Insight on Estate Planning

Year End 2014

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You haven't planned for incapacity

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Saving for college is also good for your estate plan

A 529 plan is one of the most powerful and flexible tools available for college savings. In addition to generous contribution limits (regardless of your income level) and tax-free withdrawals for college expenses, these plans also provide some unique estate planning benefits.

How do they work?

529 plans are college savings or prepaid tuition plans sponsored by states, state agencies and certain educational institutions. Let's focus on the more popular college savings plans, which generally offer the greatest benefits.

These plans allow you to make cash contributions to a tax-advantaged investment account and to withdraw both contributions and earnings free of federal — and, in most cases, state — income taxes for "qualified higher education expenses." Qualified expenses include tuition, fees, books, supplies, equipment, and a limited amount of room and board.

Contributions are nondeductible for federal income tax purposes. However, many states allow residents to claim a deduction or credit for contributions to in-state 529 plans, and a few 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.

How much can you contribute?

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 contributions for a beneficiary reach a specified limit, ranging from $235,000 to around $450,000.

What are the estate planning benefits?

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.

Even better, 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 one, you may contribute as much as $140,000 (5 × $28,000) to each plan 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 six. 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).

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What are the 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.

An attractive savings vehicle

529 plans offer a powerful combination of income tax savings and estate planning benefits. If college expenses are in your future, consider a 529 plan as part of your financing arsenal.

There's another option: The Coverdell ESA

The 529 plan is a remarkable tool, but don't overlook the Coverdell Education Savings Account (ESA), which has certain advantages over a 529 plan, albeit on a smaller scale. ESAs generally offer greater investment flexibility, lower costs and tax-free withdrawals for elementary and secondary school expenses, not just college.

If your modified adjusted gross income is less than $95,000 ($190,000 for joint filers), you can contribute up to $2,000 per year on behalf of any person under 18. Once you reach the income threshold, the contribution limit is phased out, and is eliminated once your income reaches $110,000 ($220,000 for joint filers). If your income is too high, however, you can make a gift to the student and have him or her open an ESA.

There are some disadvantages to be aware of. For example, unlike a 529 plan, an ESA is irrevocable — meaning the funds must be used by or distributed to the beneficiary by age 30 (although it may be possible to transfer the account to a family member). Also, your ability to change beneficiaries may be limited and contributions aren't deductible for state income tax purposes.

Will your estate plan benefit from a trust protector?

You likely have several different types of trusts in your estate plan. In general, to achieve the greatest tax savings, these trusts must be irrevocable, thus requiring you to give up control over the trust assets.

Even though you appoint a trustee to oversee distribution of the trust's assets, you can go a step further by appointing a trust protector. This person will serve as an overseer of the trustee's actions. Taking this step can also provide you peace of mind because the trust protector has the power to alter the trust in light of changing family situations or tax laws.

Powers available

Essentially, a trust protector is to a trustee what a corporate board of directors is to a CEO. A trustee manages the trust on a day-to-day basis.

The protector oversees the trustee and weighs in on critical decisions, such as the sale of closely held business interests or investment transactions involving large dollar amounts.

You can confer very broad powers on a trust protector. Examples include the power to:

- Remove or replace a trustee,
- Appoint a successor trustee or successor trust protector,
- Change the trust's "situs" — that is, its home state for legal purposes,
- Amend the trust terms to correct administrative provisions, clarify ambiguous language or alter beneficiaries' interests to comply with new laws or reflect changed circumstances,
- Direct, approve or veto investment decisions,
- Resolve deadlocks between co-trustees or disputes between trustees and beneficiaries, and
- Terminate the trust — for example, if Congress were to repeal the estate tax.

While it may be tempting to provide a protector with a broad range of powers, it's important to note that this can hamper the trustee's ability to manage the trust efficiently. The idea is to protect the integrity of the trust, not to appoint a co-trustee.

Trust protector in action

Trust protectors offer many benefits. For example, a protector with the power to remove and replace the trustee can do so if the trustee develops a conflict of interest or fails to manage the trust assets in the beneficiaries' best interests.

A protector with the power to modify the trust's terms can correct mistakes in the trust document or clarify ambiguous language. Or, a protector with the power to change the way trust assets are distributed if necessary to achieve your original objectives can help ensure your loved ones are provided for in the way you would have desired.

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Choosing the right person

Appointing the right trust protector is critical. Given the power he or she has over your family's wealth, you'll want to choose someone whom you trust and who's qualified to make investment and other financial decisions. Many people appoint a trusted advisor — such as an accountant, attorney or investment advisor — who may not be able or willing to serve as trustee but who can provide an extra layer of protection by monitoring the trustee's performance.

Choosing a family member as protector is possible, but it can be risky. If the protector is a beneficiary or has the power to direct the trust assets to him- or herself (or for his or her benefit), this power could be treated as a general power of appointment, exposing the protector to gift and estate tax liability and potentially triggering other negative tax consequences.

Due diligence is a must

Before deciding on appointing a trust protector, it's important for you and your estate planning advisor to review the trusts in your estate plan to ensure they're drafted in a way such that there are no misunderstandings regarding the protector's role and the authority you grant him or her.

In addition, consider relevant state laws, if any. Although protectors are common in offshore trusts, their use with domestic trusts is a relatively recent phenomenon. ▮

Charitable deductions

Substantiate them or lose them

Qualifying for a charitable deduction is, in some respects, a matter of form over substance. The IRS could disallow a deduction, even if it's otherwise legitimate, if you fail to follow the substantiation requirements to the letter. Here's a quick summary of the rules.

Cash gifts

Generally, you can substantiate gifts of less than $250 with a canceled check, written receipt or other reliable record (such as credit card statements) that indicates the name of the charity and the amount and date of your gift. Separate gifts of less than $250 generally are treated separately for these purposes, unless they're made on the same day. For example, if you write a $200 check to your favorite charity once a week, each check is treated as a separate gift under the $250 threshold. But if you write two checks on the same day, they will be treated as a $400 gift subject to the substantiation requirements discussed below.

If you donate more than $75 in exchange for goods or services other than intangible religious benefits (such as admission to religious

ceremonies), the charity must provide you with a statement that 1) advises you that your deduction is limited to the amount by which your gift exceeds the value of those goods and services, and 2) provides a good-faith estimate of that value.

Gifts of $250 or more require a "contemporaneous" written acknowledgment from the charity that includes the amount and date of your gift, the estimated value of any goods or services you received, and any intangible religious benefits provided. An e-mail will suffice.

To satisfy the contemporaneous requirement, you must have the acknowledgment in your possession before you file your income tax return or, if earlier, before the extended due date of your return.

Noncash gifts

If you make noncash gifts totaling more than $500 for the year, you must file Form 8283, "Noncash Charitable Contributions," with your federal income tax return. And for gifts of property valued at more than $5,000 ($10,000 for closely held stock) you'll need to obtain a "qualified appraisal" by a "qualified appraiser" and have the appraiser sign Sec. B, Part III, "Declaration of Appraiser." If property is valued at more than $500,000, you're required to attach a copy of the appraisal report to your return. No appraisal is required for publicly traded securities, regardless of value.

A qualified appraiser is a professional who meets certain education, experience and accreditation requirements. A qualified appraisal must 1) be prepared, signed and dated by a qualified appraiser other than the taxpayer or donee, 2) be conducted within 60 days of the gift, 3) provide certain information about the property, the appraiser and the valuation methods used, and 4) not involve fees based on a percentage of the appraised value or deduction amount.

There are special rules for gifts of art, clothing, household items and used cars.

The cost of noncompliance

A recent U.S. Tax Court case demonstrates the importance of compliance with IRS substantiation rules, particularly the qualified appraisal requirement. In *Ben Alli v. Commissioner* (T.C. Memo. 2014-15), the court disallowed a nearly $500,000 charitable deduction because the two appraisals obtained by the taxpayer failed to meet the requirements for a qualified appraisal.

Gifts of $250 or more require a "contemporaneous" written acknowledgment from the charity that includes the amount and date of your gift, the estimated value of any goods or services you received, and any intangible religious benefits provided.

The taxpayer donated an apartment building to a charity and claimed a $499,000 charitable deduction based on two appraisals. The Tax Court found both appraisals to be deficient. The first appraisal was conducted 10 years before the contribution, not within 60 days, as required. In addition, it failed to apply any of the commonly recognized valuation methods.

The second appraisal was conducted five months before the contribution, so it too was untimely. But, more significant, it was based on a "hypothetical, fully renovated version of the contributed property," when in fact the building was in poor condition.

Don't leave it to chance

If you've made substantial charitable donations, their deductibility depends on compliance with IRS substantiation rules. When in doubt, consult your tax advisor to be sure you've dotted all the i's and crossed all the t's. ▮

Estate Planning Pitfall

You haven't planned for incapacity

Most estate plans focus on what happens after you die. But if you haven't made arrangements in the event you become mentally incapacitated, your plan is incomplete. If an accident, illness or other circumstances render you unable to make financial or health care decisions — and your plan doesn't specify how these decisions will be made, and by whom — a court-appointed guardian will have to act on your behalf.

There are several tools you can use to ensure that a person you choose handles your affairs in the event you cannot, including a:

Revocable trust. Sometimes called a "living trust," it's designed to hold all or most of your assets. As trustee, you retain control over the assets, but in the event you become incapacitated, your designee takes over.

Durable power of attorney. This authorizes a designee to manage your property and finances, subject to limitations you establish.

Living will. It expresses your preferences regarding life-sustaining medical treatment in the event you're unable to communicate your wishes.

Health care power of attorney. Sometimes referred to as a durable medical power of attorney or health care proxy, this authorizes your designee to make medical decisions for you in the event you can't make or communicate them yourself.

HIPAA authorization. Even with a valid health care power of attorney, some medical providers may refuse to release medical information — even to a spouse or child — citing privacy restrictions in the Health Insurance Portability and Accountability Act of 1996 (HIPAA). So it's a good idea to sign a HIPAA authorization allowing providers to release medical information to your designee.

For these tools to be effective, you must plan ahead. If you wait until they're needed, a court may find that you lack the requisite capacity to execute them. Also, be sure to check the law in your state. In some states, certain planning tools aren't permitted, or go by different names.

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Joint Tenancy Bank Accounts as part of Estate Planning

What happens to the assets in a joint bank account when one of the account holders dies? The answer depends on how the joint account is set up. The two primary types of joint tenancy accounts are those *with* rights of survivorship (JTWROS) and those *without* rights of survivorship (JTWOROS).

Funds that belonged to a deceased account holder which remain on deposit in a joint account *with* rights of survivorship belong to the surviving account holder at the moment of death regardless of the terms of the deceased account holder's Will. On the other hand, funds belonging to a deceased account holder which remain on deposit in a joint account *without* rights of survivorship typically belong to the deceased account holder's estate.

If the funds belong to the account holder's estate, they will be subject to probate and as liquid assets, they may be used to pay administrative expenses and taxes. If there is money left after administrative expenses and taxes, the funds will pass to the residuary beneficiaries designated in the Will or, in the absence of a Will, by way of Washington's intestacy statutes. If a parent wants to establish an account that will pass money to his or her child at death outside of the probate process, he or she should fill out the "contract of deposit" (also often referred to as the "signature card") to specify his or her wish for a joint tenancy *with* rights of survivorship. Please keep in mind that setting up this type of joint account during your lifetime allows all account holders and at times, their creditors, to access one hundred percent of the funds. In other words, this probate avoidance strategy has its risks.

Whether you already have a joint account or you will open one soon, be sure to check with the financial institution to confirm how the joint tenancy is set up. Many local and national banks elect joint tenancy *with* rights of survivorship as the default option for new accounts whether or not the account holders affirmatively request the survivorship rights. In fact, many financial institutions may not even offer a joint tenancy *without* rights of survivorship. In Washington, an account that is simply designated as "joint tenancy" *should* pass as a joint tenancy *with* rights of survivorship to the individual(s) listed on the account who survive the deceased account holder. However, there is no guarantee, and disagreements over these accounts are frequently ending up in litigation.

If you would like to discuss how to properly title your accounts or assets, please contact a member of the Stokes Lawrence Estate Planning Group at (206) 626-6000 in Seattle or (509) 853-3000 in Yakima.