Legal Matters®

Estate Planning
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Help your heirs avoid capital gains tax

In the past, estate planning was mostly about reducing the impact of the federal estate tax. The tax was so onerous, and potentially affected so many people, that the goal was to avoid it like the plague.

One way to reduce estate taxes was to put assets into an irrevocable trust. The tax savings could be accomplished in a number of ways, but the key was that, when the person who created the trust died, the trust assets would go on to benefit his or her heirs, and would not be subject to the estate tax.

This was very smart planning at the time. Over the last few years, however, the situation has dramatically changed.

For one thing, the federal estate tax is now much less of a burden. This year, the tax doesn't even kick in at all unless a person who dies has an estate of more than $5.43 million. So unless a single person is worth at least that much (or a married couple is worth at least $10.86 million), it's simply not an issue.

At the same time, though, capital gains taxes have increased significantly. The federal rates have gone way up, many states have hiked their own rates, and a new 3.8% Medicare surtax on capital gains has been imposed on many taxpayers.

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The new, higher capital gains rates can be a big problem for people who in the past have used irrevocable trusts in their estate planning. Here's why: Suppose Sally dies, and in her will she leaves stocks, real estate, or other assets that have appreciated in value to Jim. For capital gains purposes, Jim's "basis" in these assets will be their value at the date of Sally's death – and not their value when Sally first bought them. Jim's basis will be "stepped up" to the date-of-death value of the assets. So if Jim sells them soon afterward, he'll owe little if any capital gains tax.

But if the assets *don't* go to Jim in Sally's will, and instead he receives them via an irrevocable trust, in many cases Jim's basis will not be "stepped up." He'll have to pay tax on all the appreciation in the assets' value since the time when Sally first bought them.

This means that many irrevocable trusts, which were set up years ago as a tax benefit, have suddenly become a tax burden. In many cases, the trusts are no longer necessary to avoid the federal estate tax, and the family might have to pay less in taxes overall if it were possible to undo the arrangement and have the trust assets be treated as part of the donor's estate.

Undoing a trust isn't always feasible, but if there's an irrevocable trust in your family, it's worth talking to an attorney to see if something can be done.

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Estate planning for people who don't have families

A growing number of older people don't have a spouse, children, or other close relatives. One of the biggest concerns in such a situation is how to prepare in case the person eventually becomes disabled or incapacitated.

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Such a person could, of course, give a power of attorney to a friend, and assume the friend will take care of things. However, friends the same age might die or become incapacitated themselves. They might be overwhelmed with all the responsibilities of taking care of a disabled person, especially since it might be a stretch to ask their own family members for help with someone who is not part of the family. And sadly, there have been many cases where friends have gotten into financial straits and ended up taking advantage of a power of attorney.

There are a number of possible solutions, but here's one that can work well, especially if you already have a good relationship with a reputable bank or trust company: Set up a revocable trust to fund your care if you become incapacitated, and have the bank or trust company oversee your situation.

Most banks will not agree to be a general agent under a power of attorney. But they will often agree to be the trustee of a revocable trust, and then accept a limited power of attorney solely for the purposes of transferring assets to the trust.

Here are some further suggestions if you choose to take this route:

- Some banks are reluctant to be a trustee if the trust contains a home, especially if the home is in another state. The solution might be to put the home into an LLC, so the trust will contain LLC shares rather than directly owning real estate.
- Transferring as many accounts as possible – checking, credit cards, etc. – to the bank will make it easier for the bank to manage your assets.
- If you have no one to name as your agent in a health care power of attorney, consider asking your doctor for a "Physician Ordered Life Sustaining Treatment" order, which details what end-of-life care you want. Unlike a living will, this is an actual doctor's order which is included in your medical chart and is binding on emergency workers.
- Finally, try to create checks and balances so someone is overseeing what the bank is doing. The terms of your trust can require the trustee to engage independent accountants, health care managers, and other professionals to keep tabs on your care.

Sales of 'longevity insurance' are growing quickly

There's a new product on the market called "longevity insurance."

This is really just a new name for an old concept, the deferred annuity. Unlike most annuities, which are purchased with a lump sum and begin paying out soon afterward, these policies typically don't begin paying anything until some 10 or 20 years after you buy them.

Sales of these annuities were up 35% last year from a year earlier.

The idea is that, if you outlive your life expectancy, you can receive fairly large annual payments in your later years for a relatively small investment upfront. But there are downsides, too, as there can be with any annuity.

If you're considering buying such a product, it's a good idea to discuss integrating it with your current estate plan.

How you can help your heirs avoid capital gains taxes

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For instance, if the irrevocable trust is a grantor trust – one that is taxable to the donor – then in some situations, Sally might be able to "swap" assets in the trust.

Suppose some of the trust assets have greatly appreciated in value and have a low basis. If Sally owns other assets that haven't appreciated in value and have a high basis, she could "take back" the low-basis assets from the trust, and pay for them with the high-basis assets. As long as the assets are of equal value, there might not be any problem with this – but the resulting capital gains taxes would be greatly reduced.

In the past, many couples' wills created a trust at the death of the first spouse. This trust provides income to the surviving spouse during his or her life, with the assets going to the children when the second spouse dies. In such a situation, it might be possible to selectively distribute low-basis trust assets to the surviving spouse, to move as many of them as possible into his or her estate and out of the trust.

There's even a technique in some cases whereby Sally could "appoint" the trust assets to go instead to an elderly family member – let's call him Phil – with a short life expectancy. Phil would then appoint the assets to go to Jim when he dies. The trust assets would get a step-up in basis at the time of Phil's death. As long as the assets aren't large enough to cause Phil's estate to owe any estate tax, everyone benefits. (This technique is tricky, though, and only works in limited circumstances.)

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Finally, if the trust's terms don't allow any of these alternatives, it might be possible to move the assets into a new trust with different rules. This is sometimes called "decanting" a trust, because the assets are being poured from an old container into a new one. Some 22 states currently allow decanting of irrevocable trusts in at least some circumstances.

In any event, it's worth taking a second look at any irrevocable trusts, so that yesterday's tax savings don't become tomorrow's tax nightmare.

Supreme Court decision alters estate planning for gay couples

The Supreme Court's recent ruling extending same-sex marriage throughout the U.S. has changed the estate planning landscape for gay couples.

The biggest change, of course, will be for couples living in states that didn't recognize same-sex marriage before the decision. But the ruling is also important for couples in states that previously permitted same-sex marriage, because in the past, their estate planning had to take into account the fact that they might travel, own property, or retire in a state that didn't recognize their union. This is no longer true.

For example, in the past, couples who resided in a "non-marriage" state couldn't take advantage of the federal law that says a person can leave an unlimited amount of assets to a spouse in a will without being subject to the federal estate tax. And they couldn't take advantage of another provision that allows one spouse to "inherit" the other's unused estate tax exemption.

Real estate was an issue, too, because in many states couples cannot own property as tenants by the entireties unless they are married. And if gay couples wanted to share equal ownership of a house or other property in a non-marriage state, but they didn't put up equal funds toward the purchase price, they might have to pay gift tax – something that's not true for married couples.

In the past, couples in non-marriage states couldn't file joint tax returns. The resulting uncertainty over long-term tax rates could play havoc with decisions over IRA and 401(k) distributions, Roth conversions, and other issues that are part of a complete estate plan.

Speaking of IRAs, couples in non-marriage states also couldn't take advantage of the IRA "spousal rollover" provision that allows people who inherit an IRA to stretch out payments and reduce taxes.

Married same-sex couples in all states will now be entitled to receive Social Security spousal and survivor benefits, which could potentially result in tens or even hundreds of thousands of dollars in additional payments over a lifetime.

In states where same-sex partners who adopted a child couldn't both be legally recognized as a parent, this will no longer be true, which has numerous estate planning implications.

Spouses of the same sex can now be named in a health care power of attorney, act as an executor, and plan a funeral without risking a legal challenge from other family members.

Finally, gay spouses will now be able to inherit assets from someone who died without a will, and claim an automatic "spousal share" in cases where a partner's will left the bulk of his or her assets to someone else.

The Supreme Court's ruling changes a great many things, and it's a good time for any same-sex couples who are married or are contemplating marriage to do a complete review of their estate plans.

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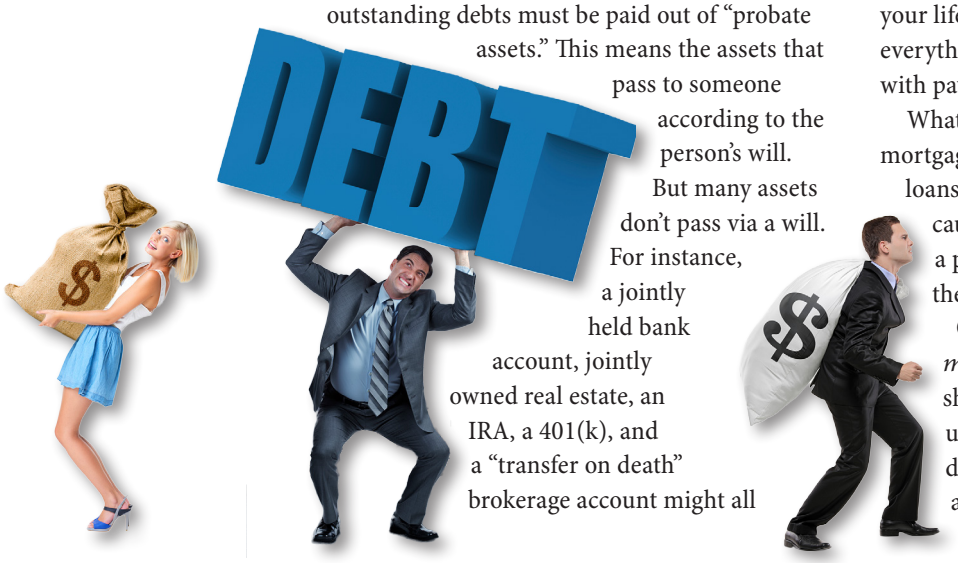
Some bequests 'look' equal, but they penalize one heir

When you're deciding how to divide your assets among multiple heirs, it's very important to consider who will pay your estate's debts out of their share. Two bequests that look equal in theory might be very different in practice once debts are taken into account.

Generally, when a person dies, his or her outstanding debts must be paid out of "probate assets." This means the assets that pass to someone according to the person's will.



But many assets don't pass via a will. For instance, a jointly held bank account, jointly owned real estate, an IRA, a 401(k), and a "transfer on death" brokerage account might all pass to someone outside of a will, and thus not count as probate assets.

Also, life insurance proceeds aren't dependent on a will and aren't considered probate assets either.

That means that if you have three children, and one gets your retirement accounts, one gets your life insurance proceeds, and the third gets everything else, the third child will be saddled with paying 100% of your debts.

What's a debt? Debts can include taxes, a mortgage, outstanding credit card bills, personal loans, condo fees, and more. Even car leases can cause problems, because some contracts treat a person's death as an "early termination" of the lease.

Of course, your children or other heirs *might* be very cooperative and agree to share the burden of your debts. But it's usually much easier for everyone if you take debts into account in your estate planning, and divide your assets accordingly.