HFG Trust White Paper Series

The ABC's to Trusts – How to minimize taxes for the affluent

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The presence of an inheritance tax dates back to the 18th century in the United States. As a result, the concept that the government collects a piece of your pie when you pass wealth to the next generation is not a new one. The good news is, with careful planning and working with a qualified estate attorney, most Americans can avoid or minimize what they owe to the IRS. This helps them accomplish their goal; enriching their loved ones. One problem we often see in the financial planning world is that clients are told many things but rarely given opportunity to understand. They are provided a giant living trust folder with over 100 pages of legal language and sent packing. This becomes problematic over time if their wishes should change or if someone comes along with a different sales pitch because they have no firm understanding of what plan they have in their hands. Estate documents can be pricey and should not be updated or drafted without fiduciary counsel.

Chances are, if you have significant wealth, you know Trusts can be used to shelter capital, and avoid or minimize paying death taxes. You might be thinking, how does this work? The concept, in reality, is much simpler than the language described in your legal documents. The IRS has stated that if your wealth is organized into very specific buckets upon passing, you can qualify for an estate tax exclusion. Why is that so important? Each person has an exclusion of $5.49MM for federal and $2.13MM for the state of Washington. Therefore, if you live in Washington State and have a net worth over $2.13MM, you have some planning to do. If you live in the state of Oregon, the exclusion is $1MM. If you are fortunate to live in a state that does not have estate taxes, you do not have to worry about this problem until your net worth reaches the Federal limit of $5.49 MM. Let's focus on the State of Washington's limit of $2.13MM and see how the use of Trusts can help.

When it comes to estate planning, the most common Trusts are referred to as A, B and C Trusts. A and C Trusts are considered Marital Trusts because they must provide for the surviving spouse. The B Trust is a Bypass or Credit Shelter Trust.

A Trust **"Power of Appointment"**	**B Trust** **"Bypass Trust" or "Credit Shelter Trust"**	**C Trust** **"Qualified Terminable Interest Property"**
This trust qualifies for the unlimited Marital Deduction (pass assets tax free to surviving spouse) and allows the surviving spouse to access both income and principal as they wish. The surviving spouse also selects who they would like the heirs to be. Typically, this prevents poor financial management and unintentional disinheritance.	A trust that is established upon death that is used to pass assets to heirs and loved ones. Spouse has the ability to access income and principal. This trust utilizes the first spouse's estate exclusions so the heirs can avoid or minimize paying estate taxes once the assets are inherited.	This marital trust also qualifies for the unlimited marital deduction, which means the value of this trust will be included in the surviving spouse's estate. The surviving spouse must be the ONLY income beneficiary and, under specific circumstances, have access to the principal. The eventual beneficiaries are selected before the trust is funded and it is typically used to ensure assets reach the right children to prevent disinheritance.

So how do we use these if we live in the state of Washington?

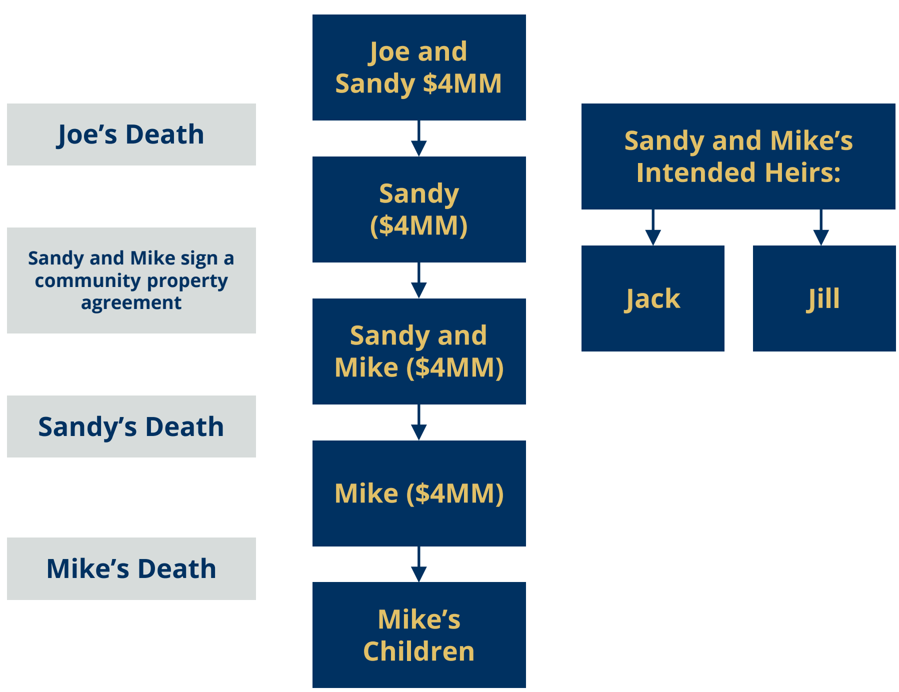
Case Study 1:

Joe and Sandy have $4MM in assets and live in the state of Washington. Their primary goal is to provide for the surviving spouse and minimize state inheritance taxes. Their vision is to leave as much of their nest egg to their children (Jack and Jill), who each have developed an acceptable level of stewardship skills. They also understand that there is risk of a second marriage, in the event of a premature death, and want to protect their wealth from unintentional disinheritance.

Reality: Let's assume Joe and Sandy have a Financial Planner that does not understand the intricacies of estate planning and counsels them to draft a simple will to avoid dying intestate (without a will). The will instructs property to pass to the surviving spouse and then to the Jack and Jill once the second spouse passes. What are the holes in this plan?

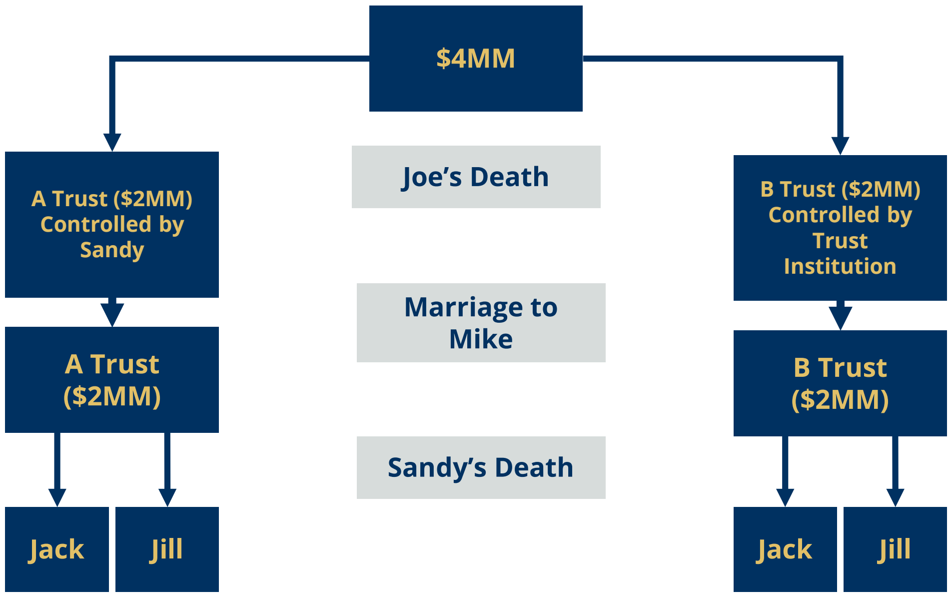
The first is taxes. If Joe passes away with $4MM of wealth, all of it is transferred to Sandy through the Unlimited Marital Deduction. Sandy has not been very healthy lately and passes away 24 months later without making any changes to her estate plan. She now passes away with $4MM of which approximately $2MM (assuming no debts, expenses or transfers are outstanding) is subject to Washington State inheritance tax (approx. 16%). Joe and Sandy's children would inherit about $3.78MM with $320k going to the state of Washington.

The second concern is more common and far more critical. Let's assume after Joe's passing that Sandy meets Mike. Mike is a wonderful man; recently separated and has children of his own. Sandy and Mike marry after a year of dating and Sandy decides to list Mike as the primary beneficiary on her retirement accounts and signs a community property agreement for their new home. A short time later, Sandy passes unexpectedly and the assets that Joe and Sandy once accumulated have now passed to Mike. Unfortunately, Mike's will has all of his estate going to his natural children, which means Jack and Jill have been unintentionally removed from their parents' estate.



Solution:

Joe and Sandy establish a B Trust to take advantage of Joe's state exclusion. Joe passes away unexpectedly and a Credit Shelter Trust is funded with Joe's share of the estate ($2MM). Sandy was also very aware of her financial and legal limitations, and had no desire to make difficult decisions upon Joe's passing, so they agreed years ago to fund a Marital Trust (A Trust) with Sandy's share of the estate ($2MM). Both Trusts have strict instructions to provide for the surviving spouse (in this case, Sandy) and, upon the second spouse passing, assets transfer directly to Jack and Jill. They hired a qualified Trust Officer to counsel Sandy and manage the Trust assets. Sandy has the authority to request funds anytime on the A Trust and use the Trust income from the B Trust each year as she pleases. The A Trust even has the flexibility to take care of Jack and Jill if the situation requires. Sandy marries Mike and passes away unexpectedly. All the Trust assets are sheltered from Washington State inheritance taxes and protected from disinheritance.



Case Study 2:

David and Mary have $12MM of net worth and live in the state of Washington. They have much more wealth than the State will allow to pass through tax free ($2MM). Their estate plan states that a B Trust is funded upon the first spouse passing to utilize the first spouse's $2MM exclusion. The remaining $10MM is divided into a QTIP Trust (C Trust) and a General POA Trust (A Trust), both qualifying for the Federal Marital Deduction to help postpone federal inheritance taxes. The surviving spouse has total control of the A Trust ($5MM) and intends to spend this down during her lifetime. The QTIP Trust also funded with $5MM will serve as supplemental income for the surviving spouse (income beneficiary) and upon passing will utilize their federal and state exclusion. If the QTIP Trust has over $2MM remaining, then she will be subject to state taxes, which at 16-20% is much more forgiving than federal inheritance Tax of 40%. She can carefully plan specific living gifts to her children to lower her A Trust and potentially save up to $2.8MM in inheritance taxes ($2MM subject to Federal and $10MM subject to State.)

*Disclaimer: This example is a simplified explanation of the actual estate values

As you can see, every family situation is unique because everyone has different goals. Something as small as living in a different state or filing for Federal Estate Exemption (portability) can alter scenarios quickly. This is why having a fiduciary counseling you along the way is so vital. For some, a Bypass Trust satisfies their need, while others require a combination of A, B and C Trusts. If you or your family fall under this category of wealth, working with a Certified Financial Planner and a qualified estate attorney may prove invaluable to ensuring your assets transfer into the right hands.