

## RECOMMENDED ESTATE PLANNING TECHNIQUES

Ryan, Swanson & Cleveland, PLLC provides estate planning services to clients with estates of all sizes. This memorandum summarizes the estate planning techniques we most frequently recommend to our clients for their consideration.

### Overview

We have found that many married couples have Wills they executed years ago, typically leaving all of their property to the surviving spouse. Many also have a community property agreement that, upon the death of one spouse, automatically will transfer all assets to the surviving spouse (regardless of what the decedent's Will provides). However, if there is a reasonable possibility that the surviving spouse will have a taxable estate (i.e., a net worth, upon his or her death, that would exceed the federal estate tax "applicable exclusion" amount), these individuals are missing a valuable estate tax savings opportunity, because they are failing to make use of the federal estate tax applicable credit of the first deceased spouse.

This is a significant issue because the federal estate tax is one of our highest taxes. The estate tax rate, if applicable, starts at 37 percent and escalates rapidly, to a maximum of 55 percent.

### Planning For Married Couples To Permit The Maximum Use Of The Applicable Credit

Under the Internal Revenue Code, every individual is entitled to an "applicable credit" (formerly known as the "unified credit") that, in effect, permits the individual to pass a certain amount of property, free of estate and gift tax, either during his or her lifetime or upon death. The amount that can be passed under the applicable credit, free of transfer taxes (referred to as the "applicable exclusion amount") is \$650,000 for deaths occurring in 1999. Under the Taxpayer Relief Act of 1997, the applicable exclusion amount is scheduled to increase incrementally each year until 2006, when it will reach \$1,000,000 per person.

Aside from the applicable credit, the federal estate tax "unlimited marital deduction" permits a married individual to pass an unlimited amount to his or her spouse, without paying tax at the time of the transfer (by lifetime gift or at death). However, the marital deduction is not an estate tax exemption; it merely permits the spouses to defer estate tax until the death of the surviving spouse. Therefore, if all of the first spouse's estate passes outright to the surviving spouse, this in essence "wastes" the first spouse's applicable credit. Although there is no estate tax due at the time of the first spouse's death (because of the marital deduction), the assets of both spouses are bunched together in the surviving spouse's estate and, if the resulting value exceeds the applicable exclusion amount available to one person (\$650,000 in 1999), the excess will be subject to estate tax upon the death of the surviving spouse.

## **Credit Shelter Trust**

As an alternative to the transfer of all assets to one spouse, we recommend that whenever a married couple have a potentially taxable estate (i.e., when the couple's combined net worth, including life insurance and retirement plans, is expected to exceed the applicable exclusion amount available to one person), they should have Wills that include provisions for a "Credit Shelter Trust" (which also may be referred to as an "Exemption Equivalent Trust"). With this type of Will, the first deceased spouse directs the first \$650,000 (for deaths occurring in 1999; or more if the applicable exclusion amount is higher in the year of death) of his or her property into a trust for the surviving spouse. The property in the trust is sheltered by the first spouse's applicable credit and is never subject to estate tax (presuming that the trust is properly maintained), even if the assets are left in the trust and permitted to grow to a much larger amount during the surviving spouse's remaining lifetime. The surviving spouse has access to the funds in the trust if needed for his or her support. Such access is somewhat limited, however, in order to prevent the trust assets from being included in the second spouse's estate for estate tax purposes.

Upon the second death, the surviving spouse also has an applicable credit that will permit the surviving spouse to pass property worth up to \$650,000 (in 1999, more in later years) to children or other beneficiaries, free of estate tax. Thus, by using the credit shelter trust, the spouses together can pass, free of estate tax, up to \$1.3 million under the law in effect for 1999 (escalating to a combined total of \$2 million in years 2006 and later).

## **Marital (QTIP) Trust**

Assume that the first deceased spouse's assets (up to the applicable exclusion amount) pass into the Credit Shelter Trust. If the deceased spouse has assets in excess of the applicable exclusion amount, those excess assets can pass to the surviving spouse, without the imposition of estate tax at the time of the first spouse's death, if the assets pass in a way that qualifies for the federal estate tax unlimited marital deduction. To accomplish this, our Wills typically provide for a marital gift either outright or in the form of a marital (QTIP) trust. If a QTIP trust is used, the surviving spouse will receive all of the net income from the trust, and also can be given access to the trust principal as needed for his or her support. However, the surviving spouse does not have the right to dispose of the QTIP property upon his or her own death (as would be the case if the surviving spouse received the property outright). Rather, the QTIP trust property remaining at the death of the surviving spouse will pass to the beneficiaries who were selected by the first deceased spouse. Thus, the QTIP trust permits the first deceased spouse to have a measure of control that would be missing in the case of an outright distribution to the surviving spouse.

If a married couple have assets in excess of the applicable exclusion amounts available to both spouses, or if a single individual has assets in excess of the applicable exclusion amount, the excess would be subject to estate tax (at the death of the surviving spouse or the single individual), at rates starting at 37 percent (or higher as the applicable exclusion amount increases). In those cases, we recommend that the client consider some additional estate planning techniques discussed below.

## **Life Insurance Planning**

Many of our clients create an irrevocable trust with their children as beneficiaries. The trustee should be someone other than the person who creates or contributes to the trust (i.e., the "trustor"). (Note that, under Washington community property law, both spouses would be considered to be trustors to the extent the trust is funded with community property, so neither spouse should be a trustee.) The trustee

is authorized (but not required) to purchase life insurance on the life of the trustor (or may purchase a joint and survivor policy insuring the lives of both husband and wife if they are the trustors). If properly created and administered, the trust (and not the trustor) is recognized as the owner of the life insurance policy. Any proceeds that are paid upon the death of the trustor are not included in his or her estate, and therefore are not subject to estate tax.

In most cases, the trust can be funded with gifts that are within the annual gift tax exclusion amount, and thus the trust can be funded without incurring gift tax liability. Because of the leverage available through the purchase of life insurance, this is an extremely popular estate planning device.

### **Family Limited Partnership or Limited Liability Company**

A family limited partnership could be established to hold stock or partnership interests in entities (other than an S Corporation), or to hold real estate or other assets directly. Such an entity enables an individual to continue to be involved with the management of the assets, as a general partner, while making gifts of fractional interests in the assets to children or other beneficiaries. Because of the discounts normally available for minority interests and lack of marketability associated with a limited partnership, such an entity can permit one to transfer assets for a lower gift tax cost than is generally available with respect to direct transfers. In other words, the partnership permits gift and estate tax savings because the partnership interests are valued at less than a pro-rata portion of the underlying asset. Gift taxes are generally lower because of the discounted value of the gifted partnership interests, and the partnership interests held at the death of the older generation often are discounted as well, assuming the older generation has retained less than a majority interest.

A limited liability company is a relatively new form of entity that operates as a corporation, but is designed to be treated as a partnership for tax purposes. That is, the entity is a "pass-through" entity for federal income tax purposes (i.e., income and loss are reported at the member level and thus double taxation at the entity level is avoided). The limited liability company offers the added advantage (over a partnership) of limited liability for its members, as in the case of a corporation, yet all of the members can be involved in management, if desired. A limited liability company also enables one to take advantage of discounts for lack of marketability and minority interests for estate and gift tax purposes, similar to the discounts available for limited partnerships described above.

Anyone considering forming a limited liability company should be aware that the Washington Department of Revenue is considering adopting the position that a limited liability company engaged in investment activities should pay business and occupation ("B&O") tax on its earnings. In order to lessen the possibility of having to pay B&O tax on investment earnings, some clients are electing to form family limited partnerships instead of limited liability companies.

### **Charitable Remainder Trust**

A charitable remainder trust can be created during one's lifetime or in a Will. The trust can be for the lifetime of the trustor (i.e., trust creator) and/or one or more other individual beneficiaries. The trustee makes distributions to the individual beneficiaries during their lives. The amount remaining in the trust at the death of the last surviving beneficiary is then distributed to a charitable organization. Under the charitable remainder trust rules, the amount distributed to the individual beneficiaries must be equal to at least five percent (and no more than 50 percent) of the fair market value of the trust assets. The value is determined either annually or at the time the trust is funded. In most cases, if the trust is funded with assets other than cash, cash equivalents or marketable securities, the value of the property must be determined by appraisal.

If a charitable remainder trust is created under a Will, the value of the remainder interest passing to charity would qualify for the federal estate tax charitable deduction. Alternatively, if a charitable remainder trust is created during one's lifetime, the trustor would be entitled to an income tax deduction as well as a gift tax deduction (and the property is removed from the trustor's taxable estate).

### **Qualified Personal Residence Trust ("QPRT")**

This estate planning tool permits a homeowner to make a gift of his or her personal residence (i.e., a primary residence and/or a vacation home) to a trust for the benefit of children or other beneficiaries. The "grantor" (i.e., homeowner who transfers the residence to the trust) is permitted to reserve the right to live in the property for a number of years (referred to as a "reserved term of years"). The number of years is selected by the grantor.

The transfer to the trust is a gift for gift tax purposes. The value of the gift (for gift tax purposes) is the fair market value of the residence at the time of transfer to the trust, decreased by the value (determined according to IRS tables) of the reserved term of years. Generally, a longer reserved term produces a correspondingly lower value of the gift for gift tax purposes. The grantor consumes a portion of his or her applicable credit when the transfer is made to the qualified personal residence trust (or, in a case where the applicable credit has been exhausted, the transfer is subject to gift taxes that year). Thus, the lower the value of the gift, the more is saved ultimately on estate taxes.

When creating a qualified personal residence trust, the gift to the trust is irrevocable, and assuming one can survive for the reserved term of years, the residence is not part of the gross estate for federal estate tax purposes. The trust would enable one to remove the value of the residence, plus any appreciation, from the (taxable) estate for a lower transfer tax cost than would be imposed if the residence were a part of the estate.

There are three main drawbacks to the qualified personal residence trust:

1. The residence passes to the children (or other beneficiaries) outright upon the expiration of the reserved term of years. If the grantor wishes to continue to occupy the residence at the end of the reserved term, the grantor needs to pay rent to the beneficiaries. Although such rental payments would represent taxable income to the children, the amount of rent paid by the grantor would be removed from the (taxable) estate. As the estate tax rate generally exceeds the income tax rate, this represents further overall tax savings.
2. If the grantor fails to survive the reserved term of years, the residence is included in the estate (so that the grantor is in no better or worse position than if he/she had not made the transfer to the trust).
3. The residence would lose the step-up in basis that would otherwise be available at the time of one's death, because the step up in basis is available only if the property is included in the decedent's estate.

Some estate planners suggest that a qualified personal residence trust should be used only when the property is not expected to be sold by the younger generation upon the death of the parent. In short, one must balance the likely estate tax savings (i.e., the highest marginal estate tax rate applicable, multiplied by the value of the residence which is being removed from the taxable estate) against the capital gains tax rate (maximum of 20 percent, generally, under current law) that will be applied in the event the property were sold. Note that the capital gains tax applies to the difference between fair

market value and basis (i.e., cost) of the property and is paid at the time of sale of the property (when cash is available). In contrast, death taxes are imposed on the entire fair market value of the property and are due nine months after death, regardless of whether the property has been sold by that time. These factors, plus the fact that the capital gains tax rate usually is lower than the estate tax rate, make the Qualified Personal Residence Trust an attractive estate planning technique.

### **Lifetime Gifts**

Under the federal gift tax annual exclusion, every individual is permitted to make gifts of up to \$10,000 per year to any individual, without paying gift tax. There is no limitation on the number of individuals who can receive annual exclusion gifts. By making annual exclusion gifts to large numbers of family members every year, an individual can save significant amounts of estate taxes that would otherwise be imposed at the time of death. For example, if an individual is in the highest (55 percent) estate tax bracket, each \$10,000 annual exclusion gift results in a potential estate tax savings of \$5,500.

In addition to making \$10,000 annual exclusion gifts, individuals may pay medical expenses or tuition on behalf of another person without paying gift tax. There is no limitation on the amount that can be paid (free of gift tax), as long as the payment is made directly to the school or medical services provider.

If a person makes additional lifetime gifts beyond \$10,000 per person per year, the first \$650,000 (more in later years, as the applicable exclusion amount increases) of such gifts would not be subject to gift tax, but would consume the donor's federal applicable credit. If a person makes gifts in excess of his or her applicable exclusion amount, this can offer additional tax savings opportunities. First, a gift would remove from the estate any appreciation in value of the property from the date of the gift. Moreover, if a gift tax is imposed and the donor survives for at least three years after making such a (taxable) gift, any gift tax paid would be removed from the donor's estate for tax purposes, resulting in lower overall transfer taxes.

### **Generation Skipping Transfer Tax ("GSTT")**

In the case of larger estates, care must be taken to prevent the imposition of the GSTT. This tax is imposed in addition to any federal estate tax that would be due with respect to an estate and is calculated at the highest marginal estate tax rate (currently 55%). The GSTT is imposed with respect to any gift (directly or through a trust) to grandchildren or other beneficiaries in a generation lower than the children.

Every individual "transferor" has a \$1 million exemption from the GSTT. This presents a long-term planning opportunity. Both spouses can use the GSTT exemption to pass property to their grandchildren or younger generations, in amounts up to \$2 million (\$1 million for each spouse) without having to pay any GSTT. By "skipping" the children's generation, this saves estate taxes that otherwise may be imposed on the children's estates.

To implement GSTT planning, one would make a gift (either during one's lifetime or at death), in an amount up to the GSTT exemption amount, to grandchildren outright, to a trust for grandchildren only, or to a trust for children and grandchildren. If a gift is made to a trust for children and grandchildren, the children could be given access to funds in the trust if needed for their support, but the access would be somewhat limited so the trust assets would not become a part of the children's (potentially taxable) estates. Alternatively, a Will can be drafted so that it includes a bequest to the children outright, but provides that if a child disclaims (i.e., refuses to accept) any portion of his or her inheritance, the

disclaimed portion would pass into a trust for his or her children. This permits the client's children to decide later whether they wish to save estate taxes on their own estates by making use of their parent's (the client's) GSTT exemption.

### **Revocable Living Trust**

The Revocable Living Trust is a Will substitute. If a client puts all of his or her assets into a Revocable Living Trust, the client can avoid probate on death. Washington has a relatively simple, straightforward probate procedure, so avoiding probate in this state is not an important goal to most people. However, if a client owns property located in another state, the Revocable Living Trust is useful, because it permits one to avoid the time and expense associated with an ancillary probate proceeding in the other state, which (in the absence of a Revocable Living Trust or other Will substitute) would be required to pass title upon the death of the owner.

Although the Revocable Living Trust often is touted as a tax savings device, this type of trust does not provide federal estate tax savings beyond what is available through the use of a properly drawn Credit Trust Will or Marital (QTIP) Trust Will.

### **Non-Probate Assets**

Any assets owned in the form of "joint tenancy with right of survivorship" are not part of one's probate estate. These assets bypass the Will and become the property of the surviving joint tenant (typically the spouse). For the reasons discussed above under the category "Wills," we recommend changing the form of ownership of such joint tenancy accounts to "tenants in common," in the case of joint tenants who are spouses. This permits each spouse to transfer his or her one-half interest in the account under the applicable estate planning documents (i.e., Will or Revocable Living Trust), thereby ensuring the full availability of the first spouse's applicable credit (assuming the Wills are revised as discussed above).

### **Retirement Plans And IRAs**

Planning for the disposition of qualified retirement plan assets and Individual Retirement Accounts ("IRAs") becomes critical as the client approaches his or her "required beginning date," which is April 1 of the year after the calendar year in which the client reaches age 70 ½ (or, in some cases, April 1 of the year after the calendar year in which the client retires). Those assets are subject to income tax when distributions are received, and are subject to estate tax if the assets do not pass to the surviving spouse in a way that qualifies for the federal estate tax marital deduction.

The maximum income tax savings generally are possible if the client can defer the required distributions for as long as possible, thereby permitting tax-free appreciation in value. This (maximum deferral) usually can be achieved if the participant names his or her spouse as primary beneficiary and elects to take distributions over a joint and survivor life expectancy. Life expectancies can be calculated using a straight line method or can be adjusted yearly ("life expectancy recalculation"). In most cases, we advise our clients (even those who are significantly younger than 70 ½) to elect out of life expectancy recalculation. This is an election that typically may be made on the beneficiary designation form provided by the plan or IRA custodian. Under IRS regulations, if the account owner or plan participant does not elect out of life expectancy recalculation, the recalculation method will apply, sometimes with unintended results.

We can assist clients by reviewing the terms of their IRAs or qualified plans and providing advice as to the distribution options that are available to them, the designation of a beneficiary and the election of a method of distribution. In cases where the assets of a qualified plan or IRA are needed to fund the client's Credit Shelter Trust, special considerations apply.