THE ESTATE PLANNER

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You've made nondeductible contributions to your IRA

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Do you need to file gift tax returns?

Avoid these common mistakes

For 2019, the lifetime gift and estate tax exemption has reached a whopping $11.40 million ($22.80 million for married couples). As a result, few people will be subject to federal gift taxes. If your wealth is well within the exemption amount, does that mean there's no need to file gift tax returns? Not necessarily. There are many situations in which it's necessary (or desirable) to file Form 709 — "United States Gift (and Generation-Skipping Transfer) Tax Return" — even if you're not liable for any gift taxes.

All gifts are taxable, except …

The federal gift tax regime begins with the assumption that all transfers of property by gift (including below-market sales or loans) are taxable, and then sets forth several exceptions. Nontaxable transfers that need not be reported on Form 709 include:

- Gifts of present interests (see below) within the annual exclusion amount (currently, $15,000 per donee),
- Direct payments of qualifying medical or educational expenses on behalf of an individual (see "Medical and educational expenses: Direct payments only" on page 3),
- Gifts to political organizations and certain tax-exempt organizations,
- Deductible charitable gifts,
- Gifts to one's U.S.-citizen spouse, either outright or to a trust that meets certain requirements, and
- Gifts to one's noncitizen spouse within a special annual exclusion amount (currently, $155,000).

If all your gifts for the year fall into these categories, no gift tax return is required. But gifts that don't meet these requirements are generally considered taxable — and must be reported on Form 709 — even if they're shielded from tax by the lifetime exemption.

Traps to avoid

If you make gifts during the year, consider whether you're required to file Form 709. And watch out for these common traps:

Future interests. The $15,000 annual exclusion applies only to present interests, such as outright gifts. Gifts of future interests, such as transfers to a trust for a donee's benefit, aren't covered, so you're required to report them on Form 709 even if they're less than $15,000. Be aware, however, that it's possible for gifts in trust to meet the present interest requirement by giving beneficiaries Crummey withdrawal powers (the right to withdraw a contribution for a limited time after it's made).

Spousal gifts. As previously noted, gifts to a U.S.-citizen spouse need not be reported on Form 709.

Medical and educational expenses: Direct payments only

Paying tuition or unreimbursed medical expenses on behalf of a child or other loved one is a great strategy for making *unlimited* tax-free gifts without using up any of your $15,000 annual exclusion or $11.40 million lifetime exemption. But it only works if you make the payments *directly* to a qualifying educational institution or medical provider.

A common mistake is to advance your child the funds he or she needs to pay the expenses or to reimburse him or her for expenses that have already been paid. These payments are treated as gifts to your child, which must be reported on Form 709 if they exceed the annual exclusion amount.

However, if you make a gift to a trust for your spouse's benefit, the trust must 1) provide that your spouse is entitled to all the trust's income for life, payable at least annually, 2) give your spouse a general power of appointment over its assets and 3) not be subject to any other person's power of appointment. Otherwise, the gift must be reported. And watch out for gifts to a noncitizen spouse: If they exceed the $155,000 annual exclusion, they must be reported whether they're outright gifts or gifts in trust.

Gift splitting. Spouses may elect to split a gift to a child or other donee, so that each spouse is deemed to have made one-half of the gift, even if one spouse wrote the check. This allows married couples to combine their annual exclusions and give up to $30,000 to each donee. To make the election, the donor spouse must file Form 709, and the other spouse must sign a consent or, in some cases, file a separate gift tax return. Keep in mind that, once you make this election, you and your spouse must split *all* gifts to third parties during the year.

529 plans. If you make gifts to a 529 college savings plan, you have the option of bunching five years' worth of annual exclusions into the first year. So, for example, you can contribute $75,000 to the plan ($150,000 for married couples) and treat the gift as if it were made over the next five years for annual exclusion purposes. To take advantage of this benefit, you must file an election on Form 709.

Consider filing voluntarily

It may be a good idea to file a gift tax return, even if it's not required. For example, if you make annual exclusion gifts of difficult-to-value assets, such as interests in a closely held business, a gift tax return that meets "adequate disclosure" requirements will trigger the three-year limitations period for audits.

Suppose you transfer business interests valued at $10 million over a period of years, through a combination of tax-free gifts to your spouse and annual exclusion gifts to your children. If the IRS finds that the interests were worth $15 million, which exceeds the lifetime exemption amount, it can assess gift taxes plus penalties and interest. If you don't file regular gift tax returns, the IRS has unlimited time to challenge the values of your gifts.

Stay on the right side of the IRS

A smart gifting strategy continues to offer significant benefits for you and your loved ones. However, to keep from running afoul of the IRS, it's critical to know when you need to file a gift tax return. Your estate planning advisor can help you in that determination. ■

Using nongrantor trusts to bypass SALT deduction limit

If you reside in a high-tax state, you may want to consider using nongrantor trusts to soften the blow of the new $10,000 federal limit on state and local tax (SALT) deductions. The limit, which was added by last year's Tax Cuts and Jobs Act (TCJA), can significantly reduce itemized deductions if your state income and property taxes are well over $10,000. A potential strategy for avoiding the limit is to transfer interests in real estate into several nongrantor trusts, each of which enjoys its own $10,000 SALT deduction.

Grantor vs. nongrantor trusts: What's the difference?

The main difference between a grantor and non-grantor trust is that a grantor trust is treated as your alter ego for tax purposes, while a nongrantor trust is treated as a separate entity. Traditionally, grantor trusts have been the vehicle of choice for estate planning purposes because the trust's income is passed through to you, as grantor, and reported on your tax return. That's an advantage, because it allows the trust assets to grow tax-free, leaving more for your heirs. By paying the tax, you essentially provide an additional, tax-free gift to your loved ones that's not limited by your gift tax exemption or annual gift tax exclusion. In addition, because the trust is an extension of you for tax purposes, you have the flexibility to sell property to the trust without triggering taxable gain.

A nongrantor trust is a discrete legal entity, which files its own tax returns and claims its own deductions.

Now that the TCJA has doubled the federal gift and estate tax exemption, fewer families are subject to gift taxes, so grantor trusts enjoy less of an advantage over nongrantor trusts. This creates an opportunity to employ non-grantor trusts to boost income tax deductions.

Nongrantor trust in action

A nongrantor trust is a discrete legal entity, which files its own tax returns and claims its own deductions. The idea behind the strategy is to divide real estate that's subject to more than $10,000 in property taxes among several trusts, each

of which enjoys its own SALT deduction up to $10,000. Each trust must also generate sufficient income against which to offset the deduction. Here's an example:

Diane pays a total of $30,000 in property taxes each year, but can deduct only $10,000 of that amount under the new limit. She transfers her real estate to a limited liability company (LLC) and then gifts one-third interests in the LLC to three nongrantor trusts. She also ensures that each trust holds sufficient assets to produce approximately $10,000 of income per year. The result: Each trust reports around $10,000 in income, which is offset by a $10,000 property tax deduction, so the trusts have no taxable income. This strategy essentially allows Diane to deduct her entire $30,000 property tax bill.

Beware the multiple trust rule

Before you attempt this strategy, be sure to consider the multiple trust rule of Internal Revenue Code Section 643(f). That section provides that, under regulations prescribed by the U.S. Treasury Department, multiple trusts may be treated as a single trust if they have "substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries" and a principal purpose of the arrangement is tax avoidance.

In the past, the multiple trust rule wasn't really a concern, because the required regulations hadn't been issued. In August 2018, however, the Treasury issued proposed regulations implementing the rule. To preserve the benefits of multiple trusts, therefore, it's important to designate a different beneficiary for each trust.

Pass the SALT

If you're losing valuable tax deductions because of the SALT limit, consider using a nongrantor trust to pass those deductions on to one or more trusts. Consult your estate tax advisor before taking action, because these trusts must be structured carefully to ensure that they qualify as nongrantor trusts and don't run afoul of the multiple trust rule. ▮

Finding your footing after a spouse dies unexpectedly

Death is a topic few wish to think about. It's one reason people tend to put off estate planning until later in life. One positive of having an estate plan is the peace of mind that comes with knowing that loved ones will be taken care of after your death.

But what if your spouse unexpectedly dies? Would you be prepared to cope emotionally and financially?

One step at a time

In the event a spouse passes away without warning, a surviving spouse will face several critical challenges, including some significant financial decisions. Of course, handling the funeral arrangements comes first.

The following are other areas that will need to be addressed:

Emotional responses. It's easy to say, and hard to do, but don't let your emotions rule your judgment. For instance, if you're tempted to immediately move out of your home, sell your spouse's business or invest a lump-sum life insurance payout, hold off. Take the time to sort out what will likely be best for you and your family in

the long run. An oft-used guideline is to wait at least one year before making any significant changes.

Death certificates. One of the first things to do is to visit your county clerk's office to officially record the death. At this time, you can obtain death certificates, which you'll need to provide for various dealings with financial institutions and others. While it may be difficult to estimate how many death certificates will ultimately be requested of you, and the numbers will vary person to person, you'll probably want to start with at least a dozen. Note that in some states the funeral home obtains the death certificate.

Notifications. Along with the county offices, you must get the word out to other interested parties, including your spouse's employer, if applicable; credit card companies; life insurance companies; retirement plan and IRA administrators; the Social Security Administration (SSA); the state motor vehicle agency; the state office for inheritance tax, if applicable; and your attorney and other professional advisors.

It's easy to say, and hard to do, but don't let your emotions rule your judgment.

Social Security benefits. If your spouse was receiving benefits, consult with the SSA as to the benefits available to a surviving spouse. Frequently, modifications are required if the survivor was the lower-earning spouse. Even if your spouse wasn't receiving benefits yet, you may be eligible for survivors' benefits, depending on your age and other factors.

Insurance. Don't assume that everything about your insurance plans will stay the same. Review your various policies — such as life, health, disability income, auto and long-term care — to ensure that you'll have the optimal coverage going forward. Make whatever beneficiary changes are required.

Retirement plans and IRAs. Besides beneficiary designations, you may face important decisions regarding employer retirement plans, such as 401(k)s, as well as traditional and Roth IRAs. For example, if your spouse had a traditional IRA, you can complete a timely rollover to an IRA of your own without owing any tax.

Investments. Review the investments that were owned solely by your spouse, as well as those you owned jointly. When you have time, sit down with your financial advisor to chart out a path for the future, focusing on changes in personal objectives, time horizon and risk tolerance.

Turn to your advisor

Once you're over the initial shock of the death, turn to your estate planning advisor for additional guidance. For example, he or she can help determine if an estate tax return is required for the deceased's estate. Generally, a return is due within nine months of the date of the death. ∎

ESTATE PLANNING RED FLAG

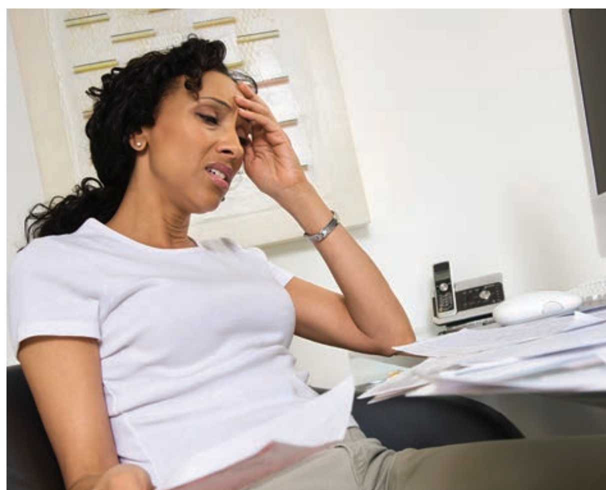
You've made nondeductible contributions to your IRA

If, like many people, your traditional IRA holds a mixture of deductible (after-tax) and nondeductible (pretax) contributions, it's critical to track your contributions carefully to avoid double taxation of distributions. Why? Because the IRS treats distributions as a blend of pretax and after-tax dollars. If you treat distributions as fully taxable, you'll end up overpaying.

For example, Christine, age 62, withdraws $40,000 from her traditional IRA on August 1, 2018. At the time, her IRA balance is $200,000, consisting of $50,000 in deductible contributions, $80,000 in nondeductible contributions and $70,000 in investment earnings. On December 31, 2018, the IRA's balance is $170,000 — $200,000 minus the $40,000 distribution plus additional contributions and earnings after August 1.

To ensure that her distribution is taxed correctly, Christine must calculate the portion attributable to nondeductible contributions (which were made with after-tax dollars and, therefore, aren't taxable again). First, she takes the IRA's year-end balance, $170,000, and adds back the $40,000 distribution, to arrive at $210,000. Next, she divides her nondeductible contributions ($80,000) by $210,000 and multiplies the resulting percentage (38%) by the amount of the distribution. The result — $15,200 — is the nondeductible portion of her distribution, which is tax-free. For purposes of future distributions, Christine's nondeductible contributions are reduced by $15,200 to $64,800.

Be aware that, if you have several IRAs, including one or more that are funded exclusively with nondeductible contributions, you can't avoid tax by taking distributions from those accounts. All your traditional IRAs are treated as a single IRA for tax purposes, so your distributions are deemed to be a combination of taxable and nontaxable funds, regardless of the account they're withdrawn from.



The easiest way to track and report your deductible and nondeductible IRA contributions is to complete and file Form 8606, "Nondeductible IRAs," with your federal income tax return each year.

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The Importance of Personal Powers of Attorney and Advanced Health Care Directives

By: Adan A. Aulet, Esq.

Recently, I was asked on two separate occasions why a power of attorney is desirable if the client's respective trust names a successor trustee or trustees to manage assets if he or she is unable to serve as the trustee. The question is valid. In fact, when I began practicing estate planning law more than twelve years ago, I myself did not appreciate the importance of durable powers of attorney and advanced health care directives. Like many, I thought if the client has a revocable trust and a will, they were pretty much covered. How wrong I was. Now that I am well into my second decade as a practicing lawyer, I have had the opportunity to understand through firsthand experience why these documents are *crucial* to a well-rounded estate plan.

A few years ago, I became involved with a client who had many years prior established and funded a revocable trust. The client did not have a durable power of attorney. As fate would have it, the client began showing signs of dementia and could no longer make personal decisions. The successor trustees did not have the authority to make decisions that were personal in nature for the client. The court (rightfully) determined that a guardian had to be appointed even though there were successor trustees who could manage the assets in the trust.

The trustee of your trust generally has no authority to deal with retirement accounts that must remain in a participant's sole name, certain insurance policies, government agencies and administrative bodies such as the IRS or Social Security Administration, the prosecution or defense of any claims in court (lawsuits), health care providers, or electronic subscriptions and accounts (email accounts, online banking accounts, social media accounts, etc.). The client referred to above needed help with all these matters, but the trustees had no power in those instances. In the client's case, a durable power of attorney would have prevented the need for the appointment of a court monitored guardian.

Also important are advanced health care directives, which are commonly referred to as a designation of health care surrogate and living will. In these documents, you can incorporate specifically tailored instructions concerning your health care and your desires concerning end-of-life decisions. You can further provide for any specific funeral instructions and provide for the manner in which your remains are kept and disposed.

As in the absence of a durable power of attorney, without advanced health care directives in place, there is no person named to make personal health care decisions for an individual. A court considering this would be duty-bound to appoint a guardian to make these decisions.

The court appointed guardian may not be the person you would otherwise choose to make these personal financial and health care decisions on your behalf. Furthermore, the appointment of guardians for financial and health care decisions requires ongoing court proceedings, including the preparation of periodic accountings and reports filed with the court until the termination of the guardianship or the death of the ward. In addition to the continuing burden, the cost to maintain a guardianship is also a noteworthy consideration.

At this point, I hope you have concluded that you should take a moment to review your estate planning documents and ensure that at a minimum you have a will or will and trust, a durable power of attorney, a designation of health care surrogate, and a living will. Moreover, now that you have the documents out, please review your existing plan and ensure that it continues to meet your wishes. Consider whether there have been any significant changes in your life such as the birth of a child or grandchild, the death or incapacity of a loved one or a named decision maker in your documents, a marriage or divorce, a change in your financial condition, or any other event that you deem significant.

If nothing else, you may have confirmed that your plan is still relevant as written. Of course, if you have any questions or wish to make changes regarding your estate plan, consult with your attorney. MacLean & Ema, P.A. has represented thousands of clients with their estate, real estate, and business needs. We would be happy to meet with you to address any questions you may have and discuss whether we can meet your legal objectives.