The Estate Planner

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Mining the Generation Gap

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Estate Planning Red Flag

You haven't recently reviewed your retirement plan beneficiary designations

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Mining the generation gap

Estate planning strategies for you and your parents

Shifting income to family members in lower tax brackets can be a powerful tax-reduction strategy. For example, it was common for parents to transfer income-producing assets to children in their teens and early twenties until the "kiddie tax" was expanded, making this technique far less effective. (See "'Kiddie tax' isn't just for kiddies anymore" on page 3.)

But don't overlook your parents. If they're in a lower income tax bracket and their estates are small enough that estate taxes aren't a concern, there are several planning opportunities worth exploring.

Give and you shall receive

One of the most effective techniques is to transfer appreciated, income-producing assets to your parents with the understanding that you'll get the assets back upon your parents' deaths. In addition to slashing income taxes, this strategy may also erase any capital gains tax liability on the assets' appreciation in value.

Here's an example that illustrates the benefits: Mary is in the 35% federal income tax bracket and hasn't used any of her gift or estate tax exemptions. Among other assets, she owns $300,000 of stock that pays a 5% "qualified" dividend. Her tax basis in the stock is $100,000. Mary gives the stock to her father, Jim, who's in the 15% tax bracket. The dividends provide Jim with additional income of $15,000 per year.

This year, qualified dividends are tax-free for taxpayers in the 10% and 15% brackets. That means Jim won't pay any federal taxes on the dividends, as long as his taxable income for the year is $35,350 or less. If Mary had held on to the stock, she would have paid a 15% tax on the dividend income.

> *If your parents have substantial balances in traditional IRAs or qualified retirement plans, they may want to consider converting them or rolling them over into a Roth IRA.*

After 2012, unless the law is changed, qualified dividends will be taxed as ordinary income. Jim will still have a big tax advantage, however, with a marginal tax rate of 15% that is nearly 25 percentage points lower than Mary's 39.6% (assuming ordinary income tax rates also go up as scheduled).

When Jim dies, he leaves the stock, which has grown in value to $350,000, to Mary. Jim's estate is well under the estate tax exemption amount, so there's no estate tax.

In addition, as long as more than a year has passed since Jim received the stock, Mary is entitled to a "stepped-up" basis. In other words, her basis in the inherited stock is $350,000 — its fair market value on the date of Jim's death — so she can turn around and sell it without triggering any capital gains taxes. If Mary had held the stock the entire time, she would have owed capital

gains taxes on $250,000 in appreciation ($350,000 less her $100,000 basis).

Pay now, save later

If your parents have substantial balances in traditional IRAs or qualified retirement plans, they may want to consider converting them or rolling them over into a Roth IRA. Doing so ensures that the distributions will be taxed at your parents' lower rate rather than at your rate after you inherit the accounts.

Here's an example: Tom and Beth are in the 35% tax bracket. Tom's parents are retired and have taxable income of approximately $35,000 per year. Tom's mother has $150,000 in a traditional IRA, all of which was funded with tax-deductible contributions. Although Tom's parents' income is enough to meet their needs, Tom's mother must withdraw taxable required minimum distributions (RMDs) from her IRA each year.

In 2012, Tom's parents can have taxable income up to $70,700 without moving out of the 15% bracket. Tom suggests to his mother that she convert $35,000 of her IRA into a Roth IRA and name him as the beneficiary.

Tom also offers to give his parents the money they need to cover the federal income taxes of $5,250 ($35,000 × 15%) on the conversion plus any associated state income taxes. The gift is within the $13,000 annual gift tax exclusion, so there's no gift tax.

Tom's mother converts similar amounts each year until the entire IRA balance has been siphoned into the Roth IRA. The conversion accomplishes two important goals: First, it eliminates the need for Tom's mother to take RMDs. (They aren't required for a Roth IRA's original owner.) Second, by paying tax on the converted amounts at his parents' 15% rate, Tom saves tens of thousands of dollars in income taxes.

When Tom inherits the Roth IRA, he can withdraw as much of the funds as he desires tax-free, so long as the assets have been in the Roth IRA for the required period. Alternatively, he can withdraw tax-free only his RMD each year (RMDs are required for Roth IRAs inherited by someone other than the original owner's spouse) and allow the remainder to continue growing tax-free over his own lifetime for his family. If Tom had inherited the traditional IRA, distributions would have been taxed at Tom and Beth's higher rate.

A family affair

The estate planning techniques described show how you can work with your parents to minimize your family's tax burden. Talk with your estate planning advisor about these and other strategies for making the most of family members' lower tax rates. ✤

"Kiddie tax" isn't just for kiddies anymore

The "kiddie tax" was designed to prevent parents from opening investment accounts in the names of their children to take advantage of their children's lower income tax brackets. It works by taxing a child's unearned income beyond certain limits at his or her parents' marginal rate. For 2012, a child's first $950 of investment income is tax-free, the next $950 is taxed at the child's rate and any excess over $1,900 is taxed at the parents' marginal rate.

Originally, the kiddie tax applied to dependent children who were 13 years old or younger. The tax was expanded in 2006 to include children age 17 or younger and again in 2008 to include children 18 or younger as well as full-time students as old as 23. The tax doesn't apply to children who are married and file jointly or to children who aren't dependents (that is, whose earned income provides more than half of their support).

Even with the expanded kiddie tax, you still may have income shifting opportunities if your children are age 19 or older (24 or older for full-time students) or fall under one of the above exceptions. Such strategies can reduce your family's overall tax bite and preserve more wealth for future generations.

Are you part of a nontraditional couple?

Unmarried and same-sex married couples face estate planning hurdles

The federal gift and estate tax laws, as well as the laws in most states, were designed with "traditional" marriages between a man and woman in mind. If you don't fall within that category because you and your partner aren't married or because you're part of a same-sex marriage, thorough planning is required to meet your estate planning goals.

Impact of same-sex marriage laws

There's a common misconception that the same-sex marriage laws enacted in several states provide same-sex married couples with the same rights and privileges as traditional married couples. But this isn't the case — at least not yet.

Under the Defense of Marriage Act (DOMA), the term "marriage" for purposes of federal law means "a legal union between one man and one woman as husband and wife" and the term "spouse" means "a person of the opposite sex who is a husband or wife." This means that same-sex married couples are treated the same as unmarried couples under the federal gift and estate tax regime.

If a member of an unmarried couple dies intestate, his or her partner likely will be disinherited.

What about state laws? Same-sex married couples who live in one of the states that authorize this type of union should be treated the same as traditional married couples for inheritance, financial and health care decision-making and tax purposes. But if they're domiciled in another state, the answer depends on that state's law. Under DOMA, a state may refuse to recognize same-sex marriages performed in other states. Some states recognize these marriages, but many do not.

Be aware that many lawmakers want to repeal DOMA. In addition, the U.S. Court of Appeals for the First Circuit recently found DOMA to be unconstitutional, and the case likely will be appealed to the U.S. Supreme Court. If either Congress repeals DOMA or the Supreme Court upholds the First Circuit's decision, the estate planning landscape will change dramatically for same-sex married couples.

Nevertheless, because currently under federal law as well as the laws of many states same-sex married couples aren't treated as married couples, such couples may need to plan as if they weren't married.

Documentation is key

Everyone should document their wishes with wills, trusts or other estate planning instruments. But it's even more critical for nontraditional couples.

When married people in traditional couples die intestate (that is, without a will), their assets are still distributed to their surviving spouses and children according to state law (though possibly not in the precise manner they would have desired). If a member of an unmarried couple dies intestate, however, his or her partner likely will be disinherited.

Planning for disability or incapacity is also important. Again, everyone should sign advance directives, powers of attorney and other documents to spell out how health care and financial decisions should be made in the event they're unable to make such decisions themselves.

But even without such documents, a spouse in a traditional couple has the right to make certain decisions on the other spouse's behalf. Members of an unmarried couple, on the other hand, generally have no rights to participate in such decisions for their partners without written authorization.

Gifting strategies

For traditional married couples, estate planning typically centers around the federal marital deduction, which allows one spouse to make unlimited gifts or bequests to the other spouse gift- and estate-tax-free (as long as the recipient spouse is a U.S. citizen). The marital deduction isn't available to unmarried couples, nor is it available on the federal level to same-sex married couples. As a result, it's critical for these couples to begin planning early to make the most of the annual gift tax exclusion and lifetime gift tax exemption.

Currently, the annual exclusion allows you to make up to $13,000 in tax-free gifts to an unlimited number of recipients each year. The lifetime exemption stands at $5.12 million, but it's scheduled to drop to $1 million beginning in 2013. Although Congress may adjust next year's lifetime exemption, it's a good idea to take advantage of the $5.12 million exemption while it lasts to the extent you can afford to do so.

Consult your advisor

If you're part of a nontraditional couple, you likely know that some traditional estate planning strategies aren't available to you. Discuss your options with your estate planning advisor about steps you can take to ensure that your wishes are respected and your goals are achieved. ✤

Asset valuation: A key component of your estate plan

While Ken is working on revising his estate plan, he decides to gift his extensive collection of antique coins to his grandson. The problem is, he doesn't know the market value of his collection, so he can't accurately report the value on his gift tax return. Ken's estate planning advisor puts him in touch with a qualified appraiser who can value the collection.

When you make a noncash gift, a professional valuation can reduce the chances that the IRS will challenge your gift tax return, thus decreasing the possibility of unplanned tax liability.

3-year statute of limitations

If you make substantial noncash gifts — either outright or in trust — IRS regulations provide for a three-year statute of limitations during which the IRS can challenge the value you report on your gift tax return. After the three-year period expires, you can enjoy the peace of mind that comes with knowing that your estate plan will work as you intended.

There's one catch, though: The statute of limitations doesn't *begin* until your gift is "adequately disclosed" on a gift tax return. Under IRS regulations, to adequately disclose a gift, you must provide a detailed description of the nature of the gift, the relationship of the parties to the transaction and the basis for the valuation. You may also be required to furnish certain financial statements or other financial data and documents.

The regulations also provide that you can satisfy the adequate disclosure rule's information requirements by submitting an appraisal report by a qualified, independent appraiser that includes details about the property, the transaction and the appraisal process. In most cases, this is the most effective way to ensure that you've disclosed gifts adequately and triggered the statute of limitations. Even if a gift's value falls under the $13,000 annual exclusion and thus won't be taxable, it's a good idea to file a gift tax return to get the statute of limitations running.

Misstatement penalties can add up

Insufficient valuations expose you to the risk that the IRS will revalue property and assess additional taxes down the road. They can also result in significant

penalties if the IRS finds that the value of property was substantially or grossly misstated.

In this context, a "substantial" misstatement occurs when you report a value that is 65% or less of the "correct" value. A "gross" misstatement occurs when you report a value that is 40% or less of the correct value. The penalty for a substantial misstatement is 20% of the amount by which your taxes are underpaid. Gross misstatements result in a 40% penalty.

Appraise your assets

To reduce the chances of triggering an IRS review of your gift tax return, have a qualified appraiser value your substantial noncash gifts at the time of the transaction. A variety of other estate planning strategies also require having accurate, supportable and well-documented valuations of assets. Your estate planning advisor can help you arrange to have your assets valued by a qualified appraiser. ✤

Estate Planning Red Flag

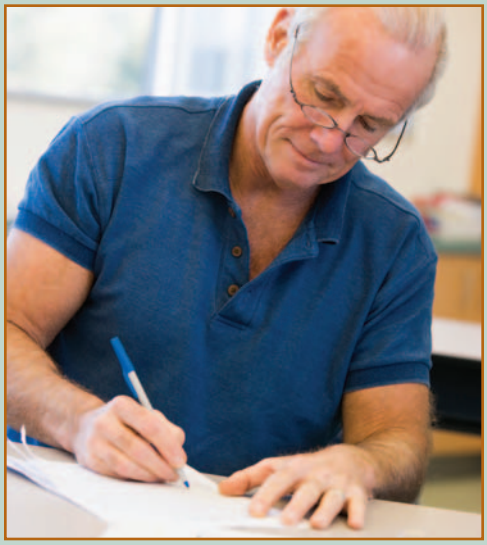
You haven't recently reviewed your retirement plan beneficiary designations

No matter how carefully you plan your estate, your objectives can easily be thwarted by inappropriate beneficiary designations for IRAs, 401(k) plans or other retirement accounts. Here are some of the most common mistakes:

Failing to coordinate beneficiary designations with the rest of your plan. Suppose that you wish to leave your wealth in trust for the benefit of your child. If you've designated the child as beneficiary of an IRA or other retirement account, he or she will receive those assets outright.

Not updating beneficiary designations after a divorce. If your former spouse is still a designated beneficiary, he or she may receive a sizable inheritance, even if you've written him or her out of your will.

Designating your estate as beneficiary. Under the required minimum distribution (RMD) rules, if you name your estate as beneficiary of an IRA or other qualified retirement account, the entire account balance will have to be distributed (and subject to tax, generally unless a Roth IRA) by Dec. 31 of the fifth year after your death.



Individual beneficiaries, on the other hand, can stretch the distributions over longer periods, maximizing tax deferral. A spouse can roll the funds into his or her own IRA and wait until age 70½ to begin RMDs. With IRAs and many employer plans, nonspousal beneficiaries can roll the funds into inherited IRAs and stretch RMDs over their life expectancies.

Not reading the fine print in employer plans. Not all employer plans allow rollovers to someone other than a spouse. If that's the case with your plan, consider rolling the funds into your own IRA during your lifetime and designating the appropriate person as beneficiary of the IRA.

Experience. Responsiveness. Value.

At Shumaker, we understand that when selecting a law firm for estate planning and related services, most clients are looking for:

- A high level of quality, sophistication, and experience.
- A creative and imaginative approach that focuses on finding solutions, not problems.
- Accessible attorneys who give clients priority treatment and extraordinary service.
- Effectiveness at a fair price.

Since 1925, Shumaker has met the expectations of clients that require this level of service. Our firm offers a comprehensive package of quality, experience, value and responsiveness with an uncompromising commitment to servicing the legal needs of every client. That's been our tradition and remains our constant goal. This is what sets us apart.

Estate planning is a complex task that often involves related areas of law, as well as various types of financial services. Our clients frequently face complicated real estate, tax, corporate and pension planning issues that significantly impact their estate plans. So our attorneys work with accountants, financial planners and other advisors to develop and implement strategies that help achieve our clients' diverse goals.

Shumaker has extensive experience in estate planning and related areas, such as business succession, insurance, asset protection and charitable giving planning. The skills of our estate planners and their ability to draw upon the expertise of specialists in other departments — as well as other professionals — ensure that each of our clients has a comprehensive, effective estate plan tailored to his or her particular needs and wishes.

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We welcome the opportunity to discuss your situation and provide the services required to help you achieve your estate planning goals. Please call us today and let us know how we can be of assistance.

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