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Estate Planning Traps That Have Nothing To Do With Estate Taxes

Many practitioners think that estate planning is dead (excuse the pun) since the exemption has been raised to $5,000,000 (indexed) and there is even talk about repealing the Federal Estate Tax. While there are many interesting techniques for estates under $10,000,000; there are even more concerns for estate planners regardless of the size of the estate.

Trap 1 (The Early Stage Alzheimer/Dementia Driver)

If your client receives a diagnosis of early stage Alzheimer's/Dementia and continues to drive, he or she could be risking their entire financial nest egg. Both States and Insurance Companies are moving on parallel courses that could result in the mandatory disclosure of an Alzheimer's/Dementia diagnosis to the DMV and/or make the insurance policy for such client economically unfeasible. On the flip side, if the client fails to disclose the diagnosis, future insurance contracts could state that the policy is void. While a number of courts have protected Alzheimer/Dementia patients from claims by their caregivers;, similar protection has not been afforded when an unrelated party is involved.

To solve this problem, the client may be able to adopt a domestic asset protection trust (not to be confused with a Medicaid Trust). For example, if the client has $3mm, he/she may want to put $1mm into the APT.
It is very important to note that the above result cannot simply be attained by purchasing a $1mm umbrella policy. The umbrella policy gives the plaintiff an additional pocket of cash to grab; whereas the same plaintiff should not be able to reach a valid APT.

Trap 2 (An Alternative to Loss Harvesting and Step Ups at Death)

Most investment advisers have two "go to" moves for an elderly client's portfolio. The first move is to simply hold onto the stocks and receive a "step up" in basis at their death (macro view). For example, if your parent paid $2mm for their shares of stock and such shares are now worth $3mm, the majority thinking is to have your parent retain the shares until he/she passes as the tax basis would be “stepped up” to $3mm at death resulting in no income taxes upon the eventual sale at the parent’s death.

More sophisticated investment gurus engage in “loss harvesting”. This is the sale of any stocks in a loss position. The purpose for loss harvesting is two fold. First, if your parents have gains that year, such gains could be sheltered. Second, advisers will tell you that you will lose the cost basis anyway as assets in a loss position are stepped down upon death (i.e. the basis becomes the fair market value on the date of death)….so there’s no real drawback to loss harvesting….except there could be.

There is a huge loophole in the tax code that states that if an asset is gifted (and the asset is in a loss position), the recipient of the gift gets a modified basis. For purposes of taking a loss, the recipient of the gift will be in no better shape than the donor; but if the shares are sold at a gain, the recipient can use the previous donor’s original basis. For example, dad gifts IBM shares with a basis of $500,000 and a fair market value of $200,000 in year one to son. Dad dies shortly after making the gift (when the fair market value of the shares is still $200,000). A few years later IBM has a resurgence and Son sells the shares for $750,000. Under this scenario, Son has gain of $250,000 ($750,000 - $500,000). Assuming a tax rate of 20%, Son pays $50,000 in taxes (so he nets $700,000).

Let’s take the other scenario where IBM stock was held until death. Son would have taken a $200,000 (stepped down) basis. Son’s gain is now $550,000 ($750,000 - $200,000) resulting in a gain of $550,000 or tax of $110,000. So instead of paying $50,000 in taxes, son pays double that.

Trap 3 (Massive Opportunity When Dealing With a Philanthropic Client)

If you have a client who gives generously, advisers understand that this could result in a really good income tax deduction in the year of the gift. In fact, even if the deduction could not be completely used currently, in many cases any unused deduction could be carried forward for up to 5 years; however with a very generous client, 5 years may not be enough.

There is a technique to enhance the use of the deduction, currently. If the client has a regular IRA, he/she can convert the IRA to a Roth in the year of the gift and use the “deferred deductions” against the gain on the conversion. That means any future earnings should not be subject to income taxes.

Let’s supersize this even more. Instead of naming your kids or your revocable trust as the beneficiary, name your grandchildren. They will have to take out the funds ratably over their life expectancies. Assuming their life expectancy is 50-70 years, there could be geometric growth in the portfolio during that time; turning a few hundred thousand into millions of income tax free dollars.

Summary

If Congress repeals the Federal Estate Tax, you will still be able to bring numerous ideas to your clients to help them move forward with their planning.   Also remember that this country swings like a pendulum from right to left and back again. This means that even if the estate tax is repealed; it may be brought back in the future. This means that you need to explore all the new laws (in detail) and get ready for a new way of looking at planning.