The Estate Planner

September/October 2014

The true cost of giving

Charitable donations in a no-estate-tax environment

Family meetings help ensure estate planning success

Could an exchange help cover LTC insurance costs?

Estate Planning Red Flag

Your will leaves everything to your life partner

Weston Hurd LLP
Attorneys at Law

Cleveland ▪ Columbus ▪ Beachwood

The Tower At Erieview
1301 East 9th Street, Suite 1900
Cleveland, Ohio 44114-1862
tel 216.241.6602 • fax 216.621.8369

10 West Broad Street, Suite 2400
Columbus, Ohio 43215-3469
tel 614.280.0200 • fax 614.280.0204

24100 Chagrin Boulevard, Suite 200
Beachwood, Ohio 44122-5535
tel 216.241.6602 • fax 216.621.8369

www.westonhurd.com

The true cost of giving

Charitable donations in a no-estate-tax environment

As the federal gift and estate tax exemption continues to climb, the number of people subject to estate taxes is shrinking. What does this mean for charitable giving?

There's a common misconception that taxes are the driving force behind most charitable donations. Reduce the tax bite, the theory goes, and charitable giving will decline. In fact, the opposite is usually true.

Tempting argument

It's tempting to argue that reducing estate taxes is a disincentive to philanthropy if you focus on the "cost" of a charitable gift.

In 2014, for example, the top federal gift and estate tax rate is 40%. If you're subject to estate taxes, every $1 million you leave to charity reduces the amount available to your heirs by $600,000. But if your estate is nontaxable, a $1 million donation reduces the amount available to your heirs by $1 million. In other words, the cost of your gift has increased from $600,000 to $1 million.

If giving becomes more "expensive," it seems logical that doing so would decline. As the following example shows, however, this isn't the way most people approach charitable giving.

More to go around

People who are charitably inclined generally don't consider the cost of giving. It's more common to determine the after-tax amount they wish their heirs to receive and leave the excess, if any, to charity.

> *People who are charitably inclined generally don't consider the cost of giving.*

Take Bill and Margaret, whose estate is worth $10 million. They created their estate plan in 2003, when the exemption amount was $1 million and the top tax rate was 49%. Their goal was to leave at least $2.5 million after estate taxes to each of their two children and the remainder to charity. They leave $9 million ($4.5 million each) to their children and $1 million to charity. If Bill and Margaret were to die in 2003, each child would inherit $2,812,500 after federal estate taxes and before any state estate taxes or administrative costs.

Fast-forward to 2014: Bill and Margaret's estate is still worth $10 million, but the exemption amount is now $5.34 million ($10.68 million for married couples), so their estate is no longer taxable. If they leave their plan as is, each child would receive $4.5 million and the same $1 million gift will go to charity. Alternatively, Bill and Margaret could

Nonqualified CRTs offer greater flexibility

A charitable remainder trust's (CRT's) exempt status enables it to provide significant tax benefits. (See main article.) But those benefits come at the cost of flexibility. Payouts are limited to a fixed amount or percentage, regardless of hardship or need, and the charity's remainder interest generally must be at least 10% of the trust's initial value.

If taxes are less of a concern, a *nonqualified* CRT provides greater flexibility to provide for your family while leaving something for charity. These trusts offer little in the way of income, gift and estate tax advantages, but they need not comply with the requirements for a qualified CRT. That means they can distribute any amount of income and principal to your beneficiaries, in the trustee's discretion.

Typically, nonqualified CRTs are established at death to take advantage of the stepped-up basis rules — the value of the initial contribution is stepped up to its fair market value, erasing any appreciation that might trigger capital gains taxes. It's advisable to distribute at least all of the trust's current income to avoid a steep income tax bill. Currently, trusts are subject to income taxes at the highest rate (39.6%), as well as the 3.8% net investment income tax, to the extent their income exceeds $12,150.

reduce the amount they leave the children to, say, $4 million each. That's still significantly more than their original goal, but now they can double their charitable gift to $2 million.

Rise of the CRT

Lower gift and estate taxes may increase interest in charitable remainder trusts (CRTs). A lifetime CRT, for example, allows you to accelerate charitable gifts you'd otherwise make at death and enjoy substantial income tax benefits in the process.

A CRT provides an income stream to you or other beneficiaries over a specified term, after which the remaining assets are transferred to a qualified charity. Payouts are based on a fixed percentage (between 5% and 50%) of the trust assets' initial value (a charitable remainder annuity trust) or its value recalculated annually (a charitable remainder unitrust). Contributions constitute taxable gifts to your noncharitable beneficiaries (other than yourself), but are shielded from tax by your unused exclusion amount.

When you establish a CRT, you enjoy a charitable deduction equal to the present value of the charity's remainder interest. Because a CRT is tax-exempt, it's an ideal vehicle for receiving highly appreciated assets, which the trustee can sell tax-free and reinvest in income-producing assets. The trust assets grow on a tax-free basis and the beneficiaries enjoy steady income from the trust, a portion of which may be taxed at favorable capital gains rates.

The right balance

If you're charitably inclined, review your estate plan in light of recent law changes. Your advisor can help ensure that your plan strikes the right balance between philanthropy and providing for your family. ✤

Family meetings help ensure estate planning success

You've spent countless hours working with your advisors to design an estate plan that provides for your family, protects your business and satisfies your charitable goals. Now it's time to put it on a shelf and forget about it, right? Wrong. Unless you communicate your plan — and the principles behind it — to your family and to your executors, trustees, guardians and agents, your plan is at risk.

By holding one or more family meetings, you can help ensure that your representatives understand and accept their responsibilities and that your loved ones understand your reasons for distributing your wealth in the manner you've chosen. Lack of communication leaves the people affected by your plan in the dark, inviting misunderstandings, hurt feelings and conflict.

Whom should you invite?

Invite your spouse, children and other family members who'll be affected by your plan (either by their inclusion or exclusion). You should also invite any nonfamily members you'll ask to serve as executors, trustees, agents or guardians of minor children.

> *Family meetings are particularly valuable when a family business is involved.*

It's a good idea to include key advisors, for two reasons: First, they can help answer questions about how your plan works. And second, creating an opportunity for your family, representatives and advisors to get to know one another will help build trust and improve the chances that your plan will operate smoothly when the time comes.

What should you discuss?

For starters, you should review the key documents that make up your plan and let everyone know where they're located. In addition, provide an overview of the estate planning decisions you've made so far and — most important — the reasoning behind them.

Many people simply divide their assets equally among their heirs. But in estate planning, equal isn't necessarily fair. For example, let's suppose Mike has adult children from a previous marriage and younger children from his current marriage. Mike put his older children through college years ago and now they're gainfully employed and financially independent.

Fairness would dictate that Mike's estate plan favor his younger children, who'll need the money for tuition and living expenses. But Mike's older children may not see it that way unless he explains it to them. A family meeting provides an opportunity for that discussion.

Other issues to discuss include charitable giving, the treatment of assets with special significance — such as vacation homes or family heirlooms — and decisions about which family members are chosen to be guardians, executors and so on.

Is there a business involved?

Family meetings are particularly valuable when a family business is involved. It may seem fair to provide a greater share to family members who work in the business.

But what if most of your wealth is tied up in the business? How do you provide for family members who don't work in the business while still rewarding the "sweat equity" of those who do?

One option is to divide ownership equally but to use voting and nonvoting stock to give management control to family members who work in the business. Another option is to leave the business to those who work in it and use life insurance to create an inheritance for other family members. Whatever the solution, the best way to avoid conflict and resentment is to discuss the issue with all interested parties and get their input.

Talk about it now

Estate planning may require you to make some tough decisions about how your wealth will be distributed. Often, the easiest way to avoid misunderstandings, hurt feelings or conflict is to explain your reasons in person — and family meetings provide an opportunity to do just that. After all, once your plan is implemented, it will be too late. ✤

Could an exchange help cover LTC insurance costs?

No estate plan is complete without considering long-term care (LTC) expenses and how to pay for them. Consider the fact that the current median rate for a private nursing home is $87,600, according to the *Genworth 2014 Cost of Care Survey*.

LTC insurance is certainly an option. But these policies can be expensive, too — particularly if you wait to buy one at retirement age. If funding an LTC insurance premium is a potential problem, consider using a total or partial tax-free exchange of an existing life insurance policy or annuity contract.

Reviewing the history

For many years, Internal Revenue Code Section 1035 has permitted taxpayers to exchange one life insurance

policy for another, one annuity contract for another, or a life insurance policy for an annuity contract without recognizing any taxable gain. (Sec. 1035 doesn't

permit an exchange of an annuity contract for a life insurance policy.)

In the late 1990s, the U.S. Tax Court approved *partial* tax-free exchanges, finding that these exchanges satisfy the requirements of Sec. 1035. A partial exchange might involve using a portion of an annuity's balance or a life insurance policy's cash value to fund a new contract or policy. In order for the transaction to be tax-free, the exchange must involve a *direct* transfer of funds from one carrier to another.

The Pension Protection Act of 2006 expanded Sec. 1035 to include LTC policies. So now it's possible to make a total or partial tax-free exchange of a life insurance policy or annuity contract for an LTC policy (as well as one LTC policy for another). Keep in mind that, to avoid negative tax consequences after making a partial exchange of an annuity contract for an LTC policy, you must wait at least 180 days before taking any distributions from the annuity.

A tax-free exchange allows you to defer taxable gain and, to the extent the gain is absorbed by LTC insurance premiums, eliminate it permanently.

Funding LTC costs

A tax-free exchange provides a source of funds for LTC coverage and offers significant tax benefits. Ordinarily, if the value of a life insurance policy or annuity contract exceeds your basis, lifetime distributions include a combination of taxable gain and nontaxable return of basis. A tax-free exchange allows you to defer taxable gain and, to the extent the gain is absorbed by LTC insurance premiums, eliminate it permanently. Consider this example:

Jessica, age 75, is concerned about possible LTC expenses and plans to buy an LTC insurance policy with a premium of $10,000 per year. She owns a nonqualified annuity (that is, an annuity that's not part of a qualified retirement plan) with a value of $250,000 and a basis of $150,000, and Jessica wishes to use a portion of the annuity funds to pay the LTC premiums. Under the annuity tax rules, distributions are treated as "income first." In other words, the first $100,000 she withdraws will be fully taxable and then any additional withdrawals will be treated as a nontaxable return of basis.

To avoid taxable gain, Jessica uses partial tax-free exchanges to fund the $10,000 annual premium payments. In an exchange, each distribution includes taxable gain and basis in the same proportions as the annuity: In this case, the gain is ($100,000/$250,000) × $10,000 = $4,000. Thus, each partial exchange used to pay LTC premiums permanently eliminates $4,000 in taxable gain.

Partial tax-free exchanges can work well for stand-alone LTC policies, which generally require annual premium payments and prohibit prepayment. Another option is a policy that combines the benefits of LTC coverage with the benefits of a life insurance policy or an annuity.

Typically, with these "combo policies," the death or annuity benefits are reduced to the extent the policy pays for LTC expenses. Often, premiums

on these policies can be paid in a lump sum, in which case a total tax-free exchange of an existing life insurance policy or annuity contract may be appropriate.

In an exchange for a combo policy, any gains used to fund LTC premiums will permanently avoid tax. But gains that become part of the policy's cash value or are used to fund annuity payments may eventually be taxed.

Offsetting LTC expenses

A key estate planning objective is preserving your wealth for your loved ones. LTC costs can quickly deplete your funds, thus allowing less wealth to pass to heirs. LTC insurance can help offset those costs, and using a tax-free exchange may be an option to help fund LTC premiums. Before taking action, however, consult your financial advisor to determine whether this strategy is right for you. ✤

Estate Planning Red Flag

Your will leaves everything to your life partner

There are many benefits to marriage, including some significant estate planning advantages. Nevertheless, for a variety of reasons, many couples — both opposite-sex and same-sex — choose not to marry. It's common for unmarried partners to leave all or most of their wealth to each other in their wills. But this can result in a significant estate tax liability.

If you and your life partner are affluent enough to make gift and estate taxes an issue — that is, if your wealth exceeds the gift and estate tax exemption amount (currently, $5.34 million) — you may enjoy significant tax benefits with a little extra planning.

Unlike married couples, who can take advantage of the marital deduction, unmarried partners can't transfer unlimited amounts to each other tax-free. To reduce their estate tax bills, they must take some additional steps. One option is to make lifetime gifts within the annual gift tax exclusion (currently, $14,000 per year per recipient). If you start making regular annual gifts early enough, you can transfer a significant amount of wealth tax-free.

Another technique — which is available *only* to unrelated persons — is the grantor retained income trust (GRIT): You transfer some or all of your assets to an irrevocable trust, reserving the right to receive the trust's income during its term. At the end of the term, the assets are transferred to your partner. If you die before the end of the trust term, however, the assets will be included in your estate. That is, they'll revert to you.

When you contribute assets to a GRIT, you make a taxable gift to your partner. But the amount of the gift for federal tax purposes is deeply discounted by subtracting the actuarial value of your reserved income and reversionary interests from the value of the assets.

Weston Hurd LLP
Attorneys at Law

Angela G. Carlin is the Co-Chair of Weston Hurd's Estate, Trust and Probate Practice Group. She focuses her practice on estate, trust and probate administration and litigation, and tax matters. Angela is the author of the Merrick-Rippner Probate Law publication which is the recognized authority in Ohio on probate law. She received the Nettie Cronise Lutes Award from the Ohio State Bar Association in 1996 as the Outstanding Woman Lawyer and for many years, she has been named as an *Ohio Super Lawyer* by Law & Politics Media, Inc. and a *Leading Lawyer* by Inside Business Magazine.

Karen A. Davey focuses her practice on estates, trust and probate administration. She also handles litigation in probate related matters, such as will contests, trust contests, and power-of-attorney disputes.

Jerrold L. Goldstein focuses his practice on estate planning, probate and corporate law. Jerry is also Co-Chair of Weston Hurd's Estate, Trust and Probate Practice Group. He represents clients in a wide variety of matters involving probate administration, probate litigation, estate and income tax compliance, wills and trusts, business formation, contract negotiations, and commercial real estate.

Gary W. Johnson advises clients on matters involving commercial litigation, business entities creation and maintenance, land use, construction law, zoning, estate planning and probate. Gary has been recognized as an *Ohio Super Lawyer* in the area of Business Litigation by Law & Politics Media, Inc.

Eugene (Gene) A. Kratus advises individuals in the areas of tax, business and estate planning and counsels privately-owned businesses and their owners on corporate, tax, mergers, acquisitions and business succession issues. His estate planning practice includes implementing various estate planning techniques, ranging from modest By-Pass Trusts to the implementation of sophisticated planning with family limited partnerships, family limited liability companies, charitable trusts and private foundations.

Samuel J. Lauricia III focuses his practice on tax planning, at both the Federal and state level, involving corporate, partnership, individual and gift tax issues, succession planning and general corporate transactions, contracts, mergers and acquisitions. Sam has been recognized as an *Ohio Rising Star* in the area of Taxation by Law & Politics Media, Inc.

Shawn W. Maestle is the Chair of Weston Hurd's Appellate section and a member of the firm's Litigation section. He focuses his practice in the areas of appellate, estate planning and probate litigation.

Teresa G. Santin is an Associate with Weston Hurd LLP. She focuses her practice on matters involving business, employment, estate planning, real estate, and white collar litigation.

Joseph B. Swartz focuses his practice on estate planning, estate administration, trust administration, and income tax for individuals, estates and trusts. Joe served as chair of the Ohio State Bar Association's Labor and Employment Law section for 2010-2012 and he has been recognized as an *Ohio Super Lawyer* for Labor and Employment by Law & Politics Media, Inc.

Carlin Comments

THE *DISCONNECT* IN PROVISIONS RELATIVE TO THE TERMINATION OF A HEALTH CARE POWER OF ATTORNEY VERSUS A GENERAL POWER OF ATTORNEY

By Angela G. Carlin

Chapter 1337 of the Ohio Revised Code contains the laws and forms concerning Powers of Attorney: Miscellaneous Provisions in R.C.1337.01 through 1337.10; Health Care Powers of Attorney in R.C.1337.11 through 1337.17; and the Uniform Power of Attorney Act in R.C.1337.21 through 1337.64 which applies to powers of attorney generally but not including a power to make health care decisions. This comment will focus on the revocation and termination of such written powers of attorney and the apparent disconnect between the powers of attorney for financial and management of the principal's (the person who executes such document) property and his or her attorney-in-fact (the person named as agent to assist the principal) when the principal loses the ability to manage his or her person or estate, and health care powers of attorney relative to the protection and care of the principal by the agent when the principal loses the ability to make health care decisions for himself or herself.

In R.C.1337.14(A) a principal who creates a valid durable power of attorney for health care may revoke that instrument or the designation of the agent at any time or in any manner, and if the principal expresses an intention to so revoke (Query: does that mean in writing or orally), when that intention is communicated to the principal's attending physician, a witness to the revocation, or to other health care personnel by the witness. In subsection (C), the statute unequivocally provides that a valid durable power of attorney for health care revokes a prior valid durable power of attorney for health care unless the instrument provides otherwise.

In March 2014, the Ohio Legislature added to R.C.1337.12 a provision that in a health care power of attorney, the principal's nomination of a guardian for himself or his estate or both would be revoked by the principal's subsequent nomination of such a guardian, and the court shall make its appointment according to the principal's most recent nomination.

As to a general (financial not health care) durable power of attorney, R.C.1337.30(A) lists that such instrument terminates when: 1) the principal dies; 2) the principal becomes incapacitated if the instrument is not durable (the validity continues notwithstanding such incapacity); 3) the principal revokes the instrument; 4) the instrument provides for its termination; 5) the purpose of the instrument is accomplished (a limited power of attorney and not general as to the powers of the agent); and 6) the principal revokes the agent's authority, or the agent dies, resigns, or becomes incapacitated, and the instrument does not provide for a successor agent. In subsection (F), the statute specifically provides that a subsequent power of attorney does not revoke a prior power of attorney, unless the subsequent instrument revokes the "previous" power of attorney, or all other powers of attorney are thus revoked. Therefore there is not an automatic revocation of the "previous" power of attorney by the subsequent instrument, unlike the automatic revocation of a health care power of attorney by such later dated health care power of attorney instrument.

In addition, to more "muddy the waters," a new amendment to R.C.1337.28 effective in March 2014 in the Uniform Power of Attorney Act does provide that the nomination of a guardian by the principal's for his person, estate or both, or such guardian for his minor children or incompetent adult child whether born at the execution of the instrument or afterward, is specifically revoked by the principal's subsequent nomination of any such guardians for himself or any of such children, and the court shall make such appointment in accordance with the principal's most recent nomination; but this amendment is limited to the appointment of a guardian within the power of attorney instrument and not the revocation of the whole prior instrument.

Consistency by the Ohio Legislature as to how and when a subsequent instrument, be it a health care power of attorney or a general power of attorney, revokes a prior instrument and the effect thereof would assist Ohio principals and their attorneys.

If you have any questions about this topic, please contact your Weston Hurd attorney.