INSIGHT ON ESTATE PLANNING

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An uncertain tax climate

An estate tax repeal might result in negative tax consequences for some families

The climate for significant tax reform in Washington is uncertain as talks alternate between heating up and cooling down. But it's clear that the tax agenda is ultimately a high priority for the Trump administration and Republican leaders in Congress. In particular, the federal estate tax remains a prime target of some lawmakers.

One possible scenario is that this tax will be repealed, with modifications to related tax law provisions. However, this could result in income tax complications for individuals who inherit assets, even with relatively modest values. In many cases, the overall tax consequences for families might be negative.

Current laws of the land

Currently, transfers between spouses generally are exempt from federal gift and estate tax thanks to the marital deduction. Transfers to other beneficiaries, such as your children, are subject to estate tax, but are shielded by a unified gift and estate tax exemption of $5.49 million in 2017 (although that amount will be reduced by prior lifetime gifts).

Furthermore, your heirs can benefit from a "step-up" in basis when they inherit assets. This means, for purposes of calculating gain or loss on the sale of inherited assets, the assets are valued on the date of your death, instead of valued at your initial cost plus adjustments. This provision replaced rules requiring heirs to "carry over" the basis of inherited assets and thus often incur income tax liability on subsequent sales.

Another benefit of current law is that, when a beneficiary inherits and sells assets, any gain on the sale is automatically treated as a long-term capital gain, regardless of how long the deceased or the heir owned the securities. The maximum tax rate on long-term capital gains currently is 15% (20% for those in the top regular income tax bracket).

Potential problems for inheritances

Of course, it remains to be seen exactly what shape estate tax reform will take, if any is enacted in the near future. But a repeal of the estate tax is likely to be accompanied by elimination of the "step-up in basis" rule and a return to a carryover basis regime, possibly with exemptions for certain assets like farms and closely held business interests, or an overall exemption. (The temporary 2010 estate tax repeal, for example, came with only a limited step-up in basis allowed on certain asset transfers.)

Gifts of securities with tax strings attached

A lifetime gift of securities to a child may be sheltered by the annual gift tax exclusion without eroding the $5.49 million gift and estate tax exemption. For 2017, the maximum gift tax exclusion is $14,000 per recipient ($28,000 for gifts split by a married couple).

However, the income tax rules for subsequent sales depend on whether the sale would have produced a loss or a gain had you sold the securities instead of gifting them:

- If the sale would have produced a loss and your child then sells at a gain, your child's basis is the same as yours. If your child then sells at a loss, the basis is the fair market value on the transfer date.
- If the sale would have produced a gain, your basis is used to calculate any future gain or loss by your child.

Depending on the situation, it may be preferable to sell the stock, claim a tax loss and then gift the proceeds to your child.

To see how this could adversely affect heirs, let's look at an example.

Suppose that Alan leaves securities to Barbara, his daughter and sole beneficiary. Alan acquired the assets for $1 million and they're worth $4 million on the date of his death. He hadn't used any of his gift and estate tax exemption during his life. Under current law, the securities would be valued at $4 million for estate tax purposes, but would be completely sheltered by the $5.49 million gift and estate tax exemption. If Barbara were to sell the securities immediately for $4 million, she would owe no capital gains tax because of the step-up in basis.

Now let's instead assume that the step-up in basis rule is replaced by a carryover basis rule and no exemption applies. There are no estate tax concerns, but Barbara is saddled with a $1 million basis for the securities. If she sells the securities for $4 million, she must report a $3 million gain. Even if the gain still qualifies for favorable tax treatment as a long-term capital gain, Barbara may owe tax at a rate of up to 20%. That could cost her a staggering $600,000.

It's possible that tax reform legislation could also lower capital gains rates. But even then, Barbara would likely have a sizable tax bill, whereas she will have none if these tax reforms aren't enacted.

It remains to be seen exactly what shape estate tax reform will take, if any is enacted in the near future.

Timing is everything

It's premature to change your will and other estate planning documents to accommodate what might happen to federal estate tax laws, especially if the language is intended to provide maximum tax benefits under current law. Just be prepared to move quickly if and when Congress revamps the rules. We're here to help when/if that time comes. •

A 529 plan can benefit your estate plan

As summer vacations wind down and thoughts turn back to school activities, you might find yourself reviewing your finances and considering the options for funding your children's (or grandchildren's) college educations. You may be familiar with the basics of a 529 plan, but did you realize it can also benefit your estate plan?

529 plan in action

529 plans are tax-advantaged college-funding plans sponsored by states, state agencies and certain educational institutions. Let's focus on the popular college savings plan, which generally offers greater benefits than the other 529 option, the prepaid tuition plan.

529 college savings plans allow you to make cash contributions to an investment account and to withdraw both contributions and earnings free of federal — and, in most cases, state — income taxes, as long as the withdrawals are used for "qualified higher education expenses." Qualified expenses include tuition, fees, books, supplies, computer equipment, software, Internet service, and a limited amount of room and board.

Contributions aren't deductible for federal income tax purposes. However, many states allow residents to claim a deduction or credit for contributions to in-state 529 plans, and some states offer these tax breaks for contributions to *any* 529 plan. Be aware that plan accounts are treated as the *parents'* asset for financial aid purposes — so long as, of course, the student files as a dependent.

The tax code doesn't impose a specific dollar limit on contributions. Rather, it requires plans to provide "adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary."

Most plans accept contributions until total in-state 529 plan balances for a beneficiary reach a specified limit, currently ranging from $235,000 to around $500,000, depending on the state.

529 plan and your estate plan

529 plans offer several significant — and unique — estate planning benefits. First, even though you can change beneficiaries or get your money back, 529 plan contributions are considered "completed gifts" for federal gift and generation-skipping transfer (GST) tax purposes. As such, they're eligible for the annual exclusion, which allows you to make gifts of up to $14,000 per year ($28,000 for married couples) to any number of recipients, without triggering gift or GST taxes and without using any of your lifetime exemption amounts.

In addition, 529 plans allow you to "bunch" five years' worth of annual exclusions into a single year. Suppose you and your spouse open 529 plans for each of your three children. In Year 1, you may contribute as much as $140,000 (5 × $28,000) to each plan gift-tax-free, for a total of $420,000. Once you've taken advantage of this option, however, you won't be able to make additional annual exclusion gifts to your children until Year 6. And if you die during this period, a portion of your contributions will be included in your taxable estate.

For estate tax purposes, all of your contributions, together with all future earnings, are removed from your taxable estate even though you retain control over the funds. Most estate tax saving strategies require you to relinquish control over your assets — for example, by placing them in an irrevocable trust. But a 529 plan shields assets from estate taxes even though you retain the right (subject to certain limitations) to control the timing of distributions, change beneficiaries, move assets from one plan to another or get your money back (subject to taxes and penalties).

529 plan disadvantages

529 plans accept only cash contributions, so you can't use stock or other assets to fund an account. Also, their administrative fees may be higher than those of other investment vehicles. And, unlike many such vehicles, your investment choices are usually limited to the plan's pre-established portfolios.

If withdrawals aren't used for the beneficiary's qualified education expenses, the earnings portion is subject to federal income taxes (at the recipient's tax rate) plus a 10% penalty and, in some cases, state income taxes.

Time to bone up on a 529 plan

If you have college-bound children (or grandchildren), there's no doubt that you should consider a 529 plan. Keep in mind that contribution limits, investment approaches and tax advantages vary from state to state, so be sure to shop around for a plan that best meets your needs. •

Would a spendthrift trust help achieve your estate planning goals?

Are you concerned that some of your beneficiaries might squander their inheritances or simply aren't equipped to handle the financial responsibilities that come with large sums of money? You don't have to hold onto your assets until the day you die with the hope that your heirs will change their ways by that time. Instead, consider using a spendthrift trust that can provide protection, regardless of how long you live.

As with other trusts, a spendthrift trust may incorporate various tax benefits, but that's not its primary focus. Regardless of whether estate tax reform is enacted in the near future, this trust type can help you provide for an heir while protecting assets from his or her potentially imprudent actions.

Spendthrift trust in action

With assistance from an estate planning advisor or attorney, set up the trust according to state laws and transfer assets to the trust account. Generally, the assets will consist of securities such as stocks, bonds and mutual funds, and possibly real estate and cash. The appointed trustee then manages the assets.

Essentially, the terms of the trust restrict the beneficiary's ability to access funds in the account. Therefore, the beneficiary can't invade the trust to indulge in a wild spending spree or sink money into a foolhardy business venture. Similarly, the trust assets can't be reached by any of the beneficiary's creditors.

Instead of having direct access to funds, the beneficiary usually receives payments from the trust on a regular basis or "as needed" based on the determination of the trustee. For example, the trust might call for two scheduled payments to be made during the year for the fall and spring semesters at the beneficiary's college. The trustee is guided by the terms of the trust and must adhere to fiduciary standards.

Be aware that the protection isn't absolute. Once the beneficiary receives a cash payment, he or she has full control over that amount. The money can be spent without restriction and may be attached by creditors.

Role of the trustee

The role of the trustee obviously is an important one. Depending on the trust terms, he or she may be responsible for making scheduled payments or have wide discretion as to whether funds should be paid, and how much and when.

For instance, the trust may empower the trustee to make set payments or retain discretion over amounts to be paid or even over whether there should be any payment at all. Or maybe the trustee is directed to pay a specified percentage of the trust assets, so the payouts fluctuate depending on investment performance. In the same vein, the trustee may be authorized to withhold payment upon the happening of specific events (such as if the beneficiary exceeds a debt threshold or has to declare bankruptcy).

Designating the trustee is an important consideration, especially in situations where he or she will have broad control. Although it's not illegal to name yourself as trustee, this is generally not recommended. More often than not, the trustee will be an attorney, financial planner or investment advisor, or someone else with the requisite experience and financial acumen. You should also name a successor trustee in the event the designated trustee dies before the end of the term or otherwise becomes incapable of handling these duties.

Other key considerations

There are several other critical aspects relating to crafting a spendthrift trust. For example, you must establish how and when the trust should terminate. The trust could be set up for a term of years or termination may occur upon a specific event (such as a child reaching the age of majority). In addition, you should provide for contingencies, such as the beneficiary dying or sustaining a serious illness or injury before the trust ends.

Finally, try to anticipate other possibilities, such as enactment of tax law changes, that could affect a spendthrift trust. A word to the wise: This isn't a do-it-yourself proposition. Consult your estate planning advisor for assistance when setting up a spendthrift trust. •

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You die without having drafted a will

Where there's a will, there's a way — a way to pass assets to your heirs in the manner in which you want. However, if you die without a will (or an appropriate trust) — "intestate" in legal parlance — your assets will be distributed according to state law, regardless of your intentions. This also increases the possibility of a contest in the courts.

The division of your assets in your estate is based on the laws in the state where you reside. However, if you own assets in a different state, such as a vacation home or investment real estate, the laws of that jurisdiction apply to those assets.

Although state laws vary, assets owned in your name generally will be split among heirs, which may include a surviving spouse, children, parents and siblings. The rules might be stretched to more distant relatives if immediate family members can't be found. If there are no surviving heirs under state law, your entire estate will go to the state.

Of course, if you own property jointly with someone who has survivorship rights, such as your spouse, legal ownership is transferred to the joint owner. Similarly, if you're married and reside in one of the handful of community property states, any property acquired during your marriage goes to the surviving spouse.

It can get more complicated for estates of those who were married at the time of death and had children from a prior marriage. Generally, those children will be entitled to share in the estate with the surviving spouse.

Best approach: Create a legally valid will (or set up an appropriate trust) spelling out your wishes. This can avoid the potential pitfalls of dying intestate.

Clark Hill Personal Legal Services Group

Thomas M. Dixon specializes in litigating cases involving wills, trusts, and probate estates. Tom has substantial experience with will and trust contests and related litigation involving claims of undue influence, lack of testamentary capacity, fraud, and duress.

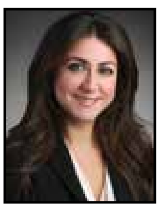
Tel: (313) 965-8587 • **Fax:** (313) 309-6887
Email: tdixon@clarkhill.com

Thomas E.F. Fabbri is an Associate in the Personal Legal Service Group of Clark Hill's Birmingham office and concentrates his practice in estate planning, tax planning, and probate matters.

Tel: (248) 988-5856 • **Fax:** (248) 988-2319
Email: tfabbri@clarkhill.com

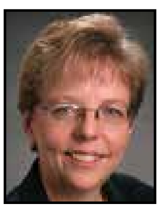
Ryan M. Holmes focuses his practice on estate and trust planning and administration, estate planning for digital assets, special needs planning and administration, income, gift, generational and estate tax planning, probate and guardianship administration, and probate, trust and guardianship litigation.

Tel: (312) 985-5918 • **Fax:** (312) 985-5594
Email: rholmes@clarkhill.com



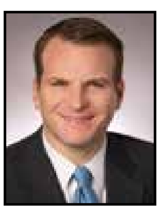
Mallory A. Kallabat is an Associate with the firm's Personal Legal Services Practice Group of Clark Hill's Birmingham office. She focuses her practice on estate planning, tax planning and probate matters.

Tel: (248) 530-6342 • **Fax:** (248) 988-2307
Email: mkallabat@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

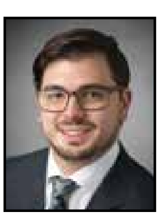


Ray J. Koenig III practices in the areas of probate litigation, trust litigation, fiduciary litigation, elder law, estate planning, and estate administration, with an emphasis on will, trust, guardianship, and advance directive contests and other fiduciary litigation. Ray has represented individuals, 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.

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

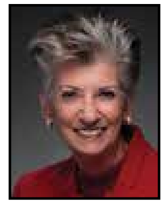
J. Thomas MacFarlane specializes in estate, tax and business succession planning and in probate matters. He is a Fellow of the American College of Trust and Estate Counsel, and he is listed in *The Best Lawyers in America*, *Michigan Super Lawyers* and *Michigan Leading Lawyers*.

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



Nicholas E. Papasifakis is an Associate in Clark Hill's Personal Legal Services Group in Birmingham, Michigan. Nick focuses his practice on estate, tax and business succession planning, and probate and trust administration and litigation.

Tel: (248) 530-9132 • **Fax:** (248) 530-9170
Email: npapasifakis@clarkhill.com



Darra L. Rayndon, a Member in Clark Hill's Estate Planning & Probate Practice Group, has over 30 years of practice experience and is certified as a tax specialist by the Arizona Bar. Darra's work includes tax planning, business entity formation and representation including corporations, partnerships, limited liability companies, and other businesses, estate and wealth succession planning, asset protection, exempt private offerings, and real estate matters.

Tel: (480) 822-6746 • **Fax:** (480) 684-1170
Email: drayndon@clarkhill.com

Heather C. Stumpf is an Associate in the firm's Estates and Trusts Practice Group. She focuses her practice on all aspects of estate and trust planning and administration. Heather advises her clients on the various complexities of estate and trust documents, including special and supplemental needs trust provisions, tax planning implications and the division of assets. She utilizes her experience acting as a corporate fiduciary to support individuals and families with retirement planning and multi-generational wealth transfer.

Tel: (412) 394-2485 • **Fax:** 412-394-2555
Email: hstumpf@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
Email: 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

Michelle Margolies Tran, Senior Counsel in Clark Hill's Estate Planning and Probate Practice Group, focuses her practice in the areas of sophisticated estate and tax planning for individuals, families, and businesses, using trusts and business entities to help her clients achieve their asset succession, estate tax reduction, and asset protection goals. She also assists her clients in the creation of business entities and business transfers, complex trust and estate administration, probate, prenuptial agreements, and QDROs.

Tel: (480) 822-6745 • **Fax:** (480) 684-1169
Email: mtran@clarkhill.com

Keith H. West is a Member with Clark Hill's Personal Legal Services practice group, has been involved in all facets of estate planning and estate administration for over 25 years. While in law school, Keith received the American Jurisprudence awards in estate planning and conflicts of law. In 2005, 2006 and 2011, Keith was named a Pennsylvania Super Lawyer, an honor bestowed upon the top five percent of Pennsylvania lawyers.

Tel: (412) 394-7756 • **Fax** (412) 394-2555
Email: kwest@clarkhill.com