Insight on Estate Planning

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You jointly own property with a family member

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The net investment income tax and your estate plan

How one affects the other

The 3.8% net investment income tax (NIIT) can affect your estate plan in two ways: First, it can increase your tax on capital gains, taxable interest and other investment income, reducing the amount of wealth available to your family. Second, the tax is particularly harsh on certain trusts used in estate planning.

How it works

The NIIT applies to net investment income (NII) earned by "high-income" individuals. (See "What's your NIIT liability?" on page 3.) It also applies to trusts and estates to the extent that their adjusted gross income (AGI) exceeds a surprisingly low threshold ($12,300 in 2015).

Investment income includes:

- Taxable interest,
- Qualified and nonqualified dividends,
- Short- and long-term capital gains (except on property used in an active trade or business),
- Rental and royalty income,
- Nonqualified annuity income,
- Income from passive business activities, and
- Income from trading financial instruments or commodities.

Investment income does *not* include:

- Wages, self-employment income, or income from nonpassive business activities,
- Tax-exempt interest (such as interest on municipal bonds),
- Distributions from IRAs or certain qualified retirement plans,
- Life insurance proceeds,
- Alimony,
- Social Security or veterans' benefits,
- Gain on the sale of an active interest in a partnership or S corporation, and
- Nontaxable gain on the sale of a principal residence.

Planning strategies for individuals

For individual income tax purposes, you can reduce or eliminate NIIT either by 1) reducing your modified adjusted gross income (MAGI) below the threshold, or 2) reducing your NII. Strategies to consider (many of which reduce both MAGI and NII) include:

- Maxing out contributions to IRAs and qualified retirement plans,
- Deferring income through an employer's nonqualified deferred compensation plan,
- Shifting investments into tax-exempt municipal bonds,
- Shifting investments into growth stocks that pay little or no dividends,
- "Harvesting" losses by selling securities at a loss and using them to offset gains,
- Investing in life insurance (cash buildup is exempt from NIIT and proceeds are excluded from both MAGI and NII),
- Purchasing individual stocks (as opposed to mutual funds) to obtain more control over the timing of capital gains,

- Transferring NII-producing assets to children or other family members in lower tax brackets,
- Using NII-producing assets to fund charitable donations, or
- Using installment sales to spread out income over several years.

Bear in mind that mutual funds typically distribute capital gains annually near the end of the calendar year or, in some cases, more than once a year. To minimize the impact of the NIIT, it's best to avoid purchasing fund shares shortly before a fund makes a capital gains distribution.

Planning strategies for trusts

Given the low AGI threshold for trusts, income reduction strategies are of little value. But it's important to understand that the NIIT applies only to a trust's *undistributed* NII. One way to avoid the NIIT is to distribute all of its income to lower-income beneficiaries.

Understand that capital gains ordinarily aren't included in a trust's distributable net income (DNI), so they're taxed at the trust level. Depending on state law and the trust's language, however, it may be possible to include capital gains in DNI and, at least at the trust level, avoid NIIT on them. Of course, the beneficiary or beneficiaries of the trust may be subject to NIIT, so it's important to plan accordingly.

You can also avoid NIIT by designing a trust as a grantor trust. Grantor trusts aren't taxed at the trust level; rather, their income is passed through to you, as grantor, and taxed at your individual income tax rate. This strategy avoids NIIT on the trust's investment income, but it may increase NIIT on your individual return, so be sure to evaluate its overall tax impact.

If you've established a nongrantor trust that holds rental real estate or other business interests, a recent U.S. Tax Court case may open the door to another strategy. The court ruled that it's possible for a trust to "materially participate" in a business for purposes of the passive activity loss rules. If your trust satisfies material participation requirements, it's possible to offset losses from these activities against nonpassive income, such as interest and dividends, reducing or even eliminating the trust's NIIT liability.

What's your NIIT liability?

For individual income tax purposes, the net investment income tax (NIIT) applies to the extent that your modified adjusted gross income (MAGI) exceeds the following threshold:

Filing Status	Threshold Amount
Married filing jointly	$250,000
Married filing separately	$125,000
Single	$200,000
Head of household (with qualifying person)	$200,000
Qualifying widow(er) with dependent child	$250,000

Generally, MAGI is equal to your adjusted gross income (AGI), unless you live and work abroad, in which case you would add back the foreign earned income exclusion to arrive at MAGI.

The NIIT applies to the *lesser* of 1) your net investment income (gross investment income minus deductible investment expenses) or 2) the amount by which your MAGI exceeds the applicable threshold.

Review your plan

As you review your estate plan, talk to your advisor about opportunities to reduce or eliminate NIIT. As always, tax planning is important, but it shouldn't override other estate and financial planning considerations. Distributing a trust's income to its beneficiaries, for example, may reduce its tax bill, but it may also defeat the trust's estate planning purposes.

Use a noncharitable purpose trust to achieve a variety of goals

Generally, trusts must have one or more human beneficiaries, but there's an exception for certain "purpose" trusts. One type of purpose trust that you may be familiar with is the charitable trust. But don't overlook the noncharitable purpose (NCP) trust as a potential tool for achieving your estate planning goals.

What is an NCP trust?

Historically, trusts were required to have human beneficiaries. Why? Because, for a trust to be valid, there must be someone to enforce it. Charitable trusts were the exception: The attorney general of the relevant jurisdiction was authorized to enforce the trust in the public interest.

Over the years, however, many U.S. states and a number of foreign jurisdictions have enacted legislation (including provisions of the Uniform Probate Code and the Uniform Trust Code) that authorizes NCP trusts. These trusts may be used to achieve a variety of purposes, such as:

- Caring for a pet or other animal (including its offspring),
- Maintaining a gravesite and providing for graveside religious ceremonies (often referred to as "honorary" trusts),
- Maintaining art collections, antiques, automobiles, jewelry or other personal property,
- Funding or otherwise sustaining a family business,
- Maintaining family residences, vacation homes or other real property, and
- Preserving digital assets.

A trust may be an NCP trust even if the grantor's children or other heirs will ultimately receive trust property as "remaindermen." Suppose, for example, that you create an NCP trust to maintain and exhibit your art collection. After a specified time period — let's say 20 years — the trust terminates and the collection is distributed to your children. The fact that your children will receive the art once the trust has fulfilled its purpose doesn't change its character as an NCP trust. Nor does it render the trust valid or enforceable absent an applicable NCP trust statute.

To be valid, an NCP must meet certain requirements. Most important, it must 1) have a purpose that's certain, reasonable and attainable, 2) not violate public policy, and 3) be capable of enforcement. Typically, an NCP trust is enforced by a designated "enforcer" — someone whose job is to ensure that the trust's purpose is fulfilled and who has the authority to bring a court action — and/or a "trust protector," who's empowered to modify the trust when its purpose has been achieved or is no longer relevant.

Which jurisdiction should you choose?

Choosing the right jurisdiction for an NCP trust is critical. The permitted uses of NCP trusts, as well as their duration, vary significantly from state to state, as do the powers of a trust protector or enforcer. Some states, for example, allow only pet trusts, honorary trusts or both. Other states authorize NCP trusts for most purposes, so long as they don't violate public policy. Most states limit an NCP trust's duration to a term of 21 years, although some permit longer terms or even "dynasty" NCP trusts of unlimited duration.

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Twenty-one years may not be sufficient for certain purposes, such as supporting a family business or caring for horses or other animals whose life expectancies exceed 21 years. If your state doesn't have an NCP trust statute, or if its requirements fail to meet your needs, you may be able to set up a trust under the laws of another state or even a foreign country. To do so, you must establish a connection with that jurisdiction, such as appointing a trustee who resides in the jurisdiction or moving trust assets there.

Offshore NCP trusts tend to offer greater planning flexibility, but they also involve greater cost and strict reporting requirements.

Seek professional help

Be aware that NCP trusts raise a variety of income, estate, gift and generation-skipping transfer tax issues. For example, certain distributions may be considered taxable gifts, even if they don't benefit any human beneficiary.

A full discussion of the tax implications is beyond the scope of this article, but it's important to consult your tax advisor to get an idea of the potential tax liabilities associated with NCP trusts. Your advisor can also help you choose the right jurisdiction and design the trust so that it meets your needs and is enforceable.

Addressing adopted children or stepchildren in your estate plan

Families that have children who are adopted, or stepchildren who haven't been legally adopted, face unique estate planning challenges. Additional consideration must be taken when a family includes an unmarried couple in a long-term relationship and one person has biological or adopted children. If your family's makeup is as such, it's important to understand your estate planning options.

Treated as equals

Adopted children are placed on an equal footing with biological children in most situations for estate planning purposes. Thus, adopted and biological children are treated the same way under a state's intestate succession laws, which control who inherits property in the absence of a will.

In addition, adopted children generally are treated identically to biological children for purposes of wills or trusts that provide for gifts or distributions to a class of persons, such as "children," "grandchildren" or "lineal descendants" — even if the child was adopted after the will or trust was executed.

No inheritance rights unless adopted

Stepchildren generally don't have any inheritance rights with respect to their parents' new spouses unless the spouse legally adopts them. If you have stepchildren and want them to share in your estate, you should either adopt them or amend your estate plan to provide for them expressly.

Of course, estate planning isn't the only reason to adopt stepchildren. Adoption also gives you all of the legal rights of a parent during your life.

Stepchildren generally don't have any inheritance rights with respect to their parents' new spouses unless the spouse legally adopts them.

Before you adopt stepchildren, however, you and your spouse should consider the potential effect on their ability to inherit from (or through) their other biological parent's relatives. In most states, when a child is adopted by a stepparent, the adoption decree severs the parent-child relationship with the other biological parent and his or her family. That means the child can't inherit from that biological parent's branch of the family — and vice versa — through intestate succession.

Second-parent adoption considerations

A growing minority of states now permit second-parent adoptions, in which an unmarried person adopts his or her partner's biological or adopted children without terminating the partner's parental rights. However, in states that recognize second-parent adoptions, their intestate succession laws may not provide for a child to inherit from the "second parent."

For unmarried couples who can't obtain a second-parent adoption, or choose not to, estate planning is especially critical — if they want the "nonparent" to have custody of the child should the "parent" die or become incapacitated and if the nonparent wants the child to inherit from him or her.

First, the parent should consider using a power of attorney for parental authority and appointing the nonparent as a guardian to ensure that he or she can act on the child's behalf and has priority over the parent's blood relatives in the event the parent dies or becomes incapacitated. Second, both partners should amend their wills. The parent's will should name his or her partner as the child's guardian, and the nonparent's will should spell out any property to be inherited by the child.

Spell out your wishes

If you have children who are adopted or stepchildren whom you haven't legally adopted, or you're unmarried but in a long-term relationship and your partner has biological or adopted children, clearly address your intentions in your will or living trust. Your estate planning advisor can help you understand your options.

Estate Planning Pitfall

You jointly own property with a family member

A common estate planning mistake that many people make is to own property jointly with a child or other family member. True, adding a loved one to the title of your home, bank account or other property can be a simple technique for leaving property to that person without the need for probate. But any convenience gained is usually outweighed by a variety of negative consequences. These include:

Higher gift and estate taxes. Depending on the size of your estate, joint ownership can trigger gift and estate taxes. When you add a family member's name to an asset's title as joint owner, for example, it's considered a taxable gift of half the asset's value. And *your* interest in the asset — including any future appreciation — remains in your taxable estate. These taxes usually can be minimized or even eliminated by transferring the asset to an irrevocable trust.

Higher income taxes. Generally, property transferred at death receives a stepped-up basis, allowing your heirs to sell it without incurring capital gains tax liability. But if you add an heir to the property's title as joint owner, only your interest in the property will enjoy this benefit. Any appreciation in the value of your heir's interests between the date he or she is added to the title and the date of your death is subject to capital gains tax.

Exposure to creditors' claims. Unlike property transferred to a properly designed trust, jointly held property may be exposed to claims by the joint owner's creditors (including a former spouse).

Loss of control. A joint owner has the right to sell his or her interest to an outside buyer without your consent and the buyer may be able to go to court to force a sale of the property. In addition, when you die, the entire property will go to the surviving owner(s), regardless of the terms of your will or other estate planning documents.

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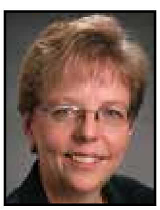

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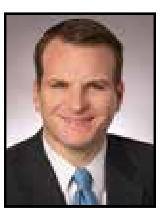

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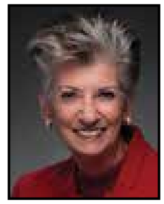

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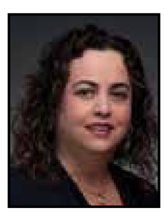

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