INSIGHT ON ESTATE PLANNING

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ESTATE PLANNING PITFALL
You haven't addressed pets in your estate plan

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Gift giving made easy

Annual exclusion reduces your taxable estate

How can you reduce the size of your taxable estate? There are many ways to accomplish this objective, including the use of irrevocable trusts and other sophisticated estate planning techniques. But one of the most effective methods is also the simplest: leveraging your annual gift tax exclusion. Using this technique can cut down your estate to a manageable size without paying any federal gift tax.

Annual exclusion primer

Using the annual gift tax exclusion, you can give to an unlimited number of family or friends cash or property valued up to a specified amount each year without owing any gift tax — so long as the gifts are considered to be "present interest" gifts. In general, a present interest gift is one in which the beneficiary has an unrestricted right to immediately use and enjoy the property. If you repeat the gifting strategy over several years, you'll see your taxable estate dwindle, while still keeping the assets within the family.

The annual gift tax exclusion, which is stated as $10,000 in the tax code and is subject to inflation indexing, currently is $14,000 per recipient. In other words, you can give each recipient gifts of cash or property valued up to $14,000 each year with no gift tax consequences. The exclusion may be increased only in increments of $1,000, so it changes infrequently. The last time it was increased, from $13,000 to $14,000, was back in 2013.

Let's suppose you have three adult children and seven grandchildren. If you give each one of them $14,000 in 2016, for a total outlay of $140,000 (10 × $14,000), you'll have reduced your estate by that amount without paying federal gift tax. If you continue this strategy for five consecutive years, you will have handed out $700,000 (5 × $140,000) completely free of gift tax. You don't even have to file any gift tax returns!

What's more, if you're married, you and your spouse can give away a combined gift of up to $28,000 a year — via split gifts — without any gift tax. Assuming you follow the same pattern of gifting all 10 family members for five years, you will have whittled down your estate by $1.4 million ($28,000 × 10 × 5).

'Tis the season to give

Gift-giving strategies based on the $14,000 annual gift tax exclusion are often implemented around the traditional holiday season. For instance, you might arrange to give three recipients $14,000 each in December and then give the same three recipients another $14,000 each in January. This reduces the size of your estate by $84,000 (3 × $14,000 × 2) in just two calendar months.

Of course, you shouldn't make such gifts in a complete vacuum. Coordinate your lifetime gifts with other aspects of your estate plan.

Of course, by giving away cash or property, you're relinquishing full control over those assets. Once they're out of your hands, they're technically gone forever. However, if this was your ultimate goal anyway, the annual gift tax exclusion can certainly provide the means with little fuss.

Giving assets that appreciate in value

The rules are a little trickier if you're gifting assets such as securities. Generally, the value of property for gift tax purposes is its fair market value. If you gift property that's appreciated in value, the recipient must use your basis (usually, the original cost) to compute the taxable gain if he or she subsequently sells the property. Nevertheless, the gain will be taxed to the recipient, who'll likely be in a lower tax bracket than you. Thus, gifting can result in income tax savings for the family as well.

In addition, be aware that gifts made directly to a financial institution to pay for tuition or to a health care provider for medical expenses on behalf of someone else don't count toward the gift tax exclusion, and, in fact, aren't even reportable gifts. You can pay tuition in excess of the annual exclusion amount of $14,000, and, in the absence of other gifts that may be reportable, you won't have to file a gift tax return.

Finally, you have one other gift tax break in your hip pocket: the lifetime gift tax exemption. This exemption applies to gifts of up to $5 million, indexed to $5.45 million in 2016, after you've exceeded the annual gift tax exclusion. But using any part of this exemption erodes the available tax shelter from estate tax, so you might decide to limit your lifetime gift giving to amounts covered by the annual gift tax exclusion.

You can give each recipient gifts of cash or property valued up to $14,000 each year with no gift tax consequences.

Talk to your advisor

Even though using the $14,000 per recipient annual exclusion is a simple way of reducing your taxable estate, this is not to say you should abandon other more sophisticated estate planning techniques designed to maximize the benefits of the $5.45 million gift and estate tax exemption. Consult with your advisor before the end of the year to determine the best plan of action for your situation. •

Should your powers of attorney be springing or nonspringing?

Jay didn't have a power of attorney (POA) as part of his estate plan when a car accident left him in a coma and on life support. The result was that Jay's family had to petition a court to make medical decisions on his behalf. If Jay had had a POA, his family would have been able to forgo the court petition and make medical decisions immediately. If a POA isn't part of your estate plan, it's time to learn more about it.

POA in action

In a nutshell, a POA appoints a trusted representative to make medical or financial decisions on your behalf in the event an accident or illness renders you unconscious or mentally incapacitated. Without it, your loved ones would have to petition a court for guardianship or conservatorship, a costly process that can delay urgent decisions.

A POA is a document under which you, as "principal," authorize a representative to be your "agent" or "attorney-in-fact," to act on your behalf. Typically, separate POAs are executed for health care and property.

A POA for health care authorizes your agent — often, a spouse, child or other family member — to make medical decisions on your behalf or consent to or discontinue medical treatment when you're unable to do so. Depending on the state you live in, the document may also be known as a medical power of attorney or health care proxy.

A POA for property appoints an agent to manage your investments, pay your bills, file tax returns, continue your practice of making annual charitable and family gifts, and otherwise handle your finances, subject to limitations you establish.

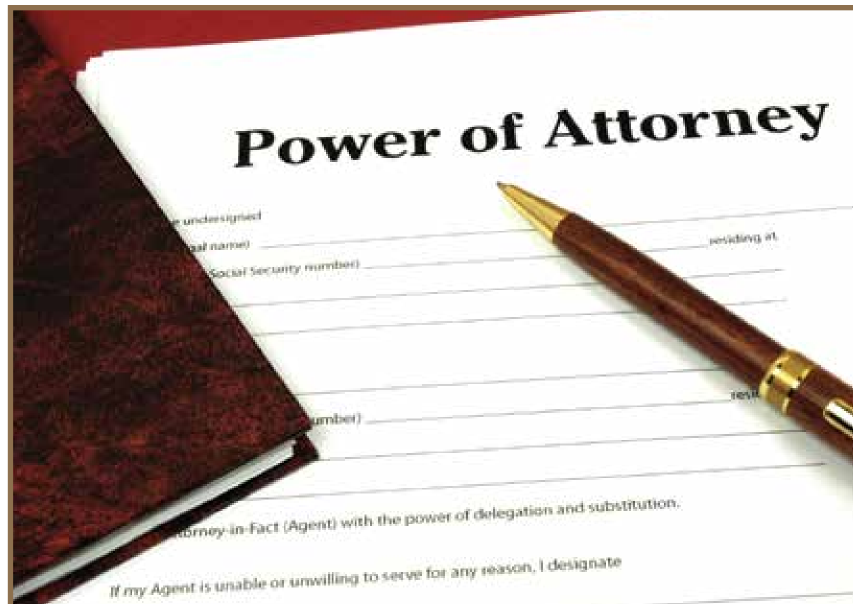
Nonspringing advantages

Generally, POAs come in two forms: *nonspringing*, or "durable" — that is, effective immediately — and *springing*; that is, effective on the occurrence of specified conditions. Typically, springing powers take effect when the principal becomes mentally incapacitated, comatose, or otherwise unable to act for himself or herself.

Nonspringing POAs offer several advantages:

- Because they're effective immediately, they allow your agent to act on your behalf for your convenience, not just when you're incapacitated. For example, if you sign a durable POA for property, you might ask your agent to conduct a business or real estate transaction in your place while you're traveling abroad.
- They avoid the need for a determination that you've become incapacitated, which can result in delays, disputes or even litigation. This allows your agents to act quickly in an emergency, making critical medical decisions or handling urgent financial matters without having to wait, for example, for one or more treating physicians to examine you and certify that you're incapacitated.

A potential disadvantage to a nonspringing POA — and the main reason some people opt for a springing POA — is the concern that your agent may be tempted to abuse his or her authority or commit fraud. But consider this: If you don't trust your agent enough to give him or her a POA that takes effect immediately, how does delaying its effect until you're deemed incapacitated solve the problem? Arguably, the risk of fraud or abuse is even greater at that time because you're unable to protect yourself.



Given the advantages of a nonspringing POA, and the potential delays associated with a springing POA, it's usually preferable to use a nonspringing POA and to make sure the person you name as agent is someone you trust unconditionally.

Take action sooner rather than later

It's important to prepare and sign a POA as soon as possible because you don't know when you might need it. And because some health care providers and financial institutions may not honor POAs that were executed years earlier, sign new documents every few years. •

Arrange your RMDs before year end

During the course of your career, you may have managed to build up a tidy nest egg, most likely augmented by tax-favored saving devices. For instance, you may have accumulated funds in qualified retirement plans, like 401(k) plans and pension plans, and traditional and Roth IRAs. Assuming you don't need all the funds to live on, your goal is to preserve some wealth for your heirs.

Can you keep what you want? Not exactly. Under strict tax rules imposed by the IRS, you must begin taking required minimum distributions (RMDs) from your retirement plans and IRAs in your seventies. And you must continue taking RMDs year in and year out without fail. Don't skip this obligation for 2016, as the penalty for omission is severe.

When should you begin taking distributions?

RMD rules apply to all employer-sponsored retirement plans, including pension and profit-sharing plans, 401(k) plans, 403(b) plans for not-for-profit organizations and 457(b) plans for government entities. The rules also cover traditional IRAs and IRA-based plans such as SEPs, SARSEPs and SIMPLE-IRAs.

The required beginning date (RBD) for RMDs is April 1 of the year *after* the year in which you turn age 70½. For example, if your 70th birthday was June 15, 2016, you must begin taking RMDs no later than April 1, 2017. This is the only year where you're allowed to take an RMD after the close of the year for which it applies. (Be aware that delaying the first RMD will result in two RMD withdrawals during that tax year.) The deadline for subsequent RMDs is December 31 of the year for which the RMD applies.

To calculate the RMD amount, you divide the balance in the plan account or IRA on December 31 of the prior year by the factor in the appropriate IRS life expectancy table. For example, use the:

- Joint and Last Survivor Table if the sole beneficiary of the account is your spouse and he or she is more than 10 years younger than you,
- Uniform Lifetime Table if your spouse isn't your sole beneficiary or your spouse isn't more than 10 years younger than you, or
- Single Life Expectancy Table if you're the beneficiary of the account.

Although you must determine the RMD separately for each IRA you own, you can withdraw the total amount from just one IRA, or any combination of IRAs that you choose. However, for qualified plans other than a 403(b), the RMD must be taken separately from each plan account. Of course, you may withdraw more than the required amount, but this will erode your savings in retirement.

What's the penalty for failing to take RMDs?

The penalty is equal to a staggering 50% of the amount that should have been withdrawn (reduced by any amount actually withdrawn). For example, if you're required to withdraw $10,000 this year and take out only $2,500, the penalty is $3,750 (50% of $7,500). Plus, you still have to pay regular income tax on the distributions when taken. Keep in mind that with the additional income there are other tax issues, such as a potential tax on net investment income (NII). RMDs don't count toward NII but will increase your modified adjusted gross income for purposes of this calculation.

As a general rule, you must take RMDs from all qualified plans and IRAs. But you don't have to withdraw an RMD from a qualified plan of an employer if you still work full-time for the employer and you don't own more than 5% of the company. There's no comparable exception for traditional IRAs. Although you don't have to take RMDs from a Roth IRA you created, your heirs must take lifetime distributions from the Roth IRA they've inherited.

Don’t procrastinate!

Typically, retirement savers will wait until December to arrange to take RMDs from qualified plans and IRAs. But that could be dangerous. It’s easy to be distracted during the holiday season and forget about the obligation. Furthermore, it can take several days, if not longer, for trading and settling funds. And haste can lead to errors and miscalculations that could cost you.

A better approach is to take your time. Make arrangements for RMDs well in advance of the December 31 deadline. Finally, confirm the required amounts with your financial advisors to ensure you’re not overpaying yourself. •

ESTATE PLANNING PITFALL

You haven’t addressed pets in your estate plan

If you’re an animal lover, a pet is a member of the family — sometimes even more so than flesh-and-blood. So you want to ensure that your beloved pet is cared for after you’re gone. Now you can make provisions for a pet through a trust in all 50 states.

Earlier this year, Minnesota became the last state to pass legislation approving “pet trusts.” This legally sanctioned arrangement allows you to set aside funds for the animal’s care. After the pet dies, any remaining funds are distributed among your heirs as directed by the trust’s terms.

The basic guidelines are comparable to trusts for people. The “grantor” — called a settlor or trustor in some states — creates the trust to take effect during his or her lifetime or at death. Typically, a trustee will hold property for the benefit of the grantor’s pet. Payments to a designated caregiver are made on a regular basis.

Depending on the state in which the trust is established, it terminates upon the death of the pet or after 21 years, whichever occurs first.

Some states allow a pet trust to continue past the 21-year term if the animal remains alive. This can be beneficial for pets that have longer life expectancies than cats and dogs, such as parrots.

Because you know your pet better than anyone else, you may provide specific instructions for its care and maintenance (for example, a specific veterinarian or brand of food). The trust can also mandate periodic visits to the vet and other obligations should you become unable to care for the pet yourself. Feel more secure knowing that your pet’s care is forever ensured — legally.

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