowinski is a tax specialist with a broad background in counseling businesses and individuals in tax and financial matters. His taxation practice includes federal and state taxes of all types, with particular emphasis on Michigan property tax issues.

Tel: (313) 965- 8244 • Fax: (313) 965-8252
Email: tnowinski@clarkhill.com

Douglas J. Rasmussen concentrates his estate planning practice on the development of financial, tax and wealth distribution strategies as well as on intra-family dispute resolution. He is a Past Chairman of the State Bar Probate and Estate Planning Section, a Fellow (and Past Regent) of the American College of Trust and Estate Counsel and an Academician of the International Academy of Estate and Trust Law. He is a frequent author, lecturer, and expert witness and has been listed in all editions of *The Best Lawyers in America*.

Tel: (313) 965-8234 • Fax: (313) 965-8252
Email: drasmussen@clarkhill.com

Stephen C. Rohr practices in the areas of business, tax and estate planning, tax litigation, and probate and trust administration. He has extensive experience drafting estate planning and business formation documents. He is a frequent lecturer on estate planning and business planning techniques to individuals and businesses. Stephen has his LL.M. in taxation from Georgetown University.

Tel: (248) 988-5850
Email: srohr@clarkhill.com

Thomas F. Sweeney is very experienced in the planning, administering and dispute resolution of trusts and estates; business planning; and the taxation of trusts, estates and gifts. He is a frequent writer and speaker for ICLE. Thomas is an adjunct tax professor at Wayne State Law School and he is listed in *The Best Lawyers in America*.

Tel: (248) 988-5867 • Fax: (248) 642-2174
E-mail: tsweeney@clarkhill.com

Steven J. Tjapkes, previously a veterinarian in private practice, works with family businesses, family farms, and agribusiness to meet the challenges of transferring family assets to the next generation. Steven lectures on estate administration and on buying and selling business assets.

Tel: (616) 608-1111 • Fax: (616) 608-1199
Email: stjapkes@clarkhill.com

Additional (adjunct) members of Clark Hill's Personal Legal Services Group include:

Dana L. Abrahams, Michael M. Antovski, Charles M. Bayer, James M. Crowley, Laura S. Del Pup, Jeffrey A. DeVree, Thomas M. Dixon, Darren J. Greca, Douglas R. Kelly, Benjamin J. Malkin, Charles E. Murphy, David E. Nims, Michael P. Nowlan, John P. Schneider, Alan D. Szuma, Duane L. Tarnacki and Mark H. Zietlow

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