The Estate Planner

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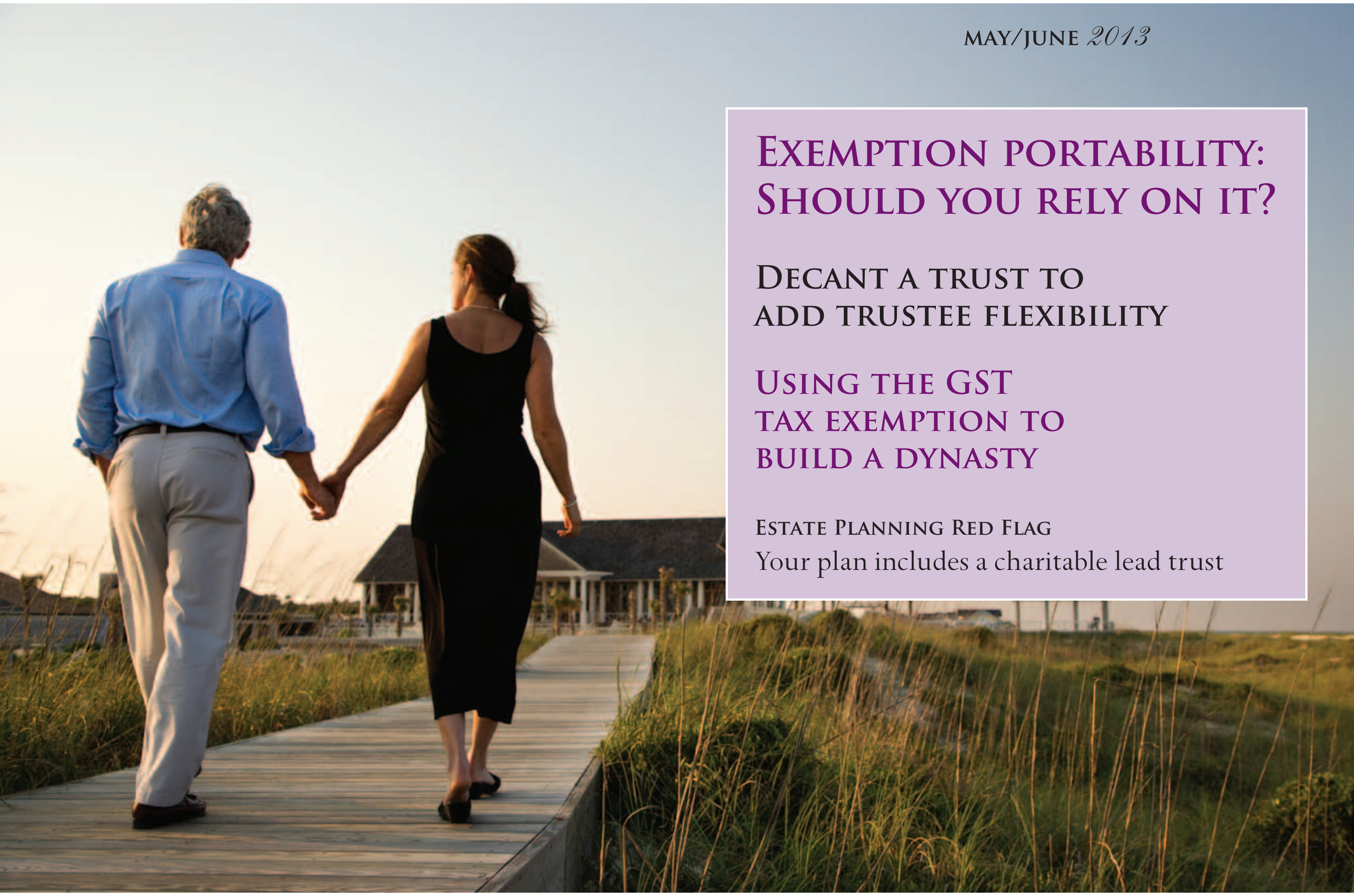

Exemption portability: Should you rely on it?

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Estate Planning Red Flag
Your plan includes a charitable lead trust

Exemption portability: Should you rely on it?

One of the significant changes under the American Taxpayer Relief Act of 2012 (ATRA), signed into law back in January, was to make estate tax exemption "portability" permanent. When one spouse dies, portability allows the surviving spouse to use the deceased spouse's unused exemption amount. This means that married couples can now maximize the benefits of their combined exemptions without the need for sophisticated estate planning involving multiple trusts.

Portability simplifies estate planning, but should you rely on it? Doing so may be appropriate under certain circumstances. But for many people, particularly the affluent, more-sophisticated strategies continue to offer significant benefits.

Life before portability

Before portability, the traditional approach for maximizing a couple's exemption amounts was to employ an "A-B trust" arrangement. Generally, the "A" trust is a marital trust and the "B" trust is a credit shelter, or "bypass," trust. For this strategy to be most effective, spouses should "equalize" their estates by, to the extent necessary, transferring assets from one to the other.

When one spouse dies, his or her assets are used to fund the credit shelter trust up to the exemption amount (currently $5.25 million) less any gift tax exemption used during life. This trust benefits the surviving spouse for life and then distributes the remaining assets to the couple's children or other beneficiaries. The excess, if any, goes into the marital trust, which benefits the surviving spouse and qualifies for the unlimited marital deduction. The assets in this trust are included in the surviving spouse's estate.

This strategy avoids estate taxes on the first spouse's death and minimizes estate taxes on the second spouse's death. The credit shelter trust fully uses the first spouse's exemption and, by limiting the second spouse's access to the trust, keeps the assets out of his or her taxable estate. If the first spouse's estate exceeds the exemption amount, the excess goes into the marital trust, where it's shielded from estate tax by the marital deduction. There may, however, be an estate tax liability on the second spouse's death, depending on the size of his or her estate.

Life after portability

If you and your spouse have estates that total less than your combined exemption (currently $10.5 million) and are unlikely to climb above that amount, portability should shield you against estate taxes without the need for trust planning.

Why the affluent still need credit shelter trusts

Nick and Nora each have $10 million in assets. Nick dies in 2013, leaving all of his assets to Nora, for a total of $20 million. Nick hasn't used any of his $5.25 million gift and estate tax exemption, and his estate files a portability election. When Nora dies 10 years later, the value of her assets has doubled, leaving her with a $40 million estate. For purposes of this example, assume that the exemption amount remains at $5.25 million and the tax rate is 40%.

Nora's estate is subject to tax on $29.5 million ($40 million less her exemption and Nick's exemption), for a tax liability of $11.8 million. Had Nick's estate plan placed $5.25 million in a credit shelter trust, Nora's estate would have avoided tax on its appreciation in value — $5.25 million — for an estate tax savings of $2.1 million.

But if your estates exceed that threshold or may do so at some point in the future, an A-B trust arrangement remains the most effective strategy for minimizing estate taxes.

When assets are placed in a credit shelter trust, their value is frozen for estate tax purposes. This means that any future appreciation on those assets bypasses your surviving spouse's estate. But if you rely on portability, future appreciation will be included in your spouse's estate. This could trigger significant estate tax liability. (See "Why the affluent still need credit shelter trusts" on page 2.)

Even if your and your spouse's combined estate is unlikely to ever exceed your combined exemption, however, trust planning offers several important benefits:

Asset protection. Portability allows you to leave your wealth to your spouse outright without wasting your estate tax exemption. But it does nothing to protect those assets from your spouse's creditors or financial mismanagement. Well-designed and managed trusts remain the most effective way to protect your assets and preserve them for future generations.

Remarriage protection. Trust planning ensures that your children are provided for, even if your spouse remarries. A credit shelter trust prevents your spouse from spending your children's inheritance on his or her new spouse or on children from the subsequent marriage. It also avoids potential loss of portability benefits in the event your spouse's new spouse dies. Portability is available only for a person's most recently deceased spouse. If your spouse remarries and his or her new spouse dies, portability will be limited to the new spouse's unused exemption — which could be little or nothing.

Generation-skipping transfer (GST) tax planning. The GST tax exemption (also $5.25 million this year) is *not* portable. So if you and your spouse wish to maximize your GST exemptions for bequests to your grandchildren, you'll want to consider trusts. (See "Using the GST tax exemption to build a dynasty" on page 5 for more on GST tax planning strategies.)

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Also keep in mind state estate tax planning. Unless your state's law recognizes portability for estate tax purposes, you may need to use trust planning to preserve your state exemption amounts.

Plan carefully

Portability has the benefit of simplicity, but before you rely on it, review your situation and consider whether you'd be better off with more-sophisticated estate planning strategies. If you decide to rely on portability, keep in mind that it's not automatic. A surviving spouse can take advantage of portability only if the deceased spouse's executor makes an election on a timely filed estate tax return. ✤

Decant a trust to add trustee flexibility

John is the trustee of his deceased brother's irrevocable trust. In light of the recently enacted estate tax laws, as well as changing circumstances surrounding his brother's family, John would like additional flexibility in adapting the trust to the new laws and evolving family situation. One of John's options is to decant the trust.

Decanting would allow John to use his distribution powers to "pour" funds from the trust into another trust with different terms. Even though this strategy is permitted in many states, decanting laws can vary dramatically from state to state.

Additional options for trustee

Depending on the language of the trust and applicable state law, decanting may allow the trustee to correct errors, take advantage of new tax laws, eliminate or add a beneficiary, extend the trust term, modify the trust's distribution standard, and add spendthrift language to protect the trust assets from creditors' claims.

If you're in the process of planning your estate, consider including trust provisions that specifically authorize your trustee to decant the trust.

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State differences

Differences in state law complicate the decanting process. In some states, decanting is authorized by common law. But in recent years, more than a dozen states have enacted decanting statutes. Several other states are considering similar laws. A detailed discussion of the various decanting laws is beyond the scope of this article, but here are several issues that you and your advisor should consider:

Taking advantage of another state's law. Generally, if your trust is in a state without a decanting law, you can take advantage of another state's law. But to avoid any potential complaints by beneficiaries, it's a good idea to move the trust to a state whose law specifically addresses this issue. In some cases, it's simply a matter of transferring the existing trust's governing jurisdiction to the new state or arranging for it to be administered in that state.

Court approval. Most states' laws permit decanting without court approval. If the trustee anticipates beneficiary objections, however, he or she may want to seek court approval voluntarily.

Beneficiaries. Decanting laws generally don't require beneficiaries to consent to a trust decanting and several don't even require that beneficiaries be notified. Where notice is required, the specific requirements are all over the map: Some laws require notice to current beneficiaries while others also include contingent or remainder beneficiaries. Even if notice isn't required, notifying beneficiaries may help stave off potential disputes down the road.

Trustee authority. When exploring decanting options, trustees should consider which states offer them the greatest flexibility to achieve their goals. Generally, decanting authority is derived from a trustee's power to make discretionary distributions. In other words, if the trustee is empowered to distribute the trust's funds among the beneficiaries, he or she should also have the power to distribute them to another trust. But state decanting laws may restrict this power.

Some decanting laws, for example, require the trustee to act in the best interests of certain beneficiaries or

heirs or to meet certain standards of care. Also, while decanting laws generally allow decanting when the trustee has complete discretion over distributions of principal and income, their rules differ for trustees whose powers are restricted. Some allow decanting only if the trustee has the authority to distribute principal, while others allow it even if the trustee has only income distribution authority.

Don't try this at home

After learning more about the benefits of decanting a trust, John is intrigued by the additional flexibility he could have as trustee. However, he's also concerned about how state law differences affect trust decanting. Before taking action, it's best to discuss the ins and outs of decanting with an estate planning advisor. ✤

Using the GST tax exemption to build a dynasty

If you wish to preserve your wealth for generations to come, you'll need to leverage your generation-skipping transfer (GST) tax exemption. Like the gift and estate tax exemption, the GST tax exemption stands at an inflation-adjusted $5.25 million, thanks to the American Taxpayer Relief Act of 2012 (ATRA).

To ensure that your GST tax exemption goes as far as possible, it's important to allocate it wisely. ATRA made permanent several GST tax-related provisions, including the automatic allocation rules. Understanding these rules — and when to opt out — will help you focus your exemption where it will do the most good. With careful planning, you can create a "dynasty trust" — a trust that continues for several generations.

How the GST tax works

GST tax applies to transfers to "skip persons" — that is, grandchildren or other relatives more than one generation below you or nonrelatives more

Allocating your exemption

If your generation-skipping gifts won't exceed the $5.25 million exemption amount, allocation isn't an issue. But if you don't have enough exemption to go around, you should allocate it in a way that maximizes the tax savings.

A powerful tool for leveraging the exemption is an irrevocable trust. You need to allocate only enough of your exemption to cover your contributions to the trust for any future growth to be shielded from GST taxes — thus creating a "dynasty."

than 37½ years younger than you. (There's an exception, however, if your child predeceases you. In that case, your grandchildren by that child are no longer considered skip persons.)

The tax applies — *in addition to* gift and estate taxes, at the highest marginal estate tax rate (currently 40%) — to:

- Direct skips — outright gifts or bequests to a grandchild or another skip person, or transfers to a trust whose beneficial interests are held only by skip persons,
- Taxable trust terminations — for example, when a child with a life interest in a trust dies, causing the trust assets to pass outright to a skip person, and
- Taxable trust distributions — distributions from a trust (other than a direct skip or trust termination) to a skip person.

The GST tax applies only to transfers that are subject to gift or estate tax. So, if you make an outright gift to a grandchild that's within the annual gift tax exclusion (currently $14,000 per recipient) or a direct payment of qualifying tuition or medical expenses on a grandchild's behalf, there's no GST tax.

Suppose, for example, that you transfer $5 million to a trust for the benefit of your grandchildren and allocate $5 million of your GST exemption to the trust. If the trust's value grows to $20 million over the next 20 years, the entire amount will be exempt from GST taxes.

As you plan your estate, pay attention to the automatic allocation rules, which automatically allocate your GST tax exemption to direct skips and certain trust contributions.

Automatic allocation

As you plan your estate, pay careful attention to the automatic allocation rules, which automatically allocate your GST tax exemption to direct skips and certain trust contributions. These rules are designed to prevent you from inadvertently losing the benefits of the exemption. But in some cases, it makes sense to opt out.

Say you're making several outright gifts to your grandchildren but you're also planning to set up a $5 million trust for their benefit. To save your exemption for the trust, where it will generate the greatest tax savings, you might want to opt out of automatic allocation for the outright gifts.

Decades of tax-free growth

By leveraging your GST tax exemption, a dynasty trust can grow and compound transfer-tax-free for decades to benefit your grandchildren and future generations. Plan carefully to ensure that automatic allocation of your exemption to other GSTs doesn't preclude you from achieving your goals. ✤

Estate Planning Red Flag

Your plan includes a charitable lead trust

Last year, the IRS finalized regulations that affect the way charitable lead trusts (CLTs) are taxed. As a result, CLTs may be less attractive than before.

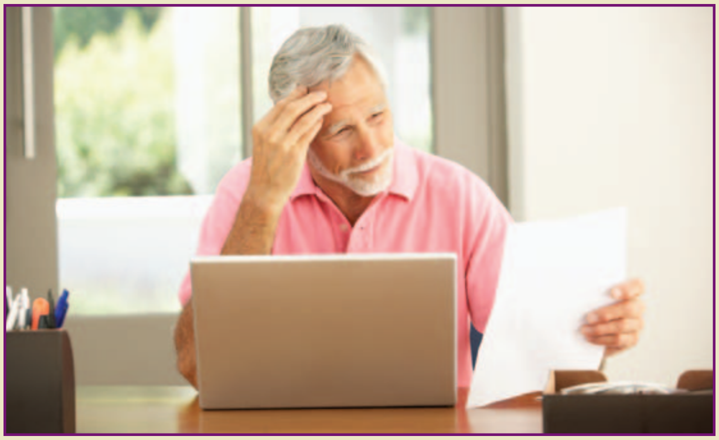
A CLT makes annual payouts to a qualified charity for a specified period or for the grantor's life. The remainder interest then passes to the grantor's heirs or other noncharitable beneficiaries. Lifetime CLTs are usually designed as nongrantor trusts, which are subject to taxes on their net income. Testamentary CLTs (that is, CLTs funded at death) are also taxable trusts.

To minimize taxes, CLTs often contain "ordering rules," which provide for the highest-taxed income classes to be distributed to charity first. Typically, distributions are made from ordinary income, followed by capital gains, then other types of income (including tax-exempt income) and finally trust principal.

The objective is to remove from the trust, to the extent possible, the least desirable income types, leveraging the benefits of the trust's charitable deduction. The income retained by the trust is either taxed at a lower rate or not taxable.

The IRS has never liked this strategy, and last year it finalized regulations that make it difficult to achieve. The regulations provide that ordering rules are disregarded for federal tax purposes unless they have "economic effect independent of income tax consequences." Instead, distributions are deemed to consist of a *pro rata* portion of each type of trust income.

Some commentators argued that ordering rules have an independent economic effect because disregarding them would increase the CLT's tax liability, reducing the trust's value and, in turn, reducing charitable distributions and jeopardizing the noncharitable beneficiaries' remainder interest. The IRS rejected this argument.



If your estate plan includes a CLT, be sure to evaluate the potential impact of the new regulations.