The Estate Planner

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Estate Planning Red Flag

You're lending money to a family member

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Double whammy

IRD triggers both estate and income taxes

Whether you're planning your estate, or you're a beneficiary receiving an inheritance, don't overlook the potential tax consequences of income in respect of a decedent (IRD). IRD refers to income earned or accrued during life, but not received until after death. Common examples include unpaid salary, fees, commissions or bonuses, retirement income (from traditional IRAs and qualified retirement plans), deferred compensation, and accrued interest, dividends or rent.

IRD often results in double taxation: It's included in the deceased's taxable estate *and* it represents taxable income to the recipient — usually, the deceased's estate, spouse or other beneficiaries. Unlike other types of assets, IRD assets don't receive a stepped-up basis, which otherwise would eliminate income taxes. Fortunately, there are strategies you can use to minimize the impact.

Unintended consequences

Failure to recognize the significance of IRD can lead to unintended estate planning consequences. Consider this example:

Rick wishes to divide his estate equally between his two children, Jill and David. He leaves real estate worth $1 million to Jill and names David the beneficiary of his $1 million IRA. On the surface, it seems that Rick's children will receive equal inheritances. But unlike the real estate Jill receives, David's inheritance is reduced substantially by income taxes. That's because the IRA is an IRD asset, so David is subject to tax on each distribution he receives. Assuming he's in the 28% tax bracket, $280,000 of the IRA's $1 million value will go to the IRS.

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Planning strategies

There are several strategies you or your beneficiaries can use to reduce or even eliminate IRD. They include:

Taking advantage of deductions. Beneficiaries shouldn't overlook the IRD deduction. To provide some relief from double taxation, the Internal Revenue Code allows recipients of IRD to claim an itemized deduction equal to the estate tax attributable to that income. (See "Calculating the IRD deduction" on page 3.)

In addition, beneficiaries are entitled to write off "deductions in respect of a decedent" (DRD), which includes IRD-related expenses they incur — such as interest, investment advisory fees or broker commissions — that would have been deductible by the deceased had he or she paid them. To support these deductions, it's important to maintain thorough records of all relevant expenses.

Deferring the tax. Beneficiaries who receive IRAs or other retirement benefits may be able to defer income taxes by "stretching" distributions over their life expectancies rather than taking a lump sum.

Using IRD assets to fund charitable donations. Charities are tax-exempt entities, so they're not taxable on IRD. If you plan to make charitable donations, try to use IRD assets to fund them whenever possible, and leave other assets to your family members. For example, you might name a charity as beneficiary of your IRA or other retirement account.

If you don't want to leave the entire account to charity, you could place it in a trust for the benefit of both charitable and noncharitable beneficiaries. But work closely with your estate planning and tax advisors to be sure the trust is set up properly and doesn't inadvertently trigger accelerated taxation of IRD.

Converting an IRA to a Roth IRA. By converting a traditional IRA into a Roth IRA during your lifetime, you can spare your beneficiaries any IRD liability. (Qualified distributions from Roth IRAs are tax-free.) You'll need to pay income tax on the converted amount, but this strategy may be advantageous if your beneficiary is in a higher tax bracket than you or isn't entitled to an IRD deduction (because your estate pays no estate taxes or your beneficiary doesn't itemize).

Allocating IRD assets among your beneficiaries. What if you can't avoid leaving IRD assets to your noncharitable beneficiaries? You can minimize the impact by distributing those assets among your heirs and allocating more IRD to beneficiaries in lower tax brackets.

Calculating the IRD deduction

Recipients of income in respect of a decedent (IRD) are entitled to an itemized deduction equal to the amount of estate tax, if any, attributable to the IRD asset. The deduction is calculated by taking the amount of tax actually paid by the deceased estate and subtracting the tax it would have paid, had the IRD asset been excluded.

Suppose, for example, that Rick's estate is valued at $10.43 million. He dies in 2015, when the estate tax exemption is $5.43 million, leaving his $1 million IRA to his son, David. Rick's estate pays $2 million in estate taxes [($10.43 million - $5.43 million) × 40%]. Had the IRA been excluded, the estate's tax liability would have been $1.6 million [($9.43 million - $5.43 million) × 40%], so David is entitled to a $400,000 income tax deduction. This deduction may or may not offset David's IRD tax liability, depending on his overall tax situation. Be aware that, if David stretches IRA distributions over his life expectancy, the IRD deduction must also be spread over that period.

Pay attention to IRD

Between estate and income taxes, IRD can quickly devour wealth meant for your family. If you have, or expect to have, IRD assets, work with your advisor to implement strategies for minimizing their estate tax impact. ✤

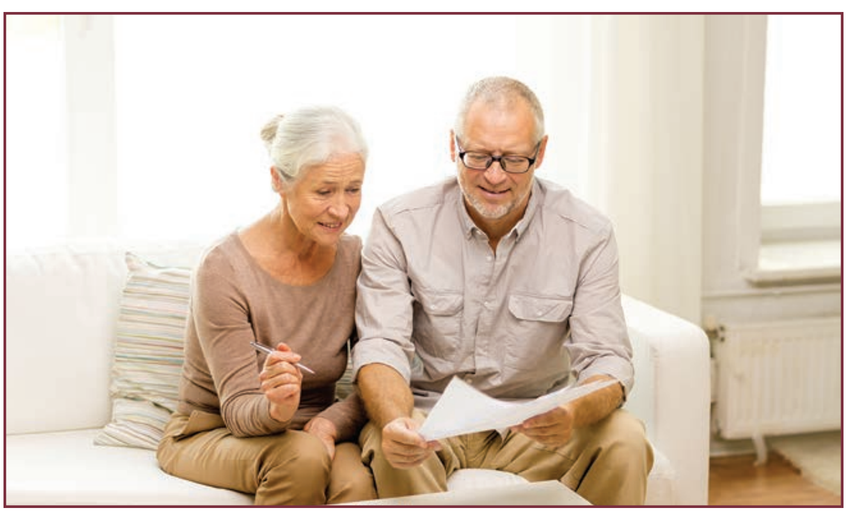
When to begin collecting Social Security depends on personal circumstances

Determining when to begin collecting Social Security benefits depends on many individual factors — including the amount of your nest egg, how much you and your spouse will need to continue your desired lifestyle during retirement, and your overall estate planning goals. In other words, the right answer should be based on your individual circumstances.

Running the numbers

If you were born at any time between 1943 and 1954, your normal retirement age is 66. If you start receiving benefits at age 66, you're entitled to a full benefit based on a formula tied to your earnings history. Many people can maximize wealth accumulation by delaying Social Security benefits to normal retirement age or even later.

You can start your Social Security retirement benefits as early as age 62, but the benefit amount you receive will be less than your full retirement benefit amount. If you start your benefits early, they'll be reduced based on the number of months you receive benefits before you reach your full retirement age.



According to the Social Security Administration, if your full retirement age is 66, the reduction of your benefits at age 62 is 25%; at 63, it's 20%; at 64, it's 13.3%; and at 65, it's 6.7%.

If your full retirement age is older than 66 (that is, you were born after 1954), you can still start your retirement benefits at 62 but the reduction in your benefit amount will be greater, up to a maximum of 30% at age 62 for people born in 1960 or later.

Calculating your breakeven point

A useful tool for choosing the right starting age is to calculate your breakeven point. For example, Sue, who is retired, is about to turn 62. She's trying to decide between taking a reduced Social Security benefit right away or waiting until her normal retirement age of 66. Let's say Sue's full monthly benefit at 66 would be $2,000 and her reduced benefit at 62 would be $1,500.

Ignoring cost of living adjustments for simplicity, Sue's breakeven point is just before her 78th birthday. At that point, her total benefits will be about the same whether she starts at age 62 (192 months × $1,500 = $288,000) or at age 66 (144 months × $2,000 = $288,000). If Sue lives to at least 78, waiting until 66 to start collecting will provide her with greater lifetime benefits. If she doesn't reach that age, she's better off starting at 62.

Let's suppose that Sue's father and grandfather both lived to be 90. If Sue follows suit, she'll receive

$72,000 of additional Social Security benefits by waiting until her normal retirement age of 66.

After determining your breakeven point, the right choice for you depends on several factors, including your actuarial life expectancy, your health and your family history. Also, keep in mind that the above example doesn't consider potential earnings on Social Security benefits. If you plan to invest your benefits, you may need to adjust your breakeven point upward or downward, depending on your expected rate of return.

Do you plan to work past eligibility age?

If you plan to continue working after you become eligible for Social Security, you're likely better off delaying benefits at least until you reach your normal retirement age. If you start anytime before the year in which you reach your normal retirement age, your benefits will be reduced by $1 for every $2 you earn above a certain threshold ($15,720 in 2015).

After you reach your normal retirement age, you can continue working without reducing your Social Security benefits. But keep in mind that, if your income exceeds certain limits, a portion of your Social Security benefits will be taxable.

Seek your advisor's advice

Several factors must be considered when determining the ideal time to begin taking Social Security benefits. Your estate planning advisor can assess your circumstances and help you maximize the potential value of your Social Security benefits. ✤

Estate planning for disabled children

ABLE accounts vs. special needs trusts

For families with disabled children, financial planning can be a challenge. On the one hand, you want to provide the happiest, most comfortable life possible for your loved one. On the other hand, you don't want to jeopardize your child's eligibility for means-tested government benefits, such as Medicaid or Supplemental Security Income (SSI), especially after you're no longer around to provide for him or her.

For many years, the most effective solution to this problem has been to set up a special needs trust (SNT), which provides resources for the care of a disabled child while preserving his or her eligibility for government benefits. SNTs also offer some asset protection against creditors' claims.

Now, many families have another option: In 2014, the Achieving a Better Life Experience (ABLE) Act was signed into law. The act created Internal Revenue Code Section 529A, which authorizes the states to offer tax-advantaged savings accounts for the blind and severely disabled, similar to Sec. 529 college savings accounts.

ABLE accounts and SNTs have different sets of advantages and disadvantages, so it's important to compare the two options carefully.

How ABLE accounts work

The ABLE Act allows family members and others to make nondeductible cash contributions to

a qualified beneficiary's ABLE account, with total annual contributions limited to the federal gift tax annual exclusion amount (currently, $14,000). To qualify, a beneficiary must have become blind or disabled before age 26.

The account grows tax-free, and earnings may be withdrawn tax-free provided they're used to pay "qualified disability expenses." These include health care, education, housing, transportation, employment training, assistive technology, personal support services, financial management and legal expenses.

An ABLE account generally won't affect the beneficiary's eligibility for Medicaid and SSI — which limits a recipient's "countable assets" to $2,000 — with a couple of exceptions. First, distributions from an ABLE account used to pay housing expenses are countable assets. Second, if an ABLE account's balance grows beyond $100,000, the beneficiary's eligibility for SSI is suspended until the balance is brought below that threshold.

Comparison with SNTs

Here's a quick review of the relative advantages and disadvantages of ABLE accounts and SNTs:

Availability. Anyone can establish an SNT, but ABLE accounts are available only if your home state offers them, or contracts with another state to make them available. Also, as previously noted, ABLE account beneficiaries must become blind or disabled before age 26. There's no age limit for SNTs.

Qualified expenses. ABLE accounts may be used to pay only specified types of expenses. SNTs may be used for any expenses the government doesn't pay for, including "quality-of-life" expenses, such as travel, recreation, hobbies and entertainment.

Tax treatment. An ABLE account's earnings and qualified distributions are tax-free. An SNT's earnings are taxable.

Contribution limits. Annual contributions to ABLE accounts currently are limited to $14,000, and total contributions are effectively limited to $100,000 to avoid suspension of SSI benefits. There are no limits on contributions to SNTs, although contributions in excess of $14,000 per year may be subject to gift tax.

An ABLE account generally won't affect the beneficiary's eligibility for Medicaid and SSI.

Investments. Contributions to ABLE accounts are limited to cash, and the beneficiary (or his or her representative) may direct the investment of the account funds twice a year. With an SNT, you can contribute a variety of assets, including cash, stock or real estate. And the trustee — preferably an experienced professional fiduciary — has complete flexibility to direct the trust's investments.

Medicaid reimbursement. If an ABLE account beneficiary dies before the account assets have been depleted, the balance must be used to reimburse the government for any Medicaid benefits the beneficiary received after the account was established. There's also a reimbursement requirement for SNTs. With either an ABLE account or an SNT, any remaining assets are distributed according to the terms of the account or the SNT.

Weigh your options

ABLE accounts offer tax advantages and are less expensive to administer. SNTs offer higher contribution limits and greater flexibility. Your estate planning advisor can help you determine which is best for your family: an ABLE account, an SNT, or one of each. ✤

Estate Planning Red Flag

You're lending money to a family member

When a family member is in financial need, your natural response may be to get out your checkbook and make a loan. But while an informal approach may feel comfortable, it pays to take steps to formalize the transaction. Why? For one thing, the IRS tends to view undocumented loans as disguised gifts. Depending on the amount in question and your tax situation, such a gift may use up some of your lifetime gift tax exemption or even trigger gift tax liability.

To avoid this result, prepare a written promissory note that spells out the loan's terms, including a fixed repayment schedule and a reasonable rate of interest. To help ensure that the IRS will treat the transaction as a bona fide loan, it's also important to make a genuine effort to collect and document your efforts in writing.

It's particularly important to charge reasonable interest. If you make a no-interest or low-interest loan to a family member (and it's not treated as a disguised gift), you'll be liable for income taxes on the "imputed interest" (with exceptions for certain small loans). Imputed interest is equal to the difference between the interest you collect from the borrower and the interest you would have collected at the applicable federal rate. In other words, you'll pay tax on interest that you didn't actually receive. What's more, imputed interest is treated as a taxable gift to the borrower.

Providing financial assistance to loved ones is a worthy endeavor. But before you write a check, do some planning to avoid unintended tax consequences.

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How to Peacefully Divide the Kingdom

By the age of 32, Alexander the Great had conquered lands from Greece to Egypt and into Asia. Then, suddenly, he fell ill and died. Alexander was a brilliant military strategist, but he failed to appoint an heir and he never considered the details of his legacy. After his death, the dispute over control of his kingdom led to 40 years of war and the murders of his son and brother. This is one of the earliest examples of poor estate planning.

Your own personal kingdom is probably more modest than Alexander's, but your need to plan for the disposition of your assets after your death is just as important to your heirs. The creation of a will or a revocable trust is usually the most common consideration in the estate planning process, but titling your assets properly is an equally-important aspect that is not often given the attention it deserves.

During Alexander's reign, he founded 20 cities that bore his name. Owning assets in your name might help your ego but it can also complicate the disposition of your assets. Proper account titling, a seemingly innocuous detail, will have a significant impact on who inherits your assets after you are gone. Any mistakes in titling can potentially derail even the most carefully-written estate plan. There are a number of common titles that most individuals will recognize; yet most of us do not understand what they mean or how they impact our estate planning. Below, we attempt to make some sense out of the titling dilemma.

Individual Name

The simplest way to title an account is to register it in your sole name. While you are alive and competent, you will enjoy sole ownership and control over the account. If you become incapacitated, however, the appointment of a guardian may be necessary to manage the asset. When you pass away, the individual account is distributed to the beneficiaries of your estate, subject to a court proceeding known as probate. Guardianship and probate proceedings are time consuming and expensive, and for this reason, many people avoid titling assets in their sole names.

Tenants in Common

Tenancy in Common (TIC) is a form of shared ownership. The TIC designation dictates that each individual owner holds a pro-rata interest in the account. Even though there are multiple owners listed on the account, each owner's share is treated as if the entire account were listed in his or her sole name.

Joint Tenants and Tenants by the Entirety

TIC ownership can be contrasted with other forms of ownership known as Joint Tenancy with Rights of Survivorship (JTWROS) and Tenancy by the Entirety (TBE). Unlike TIC, JTWROS and TBE will avoid probate proceedings on the death of one co-owner. Each owner enjoys full access to the account during life and upon the death of one owner, the surviving owner(s) will own the entire remaining interest. This is true irrespective of the provisions of your will or trust.

Ownership as TBE is limited to married couples. During the marriage, TBE ownership has the additional benefit of protection against the liabilities of one spouse. While Florida recognizes TBE, it is not recognized in every state and this should be considered when planning with this form of co-ownership.

Ownership by a Trust

As part of their estate planning, many people create revocable trusts and title accounts in the name of the trust. Creating and funding a revocable trust is an efficient way to hold title to assets because it obviates the need for guardianship and probate proceedings. Generally, the person establishing the trust (the "grantor") serves as the trustee (the legal titleholder of the trust's assets) and is also typically the sole beneficiary during life. Upon the death of the grantor, a successor trustee will manage and distribute any remaining trust assets for the beneficiaries designated within the trust.

Accounts with Beneficiaries

Probate can also be avoided with individual accounts by adding a named beneficiary to the account. These are commonly known as "transfer on death" (TOD) or "pay on death" (POD) designations. With a TOD/POD, you can designate an individual or a trust as the beneficiary of the account and that named beneficiary will automatically become the owner upon your death. These designations can typically be made on bank accounts, brokerage accounts, and retirement accounts (such as IRAs and 401Ks) to distribute the asset upon the owner's death to the designated beneficiary without a probate proceeding. It is important to note that the beneficiaries designated on such accounts will receive them upon your death, regardless of the provisions of your estate planning documents. However, merely adding a beneficiary to an account does not protect against a guardianship proceeding in the event of the account owner's incapacity.

One eyewitness account of Alexander's death claims that he vaguely left control of his empire "to the strongest!" Leaving it to heirs to determine who is the strongest was as unwise on the battlefields of Babylon as it is in a 21st century courtroom. Alexander's "probate" process involved 40 years of fighting among his friends and family. Fortunately, it is easier to avoid today. It is critical that your estate and financial plans include proper documentation, detailed instructions, and correct titling. Further, account titling and beneficiary designations should be reviewed periodically in the context of your estate plan to make sure they are still in line with your wishes. Attending to these details will help your heirs avoid an epic battle of their own.