Insight on Estate Planning

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New 3.8% Medicare contribution tax

Do you know how to reduce or eliminate your liability?

One of the funding mechanisms for health care reform is a new 3.8% Medicare contribution tax on net investment income (NII) going into effect this year. The tax applies to higher-income individuals as well as to trusts and estates.

From an estate planning perspective, implementing strategies to reduce or eliminate the 3.8% tax is important for several reasons. First, these strategies help preserve more wealth for your heirs. Second, the tax will have a big effect on trusts, so you might want to consider techniques for reducing trust income. Finally, many popular estate planning tools — such as family limited partnerships (FLPs) and lifetime gifts — can also help mitigate the impact of the tax.

Does the tax affect you?

For individuals, the 3.8% tax applies to NII to the extent modified adjusted gross income (MAGI) exceeds the applicable threshold: $250,000 for joint filers, $200,000 for single filers and heads of households, and $125,000 for married filing separately.

MAGI is your adjusted gross income (AGI) plus, if applicable, your foreign earned income exclusion. Unless you live and work abroad, MAGI is the same as the AGI reported on your income tax return.

The 3.8% tax applies to the *lesser* of 1) your NII (gross investment income less deductible investment expenses) or 2) the amount by which your MAGI exceeds the applicable threshold. (For a list of income types subject to the tax, see "What constitutes investment income?" on page 3.)

For trusts and estates, the tax applies to undistributed NII to the extent AGI exceeds the highest tax-bracket threshold ($11,950 in 2013).

How can you soften the blow?

For individuals, there are two ways to minimize the impact of the 3.8% tax: 1) reduce your MAGI (to bring it below the applicable threshold or at least minimize your exposure to the tax), or 2) reduce your NII. Strategies to consider include:

Converting a traditional IRA to a Roth IRA. Distributions from a Roth IRA don't count toward the MAGI threshold, nor are they considered NII. However, the converted amount will be included in your MAGI in the year of conversion.

While the converted amount won't be included in NII and thus won't be subject to the 3.8% tax, the MAGI increase could trigger the 3.8% tax on your NII or increase the amount of your NII that's subject to the tax. A series of partial conversions may allow you to enjoy the Roth IRA distribution benefits while avoiding or minimizing the 3.8% tax in the years of conversion.

Maxing out contributions to traditional IRAs and employer-sponsored retirement plans, such as 401(k)s. These contributions reduce MAGI, and distributions aren't included in NII (although distributions are included in MAGI and thus could trigger or increase the 3.8% tax on your NII).

Shifting some of your portfolio into tax-exempt municipal bonds. Tax-exempt interest is excluded from both MAGI and NII.

Deferring income (through your employer's nonqualified deferred compensation plan, for example). This will reduce your MAGI.

Making gifts of NII-producing property to lower-income family members or to charity. This will reduce your MAGI and NII, and the recipients will pay lower or no tax on the income.

Setting up an FLP to hold investment assets and gifting interests to your children or other family members. This strategy can lower your NII by shifting investment income to individuals with income below the MAGI threshold. It also can produce gift and estate tax benefits.

What constitutes investment income?

For purposes of the 3.8% Medicare contribution tax, net investment income (NII) includes:

- Interest, dividends, annuities, rents and royalties (unless derived in the ordinary course of an active trade or business),
- Income from investments in partnerships or other businesses in which you don't actively participate,
- Income from trading in financial instruments or commodities, and
- Net capital gains from the disposition of property (other than property held in an active trade or business) to the extent included in taxable income.

NII *doesn't* include:

- Income from an active trade or business,
- Distributions from IRAs or qualified retirement plans, as well as payouts from qualified employer-sponsored pension plans or annuities,
- Interest on tax-exempt municipal bonds,
- Life insurance proceeds, Social Security benefits and veterans' benefits,
- Gain on the sale of an active interest in a partnership or S corporation, and
- Gain on the sale of a principal residence that's excluded from income under Internal Revenue Code Section 121 (up to $250,000; $500,000 for joint filers).

Instituting installment sales of business or investment property. By spreading capital gains over several years, you can reduce MAGI and, in the case of investment assets, reduce NII.

For trusts, reducing AGI generally isn't an option. But there are several strategies for reducing NII, such as shifting assets into tax-exempt or tax-deferred investments or distributing income to lower-income beneficiaries. (The 3.8% tax applies only to *undistributed* NII in a trust.)

Another strategy for avoiding the tax on trust income is to use a grantor trust, whose income is passed through to you, as grantor. Keep in mind, though, that this strategy may increase *your* exposure to the tax.

The big picture

Tax planning is important, but it's not the only factor. As you weigh your options for reducing the 3.8% tax, be sure to consider how they fit into your overall estate and financial plans. ∎

Estate planning for adopted children and stepchildren

If you have adopted children or unadopted stepchildren, estate planning is critical to ensure that your property is distributed the way you desire. If you're unmarried and in a long-term relationship with someone who has biological or adopted children, planning may be particularly important.

Adopted children

Adopted children are placed on an equal footing with biological children in most situations for estate planning purposes. Thus, adopted and biological children are treated the same way under a state's intestate succession laws, which control who inherits property in the absence of a will.

In addition, adopted children generally are treated identically to biological children for purposes of wills or trusts that provide for gifts or distributions to a class of persons, such as "children," "grandchildren" or "lineal descendants" — even if the child was adopted after the will or trust was executed.

Stepchildren

Stepchildren generally don't have any inheritance rights with respect to their parents' new spouses unless the spouse legally adopts them. If you have stepchildren and want them to share in your estate, you should either adopt them or amend your estate plan to provide for them expressly.

Of course, estate planning isn't the only reason to adopt stepchildren. Adoption also gives you all of the legal rights of a parent during your life.

Before you adopt stepchildren, however, you and your spouse should consider the potential effect on their ability to inherit from (or through) their other biological parent's relatives. In most states, when a child is adopted by a stepparent, the adoption decree severs the parent-child relationship with the other biological parent and his or her family.

That means the child can't inherit from that biological parent's branch of the family — and vice versa — through intestate succession. For example, if Tina is adopted by her stepfather, Mark, the adoption would terminate Tina's intestate succession rights with respect to her biological father, Ed, and consequently, Ed's family.

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Most states provide an exception for certain "family realignments." From the previous example, let's suppose that Ed is deceased. Mark's adoption of Tina wouldn't sever the connection to Ed's family. If, for example, Ed's sister Emily dies intestate, Tina will be included in the class of heirs. In a state that doesn't recognize a family realignment exception, however, Tina won't be considered Emily's heir.

If you wish to *exclude* stepchildren from your estate, in most cases it's sufficient to do nothing. But some states permit stepchildren to inherit through intestate succession under certain circumstances.

And a handful of courts have invoked a doctrine of "equitable adoption." Under this doctrine, if a deceased person has raised a child as his or her own but hasn't legally adopted the child, a court may permit the child to inherit to prevent an "injustice."

Second-parent adoptions

A growing minority of states now permit second-parent adoptions, in which an unmarried person adopts his or her partner's biological or adopted children without terminating the partner's parental rights.

Some of these states permit same-sex couples to perform second-parent adoptions, while some do not. And even in states that recognize second-parent adoptions, their intestate succession laws may not provide for a child to inherit from the "second parent."

For unmarried couples who can't obtain a second-parent adoption, or choose not to, estate planning is especially critical — if they want the "nonparent" to have custody of the child should the "parent" die or become incapacitated and if the nonparent wants the child to inherit from him or her.

First, the parent should consider using a power of attorney for parental authority and appointing the nonparent as a guardian to ensure that he or she can act on the child's behalf and has priority over the parent's blood relatives in the event the parent dies or becomes incapacitated.

Second, both partners should amend their wills. The parent's will should name his or her partner as the child's guardian, and the nonparent's will should spell out any property to be inherited by the child.

Have a plan

To ensure your desired treatment of adopted children or unadopted stepchildren, the best strategy is for you and your spouse or partner to spell out your wishes in wills, trusts and other estate planning documents. As with most estate planning issues, relying on the laws of intestate succession can lead to unwelcome surprises. ∎

Shipping your trust over the state line to realize tax savings

It's not uncommon for families to relocate to another state to enjoy lower state income taxes. If trusts make up a big portion of your estate plan, and they're subject to high state income taxes, you can institute a similar strategy. Thankfully, only your trusts need to cross state lines, not your entire family. Let's take a closer look at how to change a trust's residence, or "situs," to a state with lower (or no) income taxes.

Trusts and taxes

The taxation of a trust depends on the type of trust. Revocable trusts and irrevocable "grantor" trusts — those over which the grantor retains enough control to be considered the owner for tax purposes — aren't taxed at the trust level. Rather, trust income is included on the grantor's tax return and taxed at the grantor's personal income tax rate.

Irrevocable *non*grantor trusts generally are subject to federal and state tax at the trust level on any *undistributed* ordinary income or capital gains, often at higher rates than personal income taxes. Income distributed to beneficiaries is deductible by the trust and taxable to beneficiaries.

Advantages of relocation

Relocating a trust may offer a tax advantage, therefore, if the trust is an irrevocable nongrantor trust, accumulates (rather than distributes) substantial amounts of ordinary income or capital gains, and can be moved to a state with low or no taxes on accumulated trust income.

There may also be other advantages to moving a trust. For example, the laws in some states allow

you or the trustee to obtain greater protection against creditor claims, reduce the trust's administrative expenses or create a "dynasty" trust that lasts for decades or even centuries.

Determining whether situs can be changed

For an irrevocable trust, the ability to change its situs depends on several factors, including the language of the trust document (does it authorize a change in situs?) and the laws of the current and destination states.

In determining a trust's state of "residence" for tax purposes, states generally consider one or more of the following factors: the trust creator's state of residence or domicile, the state in which the trust is administered (for example, the state where the trustees reside or where the trust's records are maintained), and the state or states in which the trust's beneficiaries reside.

Some states apply a formula based on these factors to tax a portion of the trust's income. Also, some states tax all income derived from sources within their borders — such as businesses, real estate or other assets located in the state — even if those assets are owned by a trust in another state.

Depending on state law and the language of the trust document, moving a trust may involve appointing a replacement trustee in the new state and moving the trust's assets and records to that state. In some cases it may be necessary to amend the trust document or to transfer the trust assets to a new trust in the destination state.

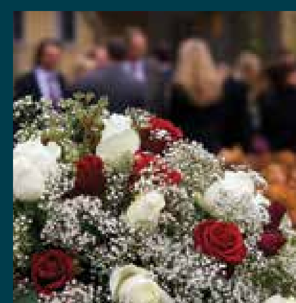
For tax purposes, a final return should be filed in the current jurisdiction. The return should explain the reasons that the trust is no longer taxable in that state.

Research the trust's destination

If you reside in a state with high income taxes, the ability to move a trust to another state offers great flexibility. However, it's important that you understand the tax and nontax consequences. Before taking action, discuss this strategy with your estate planning advisor. ∎

Estate Planning Pitfall

You're using a prepaid funeral plan



Funerals are expensive. According to the National Funeral Directors Association, average funeral costs in 2012 were nearly $8,000, excluding cemetery costs. To relieve their families of the burden of planning a funeral, many people plan their own and pay for them in advance.

Unfortunately, prepaid funeral plans are fraught with potential traps. Some plans end up costing more than the benefits they pay out. And there may be a risk that you'll lose your investment if the funeral provider goes out of business or you want to change your plans. Some states offer protection — such as requiring a funeral home or cemetery to place funds in a trust or to purchase a life insurance policy to fund funeral costs — but many do not.

If you're considering a prepaid plan, find out exactly what you're paying for. Does the plan cover merchandise only (casket, vault, etc.) or are services included? Is the price locked in or is there a possibility that your family will have to pay additional amounts?

In addition, the Federal Trade Commission recommends that you ask the following questions:

- What happens to the money you've prepaid?
- What happens to the interest income on prepayments placed in a trust account?
- Are you protected if the funeral provider goes out of business?
- Can you cancel the contract and get a full refund if you change your mind?
- What happens if you move or die while away from home? Can the plan be transferred? Is there an additional cost?

One alternative that avoids the pitfalls of prepaid plans is to let your family know your desired arrangements and set aside funds in a payable-on-death (POD) bank account. Simply name the person who will handle your funeral arrangements as beneficiary. When you die, he or she will gain immediate access to the funds without the need for probate.