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Building Creative and Flexible Wealth and Estate Planning Solutions for Your Clients in 2014

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The signing of the American Taxpayer Relief Act of 2012 ("ATRA") on January 2, 2013, certainly marked a transition for wealth and estate planning professionals and their clients. Before ATRA, planning was often dominated by the volatility and uncertainty of the federal estate, lifetime gift, and generation-skipping transfer (GST) tax exemptions (referred to collectively as federal transfer tax exemptions).

ATRA, by setting a "permanent" combined exemption of $5 million adjusted for inflation from 2010 and providing estate tax exemption "portability," made federal transfer tax planning irrelevant for the vast majority of Americans (barring future Congressional action). On the other hand, income tax planning has become vastly more important for many of your clients. ATRA instituted a new 39.6% top bracket and a 20% capital gains rate for the highest income taxpayers plus personal exemption and itemized deduction phase-outs January 2013, were surtaxes in the Affordable Care Act (ACA) on earned income (0.9%) and net investment income (3.8%) that affected many more taxpayers (a $250,000 married filing jointly threshold).

Turning away from federal transfer tax planning has allowed clients to turn toward other things that have always made estate planning important – actions such as mitigating risks of incapacity, asset protection, and protecting beneficiaries from unwise financial decisions. For many clients, this refocus is happening now, as they confront the reality of their 2013 income tax liability. As we look to the beginning of a new year, there are abundant opportunities and a few challenges – some of them familiar and others quite new.

Key Takeaways:

1) Higher top income tax brackets, higher capital gains tax rates, personal exemption/deduction phase-outs, and the ACA surtaxes make income tax planning a significant opportunity under ATRA.
2) Revocable Alaska Community Property Trust strategy designed to totally eliminate capital gains on jointly owned property when the first spouse dies.
3) Delaware and Nevada Incomplete Non-Grantor ("DING" and "NING") trust strategies can reduce combined tax rates for some clients by eliminating state-imposed taxes on trust income and sales of appreciated trust assets.
4) Stand-alone Retirement Trusts ("SRTs") can help protect beneficiaries' inherited interests in retirement accounts.
5) Asset protection trust strategies are available to shield clients' assets from attack by future

litigation and other creditors.
6) Estate plans should be updated to provide flexibility in marital deductions to achieve capital gains leverage and deal with mismatches between state and federal estate tax exemptions.
7) Planning in 2014 and beyond offers opportunities to guide clients to creatively and flexibly meet their long-term goals.

Take advantage of favorable state laws: Reducing income taxes and preserving assets
Under ATRA, the top bracket income tax rate on the highest income families jumped from 35% to 39.6%. Plus, taxes on their long-term capital gains rose a full third, up from 15% in 2012 to 20% in 2013 and beyond. Wealthy families are also subject to phase-outs of their personal exemptions and itemized deductions. As a result, clients are turning attention from estate tax strategies that will help future generations to income tax strategies that will provide relief today.

One solution some clients can turn to is the so-called "DING" and "NING" trusts that reduce the impact of state-imposed taxes on investment income and long-term capital gains.

ING is an acronym for "Incomplete Non-Grantor." Asset protection trusts drafted under the laws of Delaware (DING) or Nevada (NING) can be irrevocable and yet incomplete for federal transfer tax purposes. The client establishes the DING or NING trust and then transfers to it income producing and/or appreciated assets, such as founder's stock in a successful small business. For clients in Virginia and other states that impose income taxes, DING and NING trusts can provide significant income tax avoidance and asset protection benefits.

What You Need to Know: Because neither imposes a state income tax, any ordinary or capital gain income in a Delaware or Nevada irrevocable trust is not subject to state income tax. And because both Delaware and Nevada are strong jurisdictions for protecting assets in self-settled trusts from asset attacks by creditors, DING and NING trusts can significantly help a family protect its wealth.

Protect inherited IRAs from spendthrifts and creditors
Last April, *In re: Clark* (7th Cir. 2013) raised new concerns about whether an inherited interest in an IRA is protected from the beneficiary's bankruptcy creditors. In *Clark*, the Seventh Circuit said no. The Fifth and Eighth Circuits previously had said yes (*Chilton* and *Nessa*). The Supreme Court has accepted an appeal from *Clark* and may or may not settle the conflict.

Regardless of what the Supreme Court decides, the "Stand-alone" Retirement Plan Trust ("RPT") remains an important planning tool because the greatest risk to inherited retirement account interests is the premature withdrawal of funds by the beneficiary. When the account holder dies, the account custodian makes distributions to the trustee of the RPT, which is administered according to the trust's terms.

Care must be used – both in the RPT itself and in the beneficiary designation – to ensure the RPT qualifies as a "designated beneficiary," allowing the account distributions to be stretched over the life expectancy of the oldest beneficiary (thus maximizing the account's tax deferred growth). This stretch is especially beneficial with Roth accounts, for which all growth and distributions are tax free.

What You Need to Know: When structured properly, the RPT not only stretches out the plan benefits, it also provides substantial asset protection for the trust beneficiaries and can help beneficiaries grow into their inheritances responsibly.

Build flexibility into marital deduction planning: State exemptions and capital gains leverage

For now, the higher federal estate tax exemption means the federal estate tax is a non-issue for most clients. However, many, if not most of their estate plans, were created during a time of lower federal estate tax exemptions and/or less certainty. Many of them certainly predate the concept of estate tax exemption "portability," which first became an option in December 2010 and was made permanent under ATRA.

The end result is that many married clients have estate plans that force division of the estate into an estate tax exempt ("bypass" or "credit shelter") trust when the first spouse dies. Not only is this unnecessary tax planning for most families; it can cause highly undesirable results.

When the first spouse dies, assets that were placed in a traditional bypass or credit shelter trust, while exempt from later estate tax, will be subject to capital gains taxes when sold. That gain is determined by comparing net sale price to the asset's value when the first spouse dies. For couples who have assets that are prone to significant growth, or for surviving spouses who are fairly young, this may mean a hefty capital gains tax bill their beneficiaries won't be happy about. Planning techniques are available that avoid the capital gains tax hit to the couple's beneficiaries by including the assets in the surviving spouse's estate and providing asset protection for the surviving spouse.

With the new federal estate tax exemption, it's important to also plan with *state* estate taxes in mind. Fifteen states and the District of Columbia impose a state estate tax. Although Virginia does not impose an estate or inheritance tax, your client might move to a state that does. As of today, only two of the sixteen track the federal exemption. The others have exemptions that range from $4,000,000 on the high end (Illinois) to $675,000 on the low end (New Jersey). Maximizing the estate tax deduction on the first spouse's death requires two bypass trusts. Most plans don't do that.

What You Need to Know: In an increasingly mobile culture, clients who, even if they do not currently live in a jurisdiction that imposes an estate tax, may later move to a jurisdiction that does.

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Planning in 2014 and beyond requires creativity and flexibility
One lesson to take from 2013 with ATRA's new exemptions, rates, and the ACA's surtaxes is that plans built with flexibility will be far superior to those that are not. Another lesson is an outdated plan is a family's disaster waiting to happen. 2014 is a year of opportunity to guide clients through the confusion of higher income tax rates, challenges and opportunities in state law, and other changes, to help them protect what they have worked a lifetime to build.

Actions to Consider:

- Meet with your legal team at Carrell Blanton Ferris and other team members, including tax, and investment advisory professionals to identify strategies best suited to address today's new estate and income tax environment for your clients.
- When considering tax strategies, clients should look forward two to three years to understand the combination of income, trust, and investment cash flows.
- Expect that the tax code will continue evolving, and build flexibility into your clients' plans using modern trusts as a core tool.

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