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presents

Convention 2013
Continuing Legal Education Series

Planning for the Affluent Client or the Changing Landscape

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Philadelphia, Pennsylvania

PLANNING FOR THE AFFLUENT CLIENT

I. Who is the affluent client as opposed to the wealthy client?
II. Review of recent developments in federal estate and gift tax law (with a touch of income tax as relevant to estate planning)
III. New York estate tax with an emphasis on lifetime transfers
IV. Retirement Assets – Planning pre and post mortem with one of your client's biggest assets

Questions

Planning for the Affluent Client

I. Who is the Affluent (not wealthy) client in today's environment?

The answer will vary depending on who is asking the question. Our general focus will be on the client with less than ten million dollars with most time devoted to those whose assets are below the federal estate tax filing requirement of five million dollars. For many, depending on the nature of your community and the size of your practice, the affluent client will be someone who is paying New York Estate tax or who is on the edge of New York liability.

Why Does It Matter?

Many of the techniques we read about or hear about at estate planning programs are too complex or expensive to implement for these clients. Their concerns are to transfer assets as efficiently and inexpensively as possible to a relatively small circle of family members. Any charitable giving will likely be in the form of a legacy. Your job is to show them the circumstances in which some complexity will allow them to reach their personal goals and limit their tax liabilities.

ESTATE PLANNING FOR THE AFFLUENT (NOT WEALTHY) CLIENT

II. Review of recent developments in federal estate and gift tax law (with a touch of income tax as relevant to estate planning)

Effective for tax years 2010-2011, the Federal estate tax applicable exclusion amount was set at $5,000,000, with annual cost of living increases starting in 2012. As of 2013, the federal applicable exclusion amount is $5,250,000. The applicable exclusion amount is the amount that can pass free of federal estate and gift taxes.

For estate tax purposes, the computation of gift taxes payable uses tax rates in effect as of the date of the decedent's death and not the actual amount of gift taxes paid with respect to the gifts.

The Federal annual exclusion amount for gifts is $14,000 in 2013.

The Federal applicable exclusion amount for gifts is $5,250,000 for 2013.

PORTABILITY.

Effective 1/1/2011, portability allows the estate of the first spouse to die to irrevocably transfer any unused portion of the deceased spouse's applicable exclusion amount to the surviving spouse. (DSUE).

DSUE is not available for Generation-Skipping Transfer Taxes.

DSUE is not indexed for inflation.

Portability must be elected on a timely filed estate tax return (including extensions) for a decedent with a surviving spouse.

Example: Husband dies in 2013 with an adjusted taxable estate of $5,250,000 and leaves all his assets to his wife; those assets qualify for the marital deduction. Therefore, there are no estate taxes in the husband's estate. The husband's $5,250,000 basic exclusion amount, which was unused because of the marital deduction, is his DSUE. The executor may elect to allocate the husband's DSUE to the surviving wife, thereby increasing her federal applicable exclusion amount to $10,500,000, which can be used for lifetime gifts or estate taxes.

If the wife remarries, she is limited to the last deceased spouse's DSUE.

TAXATION OF IRA'S AT DEATH.

Upon the death of the owner of a traditional IRA or retirement accounts, these funds may be doubly taxed and subject to both estate and income taxes. If the estate is more than the applicable exclusion amount, then assets in excess of applicable exclusion amount will be subject to estate tax. Further, because the contributions to the traditional IRA are made with pre-tax money, the income earned on the IRA assets, capital gains or losses, and growth, will be income tax deferred until distributions are made. Regardless of whether there is a taxable estate, income taxes will be assessed against the beneficiary when the funds are withdrawn.

Portability is useful when an IRA and/or other qualified retirement assets comprise the bulk of an individual's estate. These types of assets will most likely decrease over the surviving spouse's lifetime due to withdrawals, so to use these assets to fund a credit shelter trust would tend to waste the deceased spouse's applicable exclusion amount. By electing portability, only the amount remaining in the second spouse-to-die's estate will be subject to estate tax.

INCOME IN RESPECT TO A DECEDENT.

Internal Revenue Code §691:

"Amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year."

By definition, death benefits under qualified retirement plans, 403(b) plans, and IRAs are income in respect to a decedent IRD.

IRD is not subject to a stepped up basis for capital gains and losses because the original contributions were never taxed.

The beneficiary of an inherited traditional IRA is required to report on their personal income tax returns actual withdrawals made from the IRA.

The income tax liability may be reduced or eliminated if:

1. The beneficiary is entitled to a federal income tax deduction (not a credit) for federal estate taxes paid on the IRA proceeds received each year. No deduction is allowed for state estate taxes. If the IRA beneficiary takes a lump sum distribution, then the entire IRA will be subject to income taxes for the beneficiary, and the entire estate tax deduction attributable to the IRA is available. If the IRA beneficiary takes withdrawals

over a period of time, then the estate tax deduction is pro-rated over the time the withdrawals are made.

2. The beneficiary is able to rollover the inherited IRA, then the beneficiary has the ability to further defer income taxes on the inheritance.

However, when designating a beneficiary of an inherited IRA, there may be an unintended consequences in naming a beneficiary younger than 24. A "kiddy tax" may apply when an individual younger than 24 may be taxed on unearned income at his parents' income tax rate.

Additionally, if a beneficiary inherits IRD and then transfers his right to receive IRD, that act will cause the IRD to be taxed to the transferor (the inherited beneficiary). This can occur when a transfer is made between individuals or when an estate or trust transfers a retirement plan to an individual beneficiary of the estate or trust. However, immediate IRD is not triggered when a beneficiary transfers the right to receive IRD to a grantor type trust under which he is the sole beneficiary during his lifetime (e.g. a Supplemental Needs Trust).

III. New York estate tax.

New York allows an annual estate tax exemption of $1 million per individual.

Effective January 1, 2000, New York repealed the New York Gift Tax, however, in calculating NYS credit for state death taxes, the federal gift tax payable is included.

New York does not allow portability.

New York has issued a memorandum that explains the computation of a gross estate fort NY estate tax purposes when an estate files a federal estate tax return only to make a portability election. Under §20.2010-2T(a)(7)(ii), an estate is not required to report the value of property qualifying for the marital deduction or charitable deduction if the federal return is being filed only for the purpose of electing portability. The value of the gross estate must be estimated based upon a good faith determination, and the property must be listed on form 706.

Issue:

If an estate is below the federal filing threshold, but is required to file a return in order to make a portability election, will that foreclose the option of a separate state QTIP election?

In TSB-M-11(9)M (issued July 29, 2011), the New York State Department of Taxation and Finance clarifies that, even if a federal estate tax return is filed solely for the purpose of electing portability, allocating GST exemption or making any other election, the same QTIP election reflected on the federal return must be made for New York estate tax purposes. If a QTIP election is not made on the federal return, it may not be made for New York purposes. *See also* TSB-M-12(4)M.

Therefore, an estate may be better off to not elect portability if to do so will cause New York estate taxes upon the death of the surviving spouse.

Estate planning for the affluent (not wealthy) client

IV. Retirement Planning

For most affluent clients their retirement related assets are the largest or a very substantial part of their wealth. This makes it important to consider how these assets are best deployed and organized from a substantive and tax perspective.

Defined Benefit Plans

If you have a client fortunate enough to be a participant in an employer's defined benefit plan then your critical decision is determining what form of benefit the client should take. In many cases the plan will offer choices ranging from single life to 100% joint and survivor annuities. The Retirement Equity Act normally requires a married participant to select a joint and survivor annuity or obtain his or her spouse's consent to some other form of benefit. Also such plans typically do not allow a change in the mode of distribution once benefits have begun. See IRC §401 (a) (11) (a), §417(a) (1), §417(a) (2). Also see RIA Tax Planning and Practice Guides §208 Survivor benefits for spouse of plan participant (7/2006)

If the client has only the right to receive a payout during his/her life and the life of any joint annuitant there is normally not going to be an estate tax issue because there would not be an includible asset. There is no pool of assets belonging to the individual and the payments terminate with death. See IRC § 2039 and Reg. §20.2039 -1 for a discussion of retirement plan inclusion

401 K Plans and other defined contribution plans

Here your client does have a distinct pool of assets belonging to her/him. On retirement the plan participant is often going to be urged to take assets from the plan and roll them into an IRA account. Increasingly employers do not want to retain retiree assets in the plan. If your client is going to roll account balances into an IRA it is EXTREMELY important to make sure this is done as what is called a direct rollover. The client should not have a check issued in her/his name.

This will result in a 20% tax withholding at the employer level. In order to then roll over the entire amount the individual needs to come up with the 20% out of pocket .In addition if the client fails to deposit the funds to an IRA within 60 days the entire amount will be a taxable distribution in the one year. IRC§402(f) (2) (A), IRC§3405(c), Reg. § 31.3405(c) Q&A -1

It is definitely preferable to have the client open an IRA account and direct the employer to issue a check payable to the bank or broker as custodian for the individual's IRA account. This is considered a direct rollover of the funds with no tax withholding and no chance of it being considered a taxable distribution. See IRC§401(a) 31(A), § 402 (c) (1), § 402(c) (3), §402(e) (6), §408(d) (3).

On death, there is inclusion of account balances for estate tax purposes. If the client dies while in service and leaves a surviving spouse, he/she may wish to leave assets with the plan if permitted. The age of the surviving spouse will influence the decision. If the spouse is relatively young distributions taken from the plan will not be subject to a 10% income tax penalty for early withdrawal. On the other hand if the spouse chooses to roll the plan assets into an IRA in his or her own name any distributions taken before 59 ½ will be subject to the 10% tax penalty unless the distribution qualifies for one of the distribution exceptions.

Non spousal beneficiaries may also roll over plan balances into an IRA. However, unlike a spouse they cannot put them into an IRA in their own name. The account must be set up as a beneficiary IRA. Such accounts have required minimum distributions based on the beneficiary's life expectancy. The ability of the beneficiary to name beneficiaries of her/his own has certain limitations. Plans are now required to allow IRA rollovers by non-spousal beneficiaries. See IRS Publication 590 pp. 25 – 26.This change came into the law in the aftermath of the Pension Protection Act of 2006.

IRA Accounts

IRA accounts and retirement plans based on IRA accounts can offer a relatively simple and inexpensive way to start the process of saving for retirement. During life an individual can save $5,500 per year (2013 limit) in a tax deferred account

provided they and their spouse if married) meet certain eligibility criteria based on income and retirement plan participation criteria. The amount goes up to $6,500 per year (2013 limit) upon attaining the age of 50. See IRC §408(a) (1), §408 (b) (4), § 219(b) (1) (A), § 219(b) (5) (A), § 219(b) (5) (B).

At age 59 ½ the client can make withdrawals which will be taxed at her/his ordinary income tax rates. There is no character retention (i.e. no capital gains or dividend treatment). All distributions are ordinary income. See IRC§408(d) (1), §408(d) (2). Conventional wisdom suggests that in the period between 59 ½ and 70 ½ distributions should be taken from non-retirement assets. However, if the account owner is in the 15% income tax bracket because of large deductions, tax exempt income, or any other reason, it may make sense to take distributions from the IRA until the 15% bracket is used. At age 70 ½ required minimum distributions will begin based on life expectancy.

Individuals can also stand the process on its head and save in a so called Roth IRA. Here the funding is done with after tax dollars. However, subject to holding period and age limitations, the amounts will be distributed free of tax. There are limits to Roth IRA eligibility depending on income. Another feature of the Roth IRA is that there are no required minimum distributions for the individual who creates the account. See IRC §408A (b), §408A(c) (1), §408A(c) (3), §408A (d) (1), §408A (d) (4).

Anyone can convert an existing IRA to a Roth IRA even if she/he would not be eligible to contribute to a Roth IRA. This can be a powerful estate planning tool. If you have a client who does not anticipate needing some or all of her/his IRA funds a tax deferred IRA can be converted to a Roth IRA and essentially create a tax free annuity for a beneficiary. The beneficiary does have required minimum distributions after the death of the account holder but if properly structured the distributions are based on the beneficiary's life expectancy and assuming that holding period limitations have been met the distributions will be free of income tax. See IRC§408(d) (1).

Conversion of the traditional IRA to a Roth IRA requires the payment of the income tax on the amount to be converted. IRC§408A (d) (3) (A) (i). One does not need to convert the entire IRA account nor does the conversion have to be done

in one year.See IRC Reg§408A -4. However, if there are after tax funds in the IRA to be converted conversion must be proportional. Ideally funds other than the IRA funds will be used to pay the tax. For a client who does not anticipate needing the funds and where the goal is to reduce her/his estate so as to reduce or eliminate estate tax this can be a powerful tool. It allows the individual to make a much larger gift to the objects of her/his bounty by paying the tax without using up any of her/his exemption equivalent because the payment of tax is not a gift.

The conversion from traditional to Roth IRA a can be reversed should the economics no longer seem attractive. This recharacterization needs to be done no later than six months after the unextended due date for filing the tax return for the year of the recharacterization. See IRC§301.9100-2(b). This allows for the account owner to change her/his thinking if the economy tanks so that the assets are not worth the tax bill paid.

At death there will be estate tax inclusion for both the traditional and the Roth IRA at the date of death value. With traditional IRAs there is also the issue of income in respect of a decedent or IRD. Because the asset has been tax deferred the asset is subject to income tax on amounts not includible on the decedent's final return. This would include amounts earned up to the decedent's date of death but not post death income. The account is subject to estate tax and income tax with an income tax deduction for estate tax paid being available to the beneficiary of the retirement account. If the beneficiary were to take a lump sum distribution the entire deduction for estate tax paid would be available to her/him in that tax year. Otherwise, the deduction is available on an annual basis depending on the amount withdrawn by the beneficiary. See RIA Tax Planning and Special Studies Paragraph 302 IRD from IRAs and Qualified Plans (05/2007) You should also look at the innumerable items written by Ed Slott on this and other IRA distribution topics. His website is www.irahelp.com.

It also demonstrates the importance of coordinating tax provisions in a will with the disposition of non-testamentary assets such as IRAs. If the will has been drafted to provide that all taxes are paid from the residue of the testamentary estate and there is a large IRA account you could have the residuary beneficiary (ies) who are often the decedent's nearest and dearest paying the estate tax bill for the

IRA and the credit against income tax for estate tax paid going to the non-testamentary beneficiary. SeeIRC §691(c).

Funding trusts with retirement assets

One can use IRA and retirement assets to fund both marital and non-marital trusts. In any case where the trust is going to be funded with this type of asset there are significant issues regarding drafting of the trust.

Whatever type of trust one might be considering the essential concern is whether the trust will be considered a designated beneficiary. Absent the trust being considered a designated beneficiary the distribution of the retirement assets will occur over a much shorter period of time. If the decedent has not reached her/his required beginning date (usually 70 ½) the assets will be distributed over a five year period. If the decedent has reached her/his required beginning date the distribution will be made over the decedent's remaining life expectancy rather than being stretched over the life expectancy of the beneficiary. See IRC Reg. §1.401(a) (9)—9 Q&A1, IRC Reg. §1.401(a) (9)—3, Q&A1, IRC Reg. §1.401(a) (9)—5 Q&A5

In order for a trust to qualify as a designated beneficiary it must pass certain tests. These are as follows:

> (1) the trust must be valid under state law, (2) the trust must be irrevocable or by its terms become irrevocable upon the death of the account owner, (3) the beneficiaries of the trust must be identifiable from the trust's terms, (4) documentation must be provided to the plan administrator within a specified period after the decedent's death, and (5) all trust beneficiaries must be individuals. See IRC Reg. §1.401(a) (9)-4, Q&A6 (b), Reg§1.401(a) (9)-4 Q&A5

If the trust meets these conditions then the trust beneficiaries can be considered designated beneficiaries for purposes of "stretching "distributions over the life

expectancies of the individuals. The life expectancy of the oldest beneficiary (whether income or remainder) will be the measuring life for determining the period over which the assets must be distributed. See IRC§401(a) (9) (B) (iii). The Single Life Expectancy Table will be used to determine distribution amounts. If the trust is drafted where the trustee may not accumulate any retirement distributions then it is considered a conduit and the individual beneficiary of the trust is the designated beneficiary and the assets must be distributed over that individual's life expectancy.

Marital Trust Issues

The most common circumstance where a retirement asset might be placed in a marital trust would be where the spouse is not the parent of the decedent's children. This is often dealt with by creation of a QTIP trust. In order to draft correctly one must look at the language of the New York version of the Uniform Principal and Income Act with regard to IRA or pension distributions. In EPTL § 11-A-4.9 (c) the trustee is instructed to allocate 10% of a required payment that is not described as interest, dividend, or similar to income and the balance to principal. In EPTL § 11-A-4.9(d), the statute provides that in a marital trust the amount allocated to income can be increased if necessary to obtain the marital deduction. This language is relevant because the Internal Revenue Code requires that a surviving spouse have a "qualifying income interest for life" in order to elect QTIP treatment where the marital trust is named as the beneficiary of the IRA. See IRC §2056(b) (7)

In order to meet the standard of a " qualifying income interest for life" it will be necessary for the trust to have certain provisions in addition to the normal QTIP language regarding income to the surviving spouse, compelling investment in income producing assets, and the like. The spouse must have the right to compel the withdrawal of the larger of the income of the IRA or the RMD on an annual basis and to require the trustee to distribute at least the income of the IRA to the surviving spouse. This language is critical to the trust's ability to obtain marital deduction treatment under the QTIP rules.

This is because the New York version of the UPIA allocating 10% to income would not stand alone satisfying the requirements of a "qualifying income

interest". The amount of the RMD as defined under EPTL 11-A 4.9 (c) is not based on the total return of the IRA and can't be an appropriate allocation between income and principal under the Internal Revenue Code. It also fails to meet the standard of being a reasonable allocation pursuant to the more general principles of allocation between principal and income found in EPTL 11 –A-4.1 absent a consideration of the specialized rule in 11-A 4.9(c).The savings language of EPTL 11 –A 4.9(d) might not be sufficient to establish the " qualifying income interest" absent the requirement to distribute at least IRA income to the surviving spouse. SeeIRC§2056 (b) (5), Reg § 20.2056(b)-5(f) (1), Reg § 20.2056(b)-5(f) (1), and Reg § 1.643(b)-1Reg § 1.643(b)-1.Also see RIA Checkpoint Estate Planning Analysis §44,723 "Marital trust named as beneficiary of decedent's IRA or qualified retirement plan—treatment as qualified terminable interest property (QTIP)"

Non Marital Trust Issues

Credit Shelter Trusts

There is a question as to whether retirement assets are best suited for the funding of a credit shelter trust. From an income tax perspective you may have concerns such as limitations on the surviving spouse's ability to make the IRA into one in her/his own name. Here the tension is between the need to give the spouse limited access to distributions in order to keep the assets out of the survivor's estate and the need to give the spouse the ability to pull down the IRA assets without restriction in order to allow her/him to convert the IRA into her/his own IRA. **Ltr. Ruls. 200618030** and **200944059**.

If the spouse is unable to put the account into her/his own IRA then s/he is unable to use the Uniform Life Table for distributions and must use the single Life Table resulting in larger distributions. It also means that the spouse as the oldest beneficiary becomes the measuring life for distributions. There can be no stretching of distributions over the lives of younger beneficiaries. See Denman, Bradford, Update on Estate Planning for IRAs and Pension Plans, Estate Planning Journal Volume 38, Number 07, July, 2011, p 8 et. seq.

Supplemental Needs Trusts

Supplemental needs trusts may also be funded with retirement assets. The issues there can be complex depending on the type of disability the individual may have and the sorts of benefits they may be receiving. If the trust is drafted as a conduit type trust where all IRA distributions must go to the beneficiary then there may be issues about eligibility for benefits. If the trustee has the right to accumulate then the oldest beneficiary will be the measuring life for distribution of the assets. In many cases this may be a remainder beneficiary who is of an older generation. Worst of all is the circumstance where the parents or guardian of the disabled person seek to benefit a charity which may have provided invaluable support to the individual during life. If the charity is named as the remainder beneficiary then the trust fails to meet the test for qualification (Remember all trust beneficiaries must be individuals.) and there is no designated beneficiary so the opportunity for a stretched out distribution is lost. See the excellent treatment in Wilcenski, E and Pleat, T.A. Dealing with Special Needs Trusts and Retirement Benefits, Estate Planning Journal February, 2009 p15

Portability

Since portability has now been made a permanent part of the Internal Revenue Code it should be considered as an alternative when making decisions about retirement assets where they are a significant portion of the decedent's estate. Where you have a married couple and the children are the children of that marriage it makes sense to consider portability on the death of the first spouse. This way the surviving spouse can be the primary beneficiary of the retirement assets. A surviving spouse has the right to take the assets and roll them into an IRA in her/his own name. If the spouse is less than 70 ½ she/he can delay distributions until age 70 ½.At death the exemption equivalent of the decedent plus the unused amount of the predeceased spouse will be available to prevent or limit any possible

federal estate tax. Moreover, s/he can name the children as primary beneficiaries of this IRA and extend the distribution period over their life expectancies upon her/his death. See Denman, Update on Estate Planning for IRAs and Pension Plans, p10

Beneficiary Designations

I cannot overemphasize the importance of naming primary and secondary beneficiaries for any retirement account. Remember it is the beneficiary designation not the will which will control the disposition of retirement assets. It is important to review beneficiary designations on a regular basis. After significant life events such as marriage, divorce, the birth of children you need to make sure the beneficiary designation reflects the client's current circumstances. I have dealt with estate administrations where designations were not changed after divorce or where a non-spousal beneficiary was named without the spouse's consent while the participant was still married. At best you are settling with varying claimants and at worst you are in litigation. If spousal rights are involved you also have the intersection (and sometimes the collision) of federal and state law.

Another point regarding the beneficiary designation is the naming of a contingent beneficiary. This is particularly important where you are planning for the possible use of disclaimers. If the surviving spouse is the primary beneficiary of a retirement account and is able to disclaim then you need to have a named beneficiary in place. It allows the extension of the distribution period if the secondary beneficiary is of a younger generation and use of exemption equivalent.

If a client has any unusual beneficiary disposition it would be prudent to draft a beneficiary designation reflecting this and submit it to the custodian. Some custodians will not accept trusts as beneficiaries and some have limitations on the number of beneficiaries. There can also be default language as to per stirpes distributions. Make sure the client's wishes will not be frustrated by the policies of the custodian.

The importance of retirement assets and the complexity of the rules surrounding their use requires attention to premortem choices for drafting and planning as well as careful post mortem administration.