Planning for Married Couples

THE BASIC ESTATE PLANNING ARRANGEMENTS NEEDED

For most long-time married couples, the overriding estate planning objective is to protect and provide for the comfort and security of the surviving spouse. Strategies that ultimately benefit the children or other beneficiaries are important but subordinate to this primary concern for the survivor's welfare. Yet many couples neglect their estate planning, or fail to properly coordinate all of the arrangements necessary to protect and provide for the surviving spouse and, at the same time, to minimize the income tax and estate taxes payable in the end.

This Monograph will begin with a review of the basic planning arrangements that every married couple in Washington should consider, including common mistakes and pitfalls, and then will discuss a few more advanced issues that Washington couples with significant personal assets should consider. Our focus is on happily married couples who anticipate having a taxable estate and have children in common. Although much of this discussion is relevant to those with prior marriages and separate sets of "his" and "her" children, a thorough consideration of the issues and strategies important to such couples is beyond the scope of this Monograph. Similarly, since the existence of a legally recognized marriage is required for certain estate and income tax rules, planning for unmarried couples is beyond the scope of this Monograph.

OVERVIEW OF PLANNING FOR A MARRIED COUPLE

Every married couple in Washington needs certain basic estate planning arrangements to protect and provide for the surviving spouse following the death of either spouse. These include appropriate Wills or a Revocable Living Trust to control disposition of the couple's property and minimize estate taxes, Durable Powers of Attorney for Financial Matters, Durable Powers of Attorney for Health Care Decisions, and Health Care Directives (also known as a "Living Will") for each spouse. In addition, asset titles must be reviewed, and beneficiary designations for each life insurance policy, annuity, and retirement plan account must be coordinated with the provisions of the Will or Living Trust. Each of these arrangements will be considered in depth hereafter.

THE BASIC ARRANGEMENTS *EVERYBODY* NEEDS WHILE THEY ARE ALIVE

There are certain "foundational" estate planning arrangements that every Washington resident should have in place, regardless of his or her circumstances. These include Durable Powers of Attorney for Financial Matters and Health Care Decisions and a Health Care Directive (or "Living Will") to provide for management and health care decisions if the individual can't manage for himself or herself. Finally, some individuals may want to consider their need for supplemental medical and/or long-term care insurance. Each of these topics is discussed in detail below.

DURABLE POWERS OF ATTORNEY- FINANCIAL & HEALTH CARE DECISIONS

In Washington, as in most states, if an individual becomes legally incompetent and unable to make decisions concerning his or her own property or medical care due to injury, illness or old age, the courts may appoint a guardian of the individual's estate or person to make required decisions. Guardianship proceedings may be embarrassing and expensive, and may result in a management and oversight procedure that may or may not be what the affected individual would have chosen for himself or herself.

To avoid such a judicially-imposed solution if the need arises, every individual should anticipate the possibility of incompetency and sign a Durable Power of Attorney, authorizing a trustworthy individual of his or her own choosing (the "Attorney in Fact") and probably one or more alternates to handle financial management and personal and health care decisions if the need arises.[1]

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[1] Sometimes individuals, acting on bad advice, add the name of an adult child or other "helper" to accounts in the erroneous belief that this is the way to authorize a helper to pay bills, manage investments,

Durable Powers of Attorney take many different forms. Most individuals give the Attorney-in-Fact broad authority to take *all appropriate actions* incident to ownership and management of the individual's assets. Such authority should *include* authority to sell assets and reinvest the proceeds, file tax returns, receive funds from third parties, and even make tax-saving gifts up to the annual exclusion amount (currently $14,000 per year) to the individual's intended beneficiaries. However, in all but extraordinary circumstances, the Power of Attorney should not include the authority to change the individual's Revocable Living Trust or change beneficiary designations with respect to life insurance, annuities, and retirement plan accounts.

A Durable Power of Attorney may take effect *immediately* or only *in the future* upon a written determination that the individual has become incompetent by his or her regular physicians (a "springing power of attorney"). Since the objective is generally only to avoid guardianship proceedings if the individual becomes incompetent, a so-called "springing power of attorney" that becomes effective only when the individual's physician(s) certify that he or she is incapable of managing his or her own personal financial affairs are popular. However, since the medical community is often unwilling to make the required determination to "trigger" such a springing power of attorney, many long-time married couples may be comfortable signing a power of attorney that is *currently effective*.

Obviously, the Attorney-in-Fact should be competent and trustworthy, and should live in Washington. Typically, a married person will name his or her spouse as the Attorney-in-Fact. Often, an individual designates the same persons who will act as Personal Representative and Trustee under the Will or Living Trust. Ultimately, the Attorney-in-Fact is accountable to the individual, the Personal Representative of the individual's estate, and the estate beneficiaries. As such, the attorney-in-fact may be liable for misdeeds or neglect.

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etc. Sometimes the helper is merely an authorized *signer* on the account but other times the individual makes the helper a *co-owner*. Joint ownership arrangements sometimes override the individual's Will, and not infrequently lead to disputes over whether the decedent intended merely to authorize the helper to assist in managing his or her finances, or intended to make a testamentary gift to the helper. In most circumstances, we recommend use of a Durable Power of Attorney to authorize a helper to manage assets rather than signatory, co-ownership or survivorship arrangements.

HEALTH CARE DIRECTIVE (OR "LIVING WILL")

In addition to a Power of Attorney authorizing a trusted family member or friend to make medical decisions if the individual is unable to participate in his or her own care, most individuals in Washington should sign, or at least consider, a Health Care Directive or so-called "Living Will". This instrument is the device by which an individual directs his or her doctor concerning continuation of medical care if he or she develops a terminal medical condition or is permanently unconscious and recovery is not expected. Washington does not permit euthanasia or "assisted suicide", but it permits individuals to express their desires concerning continuation of medical treatment under such circumstances. If an individual has signed a Living Will, and if the individual's family and physicians can agree that recovery is hopeless, treatment may be halted.

SUPPLEMENTAL MEDICAL & LONG-TERM CARE INSURANCE

As part of the estate planning process, individuals should evaluate their need for supplemental medical insurance or long-term care insurance. Even if available resources are more than adequate to cover such costs, some individuals find insurance attractive to avoid the risk that if a need arises, such costs will consume the assets they hope to leave to loved ones.

In the not-too-distant past individuals who anticipated (or feared) that the high costs of nursing home care might consume assets they hoped to leave to their children, would give their property to their children prior to admittance in the hopes of becoming eligible for Medicaid assistance. Many individuals disapprove of such artificial impoverishment attempts to qualify for public assistance. Others are dissuaded from such tactics by the real or imagined fear that care to Medicaid patients is inferior. In any event, changes to Medicaid rules in recent years have significantly restricted such strategies. However, in some limited circumstances, a few planning options remain for individuals who are willing to transfer their remaining property to their children well ahead of time.

THE WILL OR REVOCABLE LIVING TRUST

For most individuals in Washington, a Will is the basic estate planning vehicle.[2] Most spouses should have a Will that provides that upon the death of the individual, his or her half of the community property and any separate property will pass outright to the decedent's surviving spouse or to a trust for the spouse's benefit. The Will should also specify how property will be distributed if *both* spouses die in a common accident and what would happen upon the second spouse's death, if that death were to occur later than the first spouse's death. Finally, it should specify who will act as executor or Personal Representative of the decedent's estate responsible for carrying out the decedent's Will.

LEAVING EVERYTHING OUTRIGHT TO THE SURVIVING SPOUSE IS OFTEN A MISTAKE

Often, married couples incorrectly assume that upon the death of one spouse, everything should be left outright to the surviving spouse since the primary concern is the survivor, assuming that the marriage is stable, both spouses share the same loved ones, and they have confidence in one another. Indeed, many couples already have a Will along these lines and possibly a Community Property Agreement that they executed many years ago when they first got married. This approach is also reflected in the titling of bank and brokerage accounts in both spouse's names, as joint tenants with right of survivorship, and in life insurance and retirement plan beneficiary designations naming the surviving spouse. For any couple that has or hopes to accumulate a combined marital estate larger than $2,129,000 (the Washington estate tax exemption amount in 2017), leaving the decedent's entire estate to the surviving spouse outright could be a terrible mistake since it "wastes" the first-deceased spouse's Washington estate tax exemption. To understand why, an explanation of the Washington and federal estate tax is necessary.

[2] The choice between a Will and a Revocable Living Trust as the basic estate planning vehicle is discussed in a separate Smith & Zuccarini, P.S. monograph entitled ***"REVOCABLE LIVING TRUSTS- Does a Trust Make Sense for You?"***

Overview of Estate Tax Rules

In 2017, federal law allows every individual to transfer up to $5,490,000 (the "lifetime exemption amount") during life or at death without having to pay federal estate or gift taxes. Thus, federal estate taxes need only concern individuals with an estate larger than this amount. Similarly, in 2017, Washington state law imposes state estate tax on a resident individual's death only if the net value of his or her property exceeds $2,129,000 at death. Individuals whose net worth is less than this amount need not be concerned with federal or Washington estate taxes at all.

For those with larger estates, property in excess of the respective federal and Washington state exemption amounts may be subject to federal estate tax at the flat rate of 40% and/or Washington state estate tax at rates ranging from 10% up to 20%. Thus, if estate taxes are a concern at all, estate taxes are a very important consideration in estate planning.

Married individuals who leave all of their property outright to the surviving spouse don't have to pay federal or Washington state estate taxes on the first spouse's death in any event since an outright gift to the surviving spouse qualifies for the "marital deduction" on the first death and will be includible in the survivor's estate and subject to estate taxes when the surviving spouse dies. Essentially, the effect is to "defer" estate taxation until the death of the survivor when all of the couple's wealth in excess of *the survivor's own $2,129,000 Washington state estate tax exemption* will be subject to Washington state estate taxes. However, the first spouse's $2,129,000 estate tax exemption amount will have been wasted since all of the value ends up in the survivor's estate and he or she will have only his or her own $2,129,000 Washington state estate tax exemption in the end. Thus, married couples who have (or hope to accumulate) aggregate property worth more than $2,129,000 should leave their property in trust for the surviving spouse rather than outright. A trust gift also ensures that (a) the decedent's share of their property will not be subject to liabilities arising during the lifetime of the surviving spouse (e.g. a properly designed trust is exempt from the survivor's creditors' claims). Finally, it also ensures that any property remaining when the survivor dies will be distributed to the first-deceased spouse's beneficiaries (e.g. children or other relatives of the first-deceased spouse) rather than diverted pursuant to the survivor's Will which may be changed in the future.

An outright bequest to the surviving spouse may be harmful for another reason. Using appropriately drafted trusts for each other and for their descendants, a married couple with a larger estate can leave assets to their children and grandchildren in a manner that avoids imposition of estate taxes when their children (and succeeding generations of descendants) die, and also provides such children (and their descendants) lifelong protection against claims by creditors and spouse(s) *without* significantly limiting each generation's control, enjoyment and flexibility. Referred to as "a generation-skipping trust" or "G-S Trust", such a trust can confer extraordinary value on the couple's children and descendants. However, such a trust must be carefully drafted to avoid imposition of the *generation-skipping transfer tax* ("GST Tax"), an *additional tax that applies over and above the estate tax* if an individual transfers to grandchildren or to a trust that ultimately benefits grandchildren or more remote descendants an amount in excess of the generation-skipping transfer tax exemption amount. The 2017 generation-skipping transfer tax exemption amount is $5,490,000. [3]

Basic Estate Tax Planning for Married Couples

Every couple that has (or hopes to have) a combined marital estate larger than the surviving spouse's $2,129,000 Washington exemption amount needs to have a properly drafted Will or Revocable Living Trust that provides for a trust to "capture" the $2,129,000 Washington state estate tax exemption amount on the first spouse's death, and passes the balance to the survivor in a manner that qualifies for the "marital deduction".

A. Portability. In 2010, Congress passed a tax law that allowed surviving spouses to make an election following the first-deceased spouse's death to preserve any portion of the deceased spouse's lifetime exemption that was unused at the time of the spouse's death (the "Deceased Spouse Unused Exemption Amount" or "DSUE Amount"). The concept is commonly referred to as "portability" because the deceased spouse's unused exemption

[3] The benefits of a generation-skipping trust for children or grandchildren are described in the Smith & Zuccarini, P.S. monograph entitled ***"GENERATION-SKIPPING TRUSTS- The Best Way to Leave Property to your Descendants".***

can be shifted to the surviving spouse and used in addition to the survivor's own exemption amount.

Congress hoped that the new portability rule would enable married couples to forego the use of trusts in their estate planning because the surviving spouse would be able to use the first-deceased spouse's exemption amount in the end whether the first-deceased spouse left property to the survivor outright or in trust. However, for a variety of reasons, we recommend that most married couples leave property in trust for the surviving spouse rather than outright for several reasons: First, a marital trust gift benefits the surviving spouse since it is protected from claims by the survivor's creditors. Second, marital trust gift takes full advantage of the first-deceased spouse's Washington state estate tax exemption, so that the couple can pass twice as much property to their children or other beneficiaries estate tax free in the end. Third, if the couple has a larger estate and establishes long-term generation-skipping trusts for their children, a marital trust benefits the couple's children and their descendants over the long term since it enables them to utilize both spouse's federal generation-skipping transfer tax exemptions and shelter twice as much property from future estate taxes otherwise due when the children and grandchildren and successive generations of descendants die (up to $10,980,000 in 2017).[4] Finally, use of a marital trust ensures that the first-deceased spouse's desires will control the eventual distribution of his or her half of the estate, even if the survivor remarries or changes the survivor's plan of distribution. For all of these reasons, couples who have (or hope to have) combined assets in excess of the Washington state estate tax exemption amount (in 2017 that is $2,129,000) should always provide for the surviving spouse through one or more trusts to take full advantage of available estate tax exemptions and obtain the other advantages as explained above.

B. <u>THE MARITAL TRUST</u>. Upon the death of the first spouse, all of the decedent spouse's assets are contributed to a Marital Trust. While this trust is typically referred to as the "Marital Trust", it is sometimes referred to as a "QTIP Trust". Stringent requirements are required so that the Marital Trust may qualify for the estate tax marital deduction, but if these requirements are met, trust assets are not included in the first spouse's estate.

[4] See ***"GENERATION-SKIPPING TRUSTS- The Best Way to Leave Property to your Descendants".***

Instead, estate taxes are deferred until the death of the second spouse. This inclusion in the second spouse's estate allows the estate to get a second step up in basis on the trust assets, thereby reducing income taxes.

The surviving spouse *may* be named as Trustee of his or her Marital Trust, but the surviving spouse *must* be the only beneficiary of the trust. Typically, if the goal is to provide the surviving spouse with maximum flexibility, the Trustee may distribute as much principal to the survivor as she or he needs for his or her health, support and maintenance in the style historically enjoyed by the couple. The Trustee *must* distribute all of the income in the trust to the surviving spouse, at least annually. Upon the surviving spouse's death, the Marital Trust assets ultimately are distributed to the children or other designated beneficiaries, either outright or in trust, as specified by the *decedent* in his or her Will, with less risk of diversion to a new spouse or others by the surviving spouse.

Upon the second spouse's death, all of the assets in the Marital Trust and all of the assets held outright by the surviving spouse are given a second "step up in basis." Typically, when a taxpayer sells property, he or she pays capital gains on the amount that the property increased in value while he or she owned the item. However, when a person dies, all of his or her separate property and all of the couple's community property receives a full step-up in basis. That is, the property has a basis equal to its fair market value at the time of the first spouse's death. Thus, if the property was then sold, the surviving spouse or the Trustee would not owe any capital gains. Assets held in a Marital Trust would receive a second step up in basis at the surviving spouse's death, so any children or other beneficiaries would not have to pay capital gains on the appreciation that occurred between the first and second spouse's deaths (see the example in Paragraph D., below).

If a couple has (or will have) an estate that is larger than the Washington exemption amount (i.e. $2,129,000), the surviving spouse should file a Washington estate tax return even though no taxes would then be owed. The purpose of filing an estate tax return is to ensure that the Washington estate exemption is preserved. If the couple has (or will have) an estate larger than the federal exemption amount ($5,490,000), the surviving spouse should also file a federal estate tax return, even though the estate may not owe any taxes, to elect portability.

C. THE CREDIT TRUST. In some cases, a Credit Trust may also be useful. A credit trust generally takes advantage of the estate tax exemption amount and does not cause the surviving spouse to rely on portability. Different lawyers refer to this trust by a variety of different names such as "the Credit Trust", "the Credit Shelter Trust", "the Bypass Trust", "the Exemption Equivalent Trust", and various other nondescript names such as the "Family Trust". Typically, the surviving spouse is both the Trustee and the beneficiary of the trust but this is *not* required. If the goal is to give the surviving spouse the maximum possible control and benefit, the surviving spouse can act as Trustee, exercise full control over the investments, and can be authorized to withdraw as much of the trust income and/or principal as he or she *needs* for his or her *health, support and maintenance,* in the style historically enjoyed by the couple. There is considerable leeway in drafting the Credit Trust provisions, but typically the trust is designed to give the surviving spouse maximum control and benefit without causing the trust assets to be included in the surviving spouse's own taxable estate. Upon the surviving spouse's death, the Credit Trust assets ultimately are distributed to the children or other designated beneficiaries.

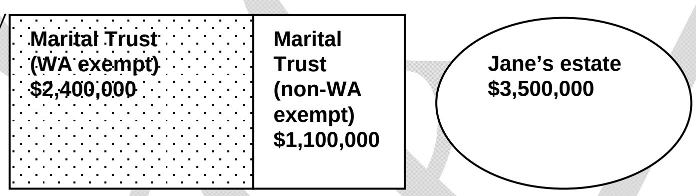
Since the Credit Trust is *not* subject to estate taxes upon the survivor's death, the recommended strategy is for the surviving spouse to live off of his or her own assets and any Marital Trust (described below), and to *grow* the Credit Trust during the survivor's lifetime unless the survivor actually *needs* to draw income or principal from the trust. If Credit Trust assets are invested for growth the Credit Trust may double or triple in size over the remainder of the surviving spouse's lifetime, enabling the first-deceased spouse's estate tax exemption to shelter considerably more than the original federal lifetime exemption amount when the second spouse dies.

D. A FEW EXAMPLES.

1. John and Jane are married, and each has a Will that provides that all of the surviving spouse's separate property and one-half of the couple's community property be contributed to a Marital Trust. John dies this year when the couple owned assets totaling $6 million. All of the assets would have a basis equal to their fair market value. No estate tax is due, and the Marital Trust is funded with assets valued at $3 million (one-half of the couple's $6 million estate). Because Jane's assets and the assets in the Marital Trust may exceed the

federal exemption amount, Jane files a federal estate tax return to elect portability and files a Washington estate tax return so that she may preserve her Washington exemption.

The Marital Trust will be administered by Jane during her lifetime. She *must* take any income produced by the Marital Trust, and *may* withdraw principal to the extent that she needs it for her health, maintenance and support. If Jane lives for five years and doesn't withdraw much Trust principal, the Marital Trust might grow to $3,500,000 or so by Jane's death. If Jane's estate also grows at that pace, Jane would have a total taxable estate of around $7 million after five years. Because Jane elected portability, she is able to add John's exemption amount ($5,490,000) to her own exemption amount (suppose that is $6 million at the time of her death), for a total exemption of $11,490,000. Thus, Jane's estate would not owe any federal estate taxes. Moreover, a portion of the Marital Trust was exempt from Washington estate taxes. Suppose the value of those assets increased to $2,400,000 and that Jane had a Washington exemption of $2,300,000 for her own estate, as illustrated below:



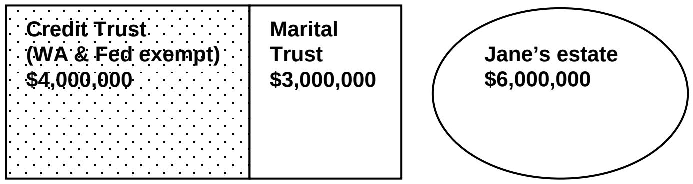
Jane's estate would owe Washington estate taxes on $2.3 million of her $7 million estate,[5] resulting in approximately $285,000 in taxes[6] (as opposed to the $676,000 that would be owed if no trusts were used and the tax was calculated on the full $7 million). If John's heirs decide to sell some of the assets, they will have a basis equal to the fair market value at the time of Jane's death. Assuming that the sale was shortly after Jane's death, they would not owe any capital gains taxes.

2. Assume the same facts as above, but that the couple instead had an estate of $12 million at the time of John's death. Rather than rely on portability, Jane decides to disclaim $2,129,000 of assets into a Credit Trust. Neither the original Credit Trust amount nor the income and appreciation of the Credit Trust amount will be included in Jane's estate or subject to estate tax at her death; however, assets in the Credit Trust will not get a

[5] Jane's $3,500,000 estate plus the $1,100,000 in the marital trust not exempt from Washington estate taxes less the presumed $2,300,000 Washington estate tax exemption.

[6] Tax calculated using Washington Estate Tax Graduated Rate Tables.

second step-up in basis on her death. The assets in the Credit Trust appreciate to $4,000,000 at the time of Jane's death, as shown below:



That amount in John's Credit Trust will pass to their children or others estate tax free pursuant to John's Will. Jane's estate and whatever amount may be in the Marital Trust will be taxable only to the extent that the combined value exceeds *her* own lifetime exemption amount. If Jane has $4 million in the Credit Trust, $3 million in a Marital Trust and $6 million of her own assets at the time of her death, Jane would not owe any federal estate taxes (assuming again that the federal exemption amount was $6 million at the time of Jane's death and that Jane made all necessary tax elections).[7] Jane's estate would owe Washington estate taxes, and John's heirs would have to pay capital gains tax on any appreciation since the time of John's death if they sell any Credit Trust assets.

Non-U.S. Citizen Spouse: A Qualified Domestic Trust (QDOT) Required

If either spouse is not U.S. citizen, the other spouse's Will must normally include a Marital Trust with certain additional special provisions designed to qualify the trust as a "qualified domestic trust" (a QDOT) in order for amounts passing to or for the non-citizen spouse to qualify for the marital deduction. If a U.S. citizen or alien dies and leaves an estate in excess of the $2,129,000 Washington estate tax lifetime exemption amount to a noncitizen spouse, such "excess" bequest will qualify for the marital deduction *only if* (1) the non-citizen spouse must become a citizen before the estate tax return is due, or (2) the assets are left to the surviving spouse in a Marital Trust designed to meet certain additional requirements to qualify as a QDOT.

[7] Jane's $6 million estate plus the $3 million in the marital trust are included in her estate, but she is entitled to an exemption equal to her deceased spouse's unused exemption ($3,361,000) plus her own exemption ($6,000,000), which exceeds her taxable estate. Additionally, Jane's estate would be entitled to a deduction for any estate taxes paid.

A QDOT must meet the same requirements as a Marital Trust (i.e., the spouse may be the only beneficiary and the trust must require income to be distributed at least annually), but there are two additional requirements: (1) at least one trustee must be an individual citizen of the United States or a domestic corporation, and (2) no distribution (other than income) can be made unless the Trustee who is a citizen/domestic corporation has the right to withhold from the distribution the tax on distributions under the Internal Revenue Code. While a U.S. trustee or co-trustee may not be preferred, this is a relatively minor price to pay for the ability to defer estate taxes until the death of the non-citizen spouse.

COMMUNITY PROPERTY ISSUES

Since Washington is a "community property state", the community property laws underlie all estate planning in Washington, and present several planning opportunities and pitfalls for Washington married couples. While a comprehensive discussion of Washington community property laws is beyond the scope of this Monograph, an understanding of the most basic rules underlying Washington community property laws is necessary. First, under Washington law, each spouse has the right to dispose of (1) his or her *separate property,* and (2) one-half of the *community property*. Therefore, the characterization of the couple's property is important.

OVERVIEW OF WASHINGTON COMMUNITY PROPERTY LAWS

Generally, *community property* is what the couple earns and accumulates from earnings (and from investment and reinvestment of such accumulations) while married and residing in Washington or another community property state. In contrast, *separate property* includes (a) assets one spouse *brought* to the marriage, (b) amounts received as separate gifts and inheritances during the marriage, and (c) earnings and gains traceable to such separate property.

Washington law favors community property, and *presumes* that all of a married couple's assets are community property unless separate property has been kept separate or can be traced to separate property. *Commingling* community and separate property in a manner that prevents tracing may suggest the intent to gift separate property to the marital community, and may cause assets to be *converted* into community property. Therefore, if either spouse has separate property that he or she wishes to keep separate, it is extremely important for such assets and the earnings therefrom (and proceeds from sale and reinvestment thereof) be titled continuously in the owner spouse's name alone and kept segregated from community assets at all times. Otherwise, if the assets are commingled, the spouse may be presumed to have made a *gift* to the marital community.

COMMUNITY PROPERTY AGREEMENTS USEFUL TO *CHARACTERIZE* ASSETS

Washington permits married couples to enter into Agreements concerning *characterization* of community property and separate property, or even *changing* the status thereof. Community Property Agreements and Separate Property Agreements are often entered into by a married couple to memorialize their agreement concerning a particular asset that may be of uncertain character, or to change its character. Such Agreements may eliminate controversy after one spouse dies or, as discussed below, may help convince the IRS that the survivor is entitled to a tax-free basis step-up in a property for income tax purposes when one spouse dies.

A different type of Community Property Agreement is also commonly entered into by couples who marry at an older age after accumulating substantial assets of their own to memorialize and preserve the separate property character of their estates, and their agreement concerning application (or non-application) of the community property laws during their marriage. This type of community property agreement is often referred to as a "Prenuptial Agreement" or "Postnuptial Agreement", and is an important defense against claims arising down the road in the event of divorce, or following the death of one spouse.

DISPOSITIVE COMMUNITY PROPERTY AGREEMENT NEARLY ALWAYS A MISTAKE

Unique among the community property states, Washington and Idaho permit married couples to enter into a special form of Community Property Agreement providing that all of a couple's property passes automatically to the surviving spouse upon the death of either spouse. Such an Agreement is often entered into by younger couples as a strategy to pass everything to the survivor upon either spouse's death with a minimum of legal hassle and without any necessity to probate the deceased spouse's Will.

A Community Property Agreement of this kind is dangerous since it *overrides* the deceased spouse's Last Will & Testament, and vests everything in the surviving spouse outright. It may be harmless enough for a young couple that owns insignificant property but it is a potential disaster for a couple that has (or hopes to have) a potentially taxable estate (a combined marital estate in excess of the $2,129,000 Washington estate tax exemption of the one surviving spouse). Such a couple needs Wills or a Revocable Living Trust that provides for a trust on the first death in order to capture the deceased spouse's $2,129,000 Washington estate tax exemption amount. If a married couple in this position utilizes a "Dispositive Community Property Agreement" of this kind to operate on the first-spouse's death, the deceased spouse's Washington exemption will be wasted, probably resulting in much higher estate taxes when the surviving spouse dies.

Many couples entered into this kind of Community Property Agreement when they executed simple Wills in the past. Any such couple that may now have a potentially taxable estate is advised to sign (and possibly record) a formal Revocation of Community Property Agreement today in order to protect and preserve each spouse's estate tax exemption amount.

Long-Time Married Couples may want to *Convert* Separate Property into Community

An often-overlooked benefit of dying is the tax-free step-up in the tax basis of property enjoyed by your heirs. Following an individual's death, the surviving spouse or children can sell appreciated shares of stock or real estate without having to pay capital gains tax since the successors receive a new tax basis in inherited property equal to its fair market value as of the date of the owner's death.

An advantage of living in a community property state is that the surviving spouse receives a tax-free basis step-up in *both halves* of the community property: not only the property inherited from the deceased spouse, but the survivor's share as well. This is a windfall, and in appropriate instances long-time married couples should consider the potential advantage of converting one spouse's separate property into community property. If such a conversion is accomplished at least one year before the non-owner spouse dies, the surviving spouse receives a windfall in the form of a stepped up basis upon the death of the non-owner spouse, enabling him or her to dispose of appreciated property tax-free without capital gains tax.

Converting separate property to community property is not without risks, and could be a disaster if the couple later obtained a divorce. Similarly, it would almost never make sense for a couple with separate children from previous marriages. However, in appropriate situations, such a move makes sense to consider.

REVIEW & COORDINATION OF ASSET TITLES

Since a Will only controls disposition of property included in the probate estate and *subject to* the Will, signing a Will with appropriate tax-saving provisions is only the first step in estate planning. Once an appropriate Will is signed, the couple must review the ownership and value of the various assets that comprise their respective estates to ensure that sufficient value will be subject to their respective Wills and available to fully-fund the Credit Trust upon either spouse's death, if possible.

Holding assets in "*joint tenancy, with right of survivorship*" (JTROS) is sometimes a problem. When assets are co-owned in this form, upon the death of one owner, his or her interest passes automatically by right of survivorship to the surviving owner regardless of the provisions in the deceased owner's Will. Therefore, the decedent's interest in assets held by a couple in JTROS aren't subject to his or her Will and aren't available to help fill up the Credit Trust. Although it may be possible to "fix" the problem by prompt action following the first spouse's death by having the surviving spouse execute a qualified disclaimer of his or her right of survivorship, this may not always be possible and is not a reliable planning strategy. Accordingly, most assets other than normal bank accounts recommended to be co-owned assets as *community property*: "John and Jane, husband

and wife". This ensures that each spouse controls his or her full half of each asset, and that the value will be available to help fund the first-deceased spouse's Credit Trust.

This issue is less critical for couples with relatively small estates (i.e. couples who can be *sure* that their combined aggregate estate in the hands of the survivor will *never* exceed $2 Million) or couples with larger estates (i.e. couples who can be *sure* that the first-deceased spouse's probate estate will include *more than* $5,490,000 in assets without counting JTROS assets, life insurance, deferred annuities, and IRAs and other qualified retirement plan accounts). In these instances, it may be *harmless* for a couple to hold assets in joint tenancy with right of survivorship, or even *useful* to avoid ancillary probate that would otherwise be required for out-of-state assets.

Coordinating Retirement Plan Assets

Similar concerns arise related to IRAs and other qualified retirement plan assets. Many individuals hold a substantial part of their wealth in IRAs and other qualified retirement plans, and some have relatively small estates outside their retirement plans. When the plan participant dies, the plan balance is paid to the participant's *designated beneficiary* and is *not* ordinarily controlled by the participant's Last Will & Testament. Therefore, once an individual's Last Will & Testament is finalized, we need to review and coordinate the retirement plan beneficiary designations with the individual's overall estate plan.

Planning for retirement plan assets is complicated, and there are a number of very technical and often conflicting rules that make it hard to generalize regarding the optimal strategy. Appropriate planning depends on a couple's particular situation and objectives. Often, planning focuses on *estate tax considerations*, and seeks to ensure that there will be sufficient funds available to fully fund the deceased spouse's Credit Trust regardless which spouse dies first. Sometimes, particularly for spouses who have been married previously and have separate children, planning aims to preserve *control* and ensure that if the participant spouse dies first, retirement plan assets will provide a secure income stream to the surviving spouse as long as she lives but can't be diverted to her own children or to a new spouse. Other times, if the couple has sufficient other income and resources on which to live, the planning focus is on *income tax deferral*, and aims to postpone and "stretch out" required plan withdrawals as long as possible to facilitate continued income tax deferral following both spouse's deaths over the lifetime(s) of their child(ren).[8]

Ultimately, planning with IRAs and other qualified retirement plan assets involves review of plan provisions pertaining to distribution options during the participant's lifetime and after his or her death, and implementation of appropriate beneficiary designations. Ideally, an individual will implement beneficiary designations that (1) ensure that the surviving spouse will be in a position to effect a "spousal rollover" of plan assets on the participant-spouse's death, if appropriate, to postpone required withdrawals as long as possible; (2) ensure that plan assets will be available to fund the owner's Marital Trust, if needed, so that no part of the owner's estate tax exemptions will be wasted, (3) ensure that even if the nonparticipant spouse dies first, there will be sufficient assets available in his or her probate estate to fully fund his or her Marital Trust so that no part of the nonparticipant spouse's estate tax exemptions will be wasted; and (4) ensure that in a second marriage situation or otherwise if preservation of control is a high priority, required plan distributions will be to the deceased participant's Credit Trust or Marital Trust rather than to the surviving spouse outright so that the participant's Will ultimately controls who receives the retirement plan balance.

Proper beneficiary designations are the key to achieving each of these objectives, and if possible, flexibility for post-mortem planning should be built into the beneficiary designations in the form of *alternate* beneficiary designations to be triggered by a qualified disclaimer. *Once a participant's Will is finalized, payout options for each retirement plan and beneficiary designations should be reviewed and coordinated as required to ensure that the participant's objectives will be realized.* ***Payout options and beneficiary designations should be revisited again when the participant spouse turns 70½ years of age, and periodically thereafter.***

[8] The mechanics of "the deferral game" are discussed in detail in a separate Smith & Zuccarini, P.S. Monograph entitled ***"THE ETERNAL IRA- Leaving your Retirement Plan to your Children".***

COORDINATING LIFE INSURANCE

Review of the sufficiency of a couple's existing life insurance coverage should be part of the estate planning process. Since Smith & Zuccarini, P.S. is *not* in the business of *selling* life insurance, we are uniquely situated to provide objective advice concerning the potential benefits of life insurance in estate planning and appropriate coverage amounts, and we are experienced in planning with life insurance.

Life Insurance, like qualified retirement plan assets, comprises a significant part of many individual's net wealth and is another "nonprobate asset" that typically passes outside the individual's probate estate. Typically, when an individual insured dies, the proceeds of life insurance policies on his or her life are paid to the designated beneficiary, and unless the individual's estate is designated as the beneficiary, the provisions of his or her Will are irrelevant. Consequently, careful consideration should be given to where the funds should be paid, whether or not they will be needed to fund the insured's Credit Trust, who should control the ultimate disposition of the insurance proceeds, and similar issues. In addition, since proceeds of insurance policies owned and controlled by the insured are included in his or her taxable estate for federal estate tax purposes, individuals with significant assets and/or life insurance are well advised to consider establishing an Irrevocable Life Insurance Trust to own their life insurance to avoid estate taxes otherwise due thereon. Finally, some couples who have substantial estates and anticipate owing a substantial estate tax in the end, may want to explore the purchase of additional life insurance, possibly a "2nd to Die" or "Survivorship" policy, to help fund payment of their anticipated estate tax liability in the end without forced liquidation of assets. This strategy needs to be thought through like any investment, but may be particularly attractive for couples with a substantial portion of their wealth tied up in illiquid assets such as a closely-held business interest or real estate, or in income tax-deferred assets such as a large IRA or qualified retirement plan.

Other objectives include (1) purchase of life insurance payable on one spouse's death to fund desired immediate gifts to children, grandchildren or charity, (2) purchase of life insurance on the employee-spouse's life as "pension replacement" insurance for the benefit of the surviving spouse to avoid a costly "joint and survivor" benefit election or to facilitate the "Eternal IRA" strategy alluded to above, or (3) purchase of insurance for benefit of a 2nd spouse where the decedent had children from a prior marriage, so that the surviving spouse receives financial security without the children having to wait until the new spouse's death to receive their inheritance.

COORDINATING LIFE INSURANCE BENEFICIARY DESIGNATIONS

Many couples assume that life insurance proceeds should be paid to the surviving spouse, and designate the noninsured spouse as the primary beneficiary and the children as the secondary beneficiary without giving much thought to alternatives. The drawback of designating the surviving spouse is that the funds will pass to him or her outside the Will (rather than into the trusts established pursuant to the Will). Thus, neither spouse's half of the insurance proceeds will be available to fund the decedent's testamentary trust(s); moreover, if the insurance proceeds pass outright to the surviving spouse, they will be subject to future creditors' claims and to possible diversion in the event that the surviving spouse remarries. Generally, this is not desired.

In general, unless insurance is held in a Life Insurance Trust to avoid estate taxes, the predominant planning objectives are to ensure that (1) insurance proceeds will be available to help fund the deceased spouse's Credit Trust, if needed, and that (2) the deceased insured spouse's Will or Revocable Living Trust will control the ultimate distribution of the insured spouse's interest in such insurance proceeds following the survivor's death. Often, the best approach is for a couple to designate the decedent's estate as the beneficiary of the decedent's life insurance.

ESTABLISHING AN IRREVOCABLE LIFE INSURANCE TRUST TO SAVE ESTATE TAXES

Couples who own or plan to acquire a significant amount of life insurance should consider establishing an Irrevocable Life Insurance Trust (an "ILIT") to own their life insurance policies in order to avoid estate taxes otherwise due on their life insurance proceeds when they die.[9] Typically, a Life Insurance Trust is established by the insured spouse for the benefit of the surviving spouse, or sometimes for the benefit of children and their descendants. The Trust is irrevocable, and the Trustee should be technically *independent* (i.e. most individuals name a sibling or child unless a professional trustee is preferred).

The insured transfers to the Trustee all ownership rights over existing life insurance policies, or cash to be used to purchase new life insurance policies, and makes additional annual transfers to the Trustee to be used to pay annual premiums. When the insured dies, the proceeds are paid to the Trustee, and the Trust Agreement is properly drafted, the proceeds will be excluded from the insured's taxable estate.

Depending upon the provisions of the Life Insurance Trust Agreement, the proceeds may be used to provide extra support or financial security for the surviving spouse, may be used to pay estate taxes at the surviving spouse's death, or may be held for children or grandchildren.

Ultimately, an Irrevocable Life Insurance Trust may be used to preserve *existing* life insurance policies from erosion by estate taxes, or may be used to purchase a *new* life insurance policy outside the insured's taxable estate. In either event, because the 2017 federal estate tax rate is 40% and the Washington estate tax has a top rate of an additional 20%, the potential savings may be substantial. For example, a fully taxable estate could save up to $520,000 in estate taxes on a $1 million policy.[10] And if the Life Insurance Trust is designed as a "Dynasty Trust" to benefit more than one succeeding generation of the descendants with appropriate generation-skipping transfer tax provisions, the combined estate tax savings can be truly enormous.

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[9] The potential benefits of the Irrevocable Life Insurance Trust technique, and the mechanics for establishing and implementing an ILIT, are described in detail in a separate Smith & Zuccarini, P.S. Monograph entitled ***"IRREVOCABLE LIFE INSURANCE TRUSTS- Getting the most from your Life Insurance."***

[10] This figure is calculated assuming a 20% Washington Estate Tax, a deduction for the Washington tax paid, then a 40% estate tax, resulting in a combined tax rate of 52%.

A PHASED APPROACH TO ESTATE PLANNING

Every married couple in Washington needs certain basic estate planning arrangements to protect and provide for the surviving spouse following the death of either spouse. We recommend that couples recognize two distinct phases to their estate planning: Phase One Estate Planning consists of implementing appropriate Wills or a Revocable Living Trust to provide for the surviving spouse and the ultimate disposition of the couple's estate with appropriate estate tax provisions, as well as Durable Powers of Attorney for Financial Matters, Durable Powers of Attorney for Health Care Decisions, and Health Care Directives (also known as a "Living Will") for each spouse. In addition, as part of Phase One Estate Planning, the manner in which each significant asset is now held should be reviewed, and adjusted where necessary. Finally, beneficiary designations for each life insurance policy, annuity, and retirement plan account should be reviewed and changed to the extent appropriate to properly coordinate these important *nonprobate* assets with the couple's overall plan.

Phase Two Estate Planning consists of more specialized planning strategies designed to achieve specific objectives. These include: (1) planning strategies designed to reduce estate taxes and/or plan for funding anticipated estate taxes, (2) business succession planning, (3) asset protection planning, and (4) philanthropic estate planning.[11] Depending on a couple's particular situation and objectives, Phase Two Estate Planning may be the most important part of their personal planning, or entirely unnecessary.

Attorneys at Smith & Zuccarini, P.S. have assisted thousands of individuals with their estate planning over more than three decades, and are thoroughly familiar with estate planning strategies. We will be happy to meet with you to review your particular circumstances, and assist you in determining the most appropriate planning strategies for *you*.

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[11] Smith & Zuccarini, P.S. has prepared separate Monograph dealing with each of these topics that are available upon request; in addition, we address these topics at our Advanced Estate Planning Seminar each month.

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TYPICAL WILLS FOR A MARRIED COUPLE

Deceased Spouse

(1/2 Community Property + Separate Property, if any)

When first-deceased spouse dies, after specific bequests, if any, Deceased Spouse's residuary estate allocated to Marital Trust designed to (a) take full advantage of available federal and Washington state estate tax exemptions*, (b) defer federal or Washington state estate tax obligations, if any, until the surviving spouse's death, and (c) enable trust remainder beneficiaries to receive trust assets with a "stepped up" income tax basis equal to the fair market value on the surviving spouse's death *if **appropriate elections are made on timely filed federal and/or Washington state estate tax returns after the first-deceased spouse's death***. Marital Trust divisible into two or more subtrusts as required to minimize federal or state estate taxes.

Marital Trust(s) for Surviving Spouse

Marital Trust Income distributed to surviving spouse, and **Trust Principal** distributable if needed for support, maintenance & health care. **Surviving Spouse is Beneficiary & Trustee.**

Surviving Spouse should consider "disclaiming" assets to a separate Credit Trust (usually no more than the amount of the Washington state estate tax exemption ($2,129,000 in 2017*)) if survivor's advisors determine that the estate tax benefits of doing so will exceed the income tax costs

Credit Trust for Surviving Spouse

Credit Trust Income (& Principal) distributable to Surviving Spouse if needed for maintenance and support, or health care, otherwise income may accumulate.
Surviving Spouse is Beneficiary & Trustee.

First-Deceased Spouse's property passes to Marital Trust unless Survivor disclaims all or a portion of the Deceased Spouse's property to Credit Trust.

Surviving Spouse

(1/2 Community Property + Separate Property, if any)

Surviving Spouse retains ownership & control of his/her own estate, with full right to use & enjoy such assets and/or change his or her own Will.

When Surviving Spouse dies, federal &/or state estate taxes imposed on combined total of (a) survivor's estate + (b) any portion of first-deceased spouse's Marital Trust(s) not covered by first-deceased spouse's own exemption(s)*

Residue of Surviving Spouse's estate ultimately divided & distributed outright or in trust for children (or their surviving descendants, per stirpes) as provided in Surviving Spouse's Will.

In 2017, excess over $2,129,000 is subject to Washington state estate tax, and excess over $5,490,000 (plus any DSUE amount) is subject to federal estate tax. Such amounts are indexed for inflation and will change in future years.

When Surviving Spouses dies, Trust remainder (s) divided & distributed outright or trust for children

Separate Descendant's Trust(s) for each Child

(or each of his or her surviving Descendants, per stirpes)

- **Trust income & principal distributable as needed for beneficiary's support, education & health care.**
- Trust distributed in stages: 1/3 at age 25, 1/3 at age 30, and balance at age 35.
- If a child dies prior to termination and distribution, his or her trust subdivided into separate shares for his or her descendants, per stirpes, with each separate share to be administered for grandchildren on the same basis as for child. If beneficiary has no descendants then living, reallocated to parents' descendants, per stirpes, if any, or if none, distributed as provided in Article 3.3.

If neither spouse nor any of your descendants survive, each estate (& trust remainders) distributed as provided in each spouse's Will.

***In 2017, each decedent's estate is entitled to an exemption from federal estate tax of $5,490,000, reduced by any lifetime gifts ,and an exemption from Washington estate taxes of $2,129,000. Taxes are subject to change at any time. To obtain optimum estate and income tax results it may be necessary to file a federal and/or Washington state estate tax return after the first spouse's death to make recommended elections even if return(s) are not otherwise required to be filed. Consult your estate planning attorney.**

TYPICAL GST WILLS FOR A MARRIED COUPLE

Deceased Spouse

(1/2 Community Property + Separate Property, if any)

When first-deceased spouse dies, after specific bequests in Article 2, Deceased Spouse's residuary estate allocated to Marital Trust designed to (a) take full advantage of available federal and Washington state estate tax exemptions*, (b) defer federal or Washington state estate tax obligations, if any, until the surviving spouse's death, and (c) enable trust remainder beneficiaries to receive trust assets with a "stepped up" income tax basis equal to the fair market value on the surviving spouse's death *if **appropriate elections are made on timely filed federal and/or Washington state estate tax returns after the first-deceased spouse's death***. Marital Trust divisible into two or more subtrusts as required to minimize federal or state estate taxes.

Surviving Spouse

(1/2 Community Property + Separate Property, if any)

Surviving Spouse retains ownership & control of his/her own estate, with full right to use & enjoy such assets and/or change his or her own Will.

When Surviving Spouse dies, federal &/or state estate taxes imposed on combined total of (a) survivor's estate + (b) any portion of first-deceased spouse's Marital Trust(s) not covered by first-deceased spouse's own exemption(s)*

Residue of Surviving Spouse's estate ultimately divided & distributed as provided in Article 3.2 or 3.3 of Surviving Spouse's Will.

In 2017, excess over $2,129,000 is subject to Washington state estate tax, and excess over $5,490,000 (plus any DSUE amount) is subject to federal estate tax. Such amounts are indexed for inflation and will change in future years.

Marital Trust(s) for Surviving Spouse

Marital Trust Income distributed to surviving spouse, and **Trust Principal** distributable if needed for support, maintenance & health care. **Surviving Spouse is Beneficiary & Trustee.**

Surviving Spouse should consider "disclaiming" assets to a separate Credit Trust (usually no more than the amount of the Washington state estate tax exemption ($2,129,000 in 2016*)) if survivor's advisors determine that the estate tax benefits of doing so will exceed the income tax costs

First-Deceased Spouse's property passes to Marital Trust unless Survivor disclaims all or a portion of the Deceased Spouse's property to Credit Trust.

Credit Trust for Surviving Spouse

Credit Trust Income (& Principal) distributable to Surviving Spouse if needed for maintenance and support, or health care, otherwise income may accumulate.
Surviving Spouse is Beneficiary & Trustee.

When Surviving Spouses dies, Trust remainder (s) divided & distributed as provided in Article 3.2 or 3.3.

Separate Descendant's Trust(s) for each Child

(or each of his or her surviving Descendants, per stirpes)

- **Each child's Descendant's Trust is a generation-skipping trust that continues for his or her lifetime**, with income & principal distributed as needed for education, maintenance & health care.)
- After age 35, each child will be sole Trustee of his or her separate Descendant's Trust with right to designate successor Trustee(s).
- On each child's death, his or her trust subdivided into separate shares for his or her descendants, per stirpes, with each separate share to be administered as a separate trust for the lifetime of such deceased child's descendant on the same basis, Under current Washington law, trust duration limited to 150 years.
- Each child (or successive beneficiary) has testamentary power of appointment enabling him to control the disposition of his own separate trust.

***In 2017, each decedent's estate is entitled to an exemption from federal estate tax of $5,490,000, reduced by any lifetime gifts ,and an exemption from Washington estate taxes of $2,129,000. Taxes are subject to change at any time. To obtain optimum estate and income tax results it may be necessary to file a federal and/or Washington state estate tax return after the first spouse's death to make recommended elections even if return(s) are not otherwise required to be filed. Consult your estate planning attorney.**