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PRACTICAL PLANNER

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CURRENT TAX, ESTATE AND FINANCIAL PLANNING

Summary: Commerce Clearing House (CCH) publishes one of the most widely used on-line tax, estate and financial planning research resources. Their Advisory Board meets annually to discuss the state of planning, this issue of Practical Planner summarizes many of the ideas from their most recent meeting.

■ **Permanent Changes: We now have a $5 million, inflation adjusted, permanent, transfer tax exemption. But are the 2012 tax law changes really "permanent"? President Obama has already proposed in his budget (Greenbook) subsequent to the 2012 act to change the "permanent" rules to tax the wealthy more. Do we really have permanency? Few commentators are convinced this is the case. So while the new law is "permanent," it seems that nary a tax specialist around is convinced. What does that mean to taxpayers? If there are tax breaks still available you can benefit from, grab 'em while you can.**

■ **Planning for Large Estates: What planning is being done for large estates? Do we mean venti, grande...? Whatever. Anyone worth more than the federal exemption, those worth less but who live in decoupled states with low exemptions, and anyone else who just loves to have complex and costly estate planning, should continue to deploy the existing arsenal of estate tax planning techniques used in the past. Many of these can be tweaked to better deal with the higher income tax rates. Several of these fall in the category discussed above of "grab 'em while you can." ♣ Is there anyone who is wealthy who did not make large gifts to trusts in 2012 before the law may have changed? Those of you who didn't should use what remains of your $5.25 million exemption. Most if not all gifts should be made to irrevocable, dynastic, grantor, trusts (there's a long list of remaining adjectives, but…). ♣ Self-settled, asset protection, completed gift, trusts remain popular for some. These are trusts to which you gift assets, intend those asset be removed from your estate, yet you remain, in some fashion, a beneficiary of the trust. In spite of several recent court cases ruling against self-settled trusts, there were no grumblings from the Board when one well known adviser mentioned that he continues to use these. That's good news for anyone worried about lawsuits, malpractice, taxes, or divorce (does that leave anyone out?). Nonetheless, caution is in order. ♣ GRATs (grantor retained annuity trusts) remain popular, despite the fact that the President's Greenbook still recommends establishing a minimum 10 year term. For those wealthy folks who have used up their exemption amounts, zeroed-out GRATs, which shift the growth in the value of assets above a hurdle rate of return outside the estate, with little or no current use of gift exemption, are an ideal tool. ♣ Sales to defective grantor trusts are hot since interest rates remain low and many asset values have not fully recovered from the recession. President Obama has targeted this technique for restriction or repeal. ♣ FLPs and LLCs provide control, asset protection, and valuation discounts. Recent cases on discounts seem to vary as to amounts of discounts that might be allowed, but in most cases meaningful leverage can be obtained. ♣ SCINs (self-cancelling installment notes) can be used when a parent sells appreciating assets to a child or trust. If the parent dies before the note is repaid in full, the note is cancelled and no value remains subject to estate tax. ♣ Transfers to grantor trust remain the rage. These trust have you, as the grantor/donor continue to pay income tax on income earned by the trust. This characterization continues to reduce your estate by the income tax paid and also permits you to "swap" assets without triggering capital gains tax. This can enable you to bring appreciated trust assets back into your estate so that their tax basis (the amount on which gain or loss is calculated) is increased (stepped-up) to fair value at death. ♣ Low interest loans to family members are a simple technique to shift growth out**

(Continued on page 2)

CHECKLIST: INCOME TAX TIPS

Summary: The CCH Advisory Board also tackled the new income tax paradigm. We face some of the highest income and capital gains tax rates in many years, and there is more progressivity in the tax system as well. More attention to the income tax consequences of planning, even of estate planning, is the new normal.

√ **Gifts (and other transfers) should be to grantor trusts. As explained in the lead article this supports continued tax burn as the donor pays income tax on trust earnings, but more importantly permits you to "swap" assets transferred to the trust back into your estate to capture a basis "step up" at death. These two benefits are so powerful that wealthy taxpayers meowing for simplicity or cheap planning will miss out on the tax planning fun.**

√ **Buy back or swap assets before death to obtain basis step up. If you've left your Ouija board at home, you had best opt for periodic reviews with your advisers to identify what assets to swap or move where, when and how.**

√ **Integrate income tax planning with your overall investment strategies. Consider the new dimensions to the income tax system: 39.6% tax rate on high income individuals, an additional 5% capital gains rate, a 3.8% Medicare tax on net investment income (NII). 0% capital gain rate at 15% ordinary income bracket,**

(Continued on page 3)

...CURRENT TAX, ESTATE AND FINANCIAL PLANNING

(Continued from page 1)

of a benefactor's estate while interest rates remain low. ♣ Split-dollar insurance loan arrangements are another type of loan technique used to purchase life insurance. Low interest rates make these useful, but also, the incredible income tax benefits permanent life insurance affords, and continued estate tax leverage, make these transactions popular. ♣ Partnership freeze transactions are useful if you own negative basis real estate and in other circumstances.

■ Gift Planning Human Aspects: ♣Tax driven planning will not be particularly relevant for most clients. Only about 3-4,000 estates a year will pay a federal estate tax. That being said, about 20 states have decoupled from the federal estate tax rules so many estates will face state estate or inheritance taxes. While these can "add up" the 16% highest rate is nothing like the confiscatory estate tax many would have faced. What all this means is that the estate planning conversation will finally have room for more than a discussion of taxes for most folks. That's a good thing IF people still pursue planning. ♣ Planning will focus more on personal goals and what is often referred to as values based wealth transfers. This is the warm and fuzzy stuff many advisers did not learn about in law school! How do you want to incentivize your descendants? What types of values do you want to communicate to your heirs? ♣ What benefits do you wish to give to your heirs? ♣ Consider creating a statement of objectives, a sort of "family wealth charter" analogous to a business' mission statement. What is your intent for bequests? What do you hope the money left will do for your heirs? What planning desires might you provide as a guide for heirs and trustees? This statement should be reviewed periodically and refined. It should evolve over time as your wishes become clearer and your heirs begin to be brought into the planning process. Have you ever had your children attend an estate planning meeting? You should! ♣ While everyone of means lamented the estate tax as the ultimate destructive force of family wealth, the estate tax at its worst did not hold a candle to the negative impact of family controversy, liability issues, and divorce. For those of moderate wealth, health issues can be the biggest threat to family wealth. These aspects of planning are stepping out of the shadows and starting to receive attention.

■ Will Drafting. ♣ With no estate tax, many will favor simplicity and opt for outright distributions to heirs instead of trusts. That will often prove to be the worst decision. The better answer in many cases will be long term or perpetual trusts. Nothing can protect wealth better from taxes, divorce or lawsuits then a trust. The control or complexity issues are really a smoke screen or excuse clients use to avoid doing what is best. ♣ Wills should include broad authority to shift trust situs to move, if feasible, a trust to a less taxing state if the beneficiaries and trustees move. This is also important as the nuclear family continues to disintegrate and mobility increases. ♣ In moderate estates, include the right, or a mechanism, not to fund trusts provided in the will, or to terminate a trust once formed. Flexibility is key. (Doesn't this contradict what I just said above about trusts being the cat's meow of planning? Of course, but us lawyers are allowed to make contradictory statements). ♣ Allow trustees to include capital gains as part of income so trustees can distribute capital gains to beneficiaries. This may permit capital gains to be taxed to beneficiaries in lower brackets. ♣ It might be more common, especially for first marriage situations, to include a power to distribute appreciated assets from bypass trust. This will enable the family to include those assets in the estate of the second spouse to die and thereby capture a basis increase (step-up) on the second spouse's death. PP

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...Checklist: Income Tax Tips

(Continued from page 1)

15% rate up to $450,000 of income for a married couple, and 20% over that. The different income levels at which itemized deductions are phased out, the highest tax brackets, kick in, or the Medicare tax applies, will leave those using seat of the pants tax planning behind. You need to plan over a longer time horizon in order to ascertain when to realize gains to minimize capital gains tax rates. When you identify the different thresholds, you can then project how much additional income to trigger before you hit the next tax threshold. Then you can trigger just the right amount of income, not to much, not too little. Kinda the tax version of the three bears and the porridge.

√ For trusts the highest brackets apply at very low levels of income. In 2013 trust income over $11,950 is zapped with the highest capital gains tax and the 3.8% tax. So planning distributions to beneficiaries, and assuring flexibility to distribute capital gains (and being able to include them in accounting income), will require watching the income thresholds applicable to trusts.

√ Taxpayers, especially those over 70 ½, will need projections to ascertain marginal tax rates to plan. For example, it may be advantageous to do a Roth conversion.

√ Charitable remainder trusts (CRTs) are hot because they can be used to minimize income taxes. CRTs can avoid higher tax rates today, and can distribute out at lower rates when you as a beneficiary are in a lower rate bracket, e.g., after retirement.

√ If you've stopped working, and are under age 70 ½, you may not yet be taking required minimum distributions (RMDs) from you retirement plan. Conventional wisdom has been to defer taking RMDs until you had to. But now that tax rates are more progressive, it might now be advantageous to take some of that income in that gap years between retirement but before 70 1/2 to realize it at lower tax brackets. This may reduce the ultimate RMDs that come out of your IRA, but you are accelerating income taxes..

√ Have your CPAs review investment planning considerations when they review your income tax returns. Have them coordinate with your wealth managers. Income tax planning must be more integrated with your overall financial plan.

√ Investment and tax planning should be considered when evaluating estimated tax payments. Carefully orchestrated gain harvesting might lower tax estimates.

√ Locate high earning assets in qualified plans to shelter the income from the higher income tax rates.

√ Pack assets into your Roth IRA when feasible. Use 401(k) plans to shift assets into Roth IRAs.

√ Use ETFs to minimize current income taxes.

√ Diversification is critical in light of continued investment uncertainty. The tepid recovery has not changed this worry.

√ Interest rates make it vitally important to address interest sensitive investment assets, e.g., muni-bonds. Interest rates are likely to increase further. This will have a significant impact on costs of margin accounts leveraged portfolios, asset allocations, and other considerations. PP

Recent Developments

DOMA: ■ In the recent Windsor case the Supreme Court held that Section 3 of the Defense of Marriage Act (DOMA) was unconstitutional. Marriage is no longer defined as between a husband and wife. State definitions of marriage will control, so if you were married in a state that recognizes your marriage, the federal government will recognize it too. ■ The IRS quickly issued Revenue Ruling 2013-17 and two sets of Frequently Asked Questions (FAQs). ■ Planning for same sex couples will never be the same. Anyone affected should revisit planning immediately, especially the potential for filing tax refund claims. ■ A qualifying couple will be treated no different than any other married couple for federal estate tax purposes. This means for the first time same sex couples can plan their estates using marital trusts and all the planning options others have used. Wills need to be revised. If your same sex spouse died recently and a tax was paid, it may be advisable to file a refund claim in case the IRS permits this. Even though the FAQs generally apply prospectively, perhaps estate tax refunds will be too. ■ If you were married in a state that recognizes same sex marriages but then moved to a state that does not, you will retain the protection of marriage status for income and estate tax purposes. There had been uncertainty as to whether you had to live in and die in a state that recognized same sex marriage. No longer. ■ If one same sex spouse had left a pension to a charity or parent, and if no waiver was signed, with DOMA repealed the surviving spouse may have a claim on these retirement assets. ■ Registered domestic partners or those who have entered civil unions will not be treated as married for federal tax purpose. These couples should evaluate the benefits of being married in a state that permits it since the tax consequences of marriage are now available with certainty, and the economic benefits can be substantial. ■ Couples should amend prior income tax returns for 2011 and earlier open tax years (3 years from filing) and file a married filing joint return before the statute of limitations runs. The savings for some could be significant. PP

PRACTICAL PLANNER NEWSLETTER
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PLANNING POTPOURRI

■ Powers of Appointment. ♣ Powers of appointment for you non-tax geeks are rights to appoint or designate where assets, such as in a trust, can be distributed. A general power of appointment includes the right to appoint trust assets to your creditors or your estate. This right causes the assets to be included in your taxable estate. ♣ So what's the hottest new idea since the Sham Wow? Expand the scope of trust beneficiaries to facilitate income splitting. For example, a typical credit shelter trust in the old days may have only had the surviving spouse as a beneficiary. Now, include your mother and mother-in-law (imagine how fun annual trust meetings can be!) can all get distributions to spread income to those in the lowest tax brackets. ♣ But just like the Sham Wow infomercial, "there's more!" ♣ Give an independent trustee the right to give these folks general powers of appointment over appreciated assets, or negative basis real estate investments, so that those assets can be included in their taxable estate and get an increase in basis on their deaths. Wow! ♣ So if your mother in law is not loaded she can be given this right. She doesn't have to act on it, it just has to be there. Appreciated assets subject to her general power of appointment are pulled into her estate, but if she is well below the $5M federal estate tax exemption, and lives in Florida which has no state estate tax, the tax basis of those assets will be stepped up and capital gains will magically disappear, and no estate tax will be triggered. ♣ However, if there is an institutional trustee, they may be quite concerned and cautious about exercising the power. ♣ Do this with caution because of creditor issues (does your mother in law drive like your teenage son?). Trust beneficiaries rights are being expanded by states. Most states are expanding the rights of beneficiaries to receive information about trust operations and assets, the right to demand an accounting of the trust, etc. To some extent this can be addressed by selecting a state (situs) that limits these rights. This is yet another example of why the default planning answer is to set up trusts in a trust friendly state like Nevada or Alaska, ya never know when or how it may come in handy. ♣ Creative uses of powers of appointments could prove to be the tax planning gold that grantor trusts have been. That's a big statement. ♣ Less creative uses of these powers will likely prove to be the optimal retirement plan for many probate litigators. PP

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in plain English