INSIGHT ON ESTATE PLANNING

Small business owners may qualify for the special use valuation method

Need to make a "quick fix" to your will?

Executing a codicil may be the answer

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ESTATE PLANNING PITFALL

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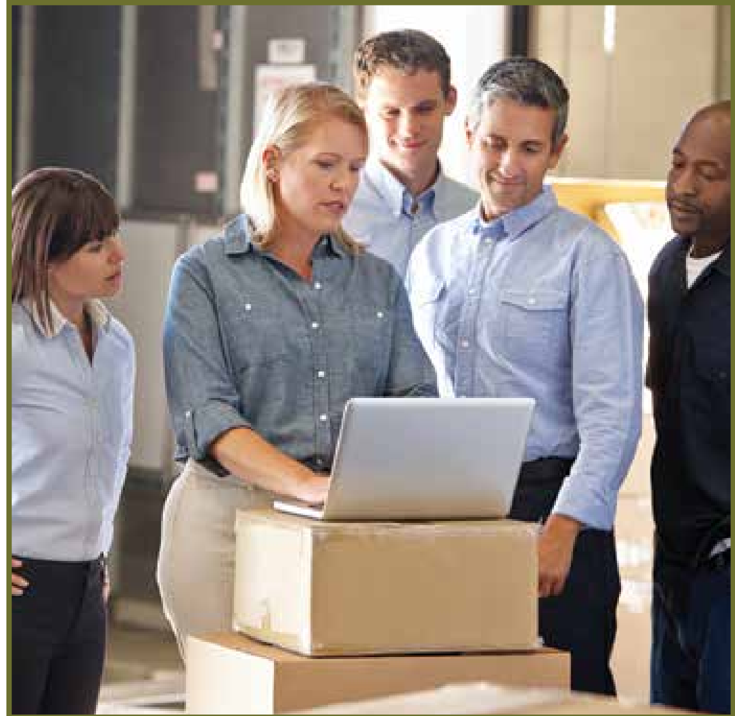
Small business owners may qualify for the special use valuation method

The need for estate planning is essential for small business owners who have most of their personal fortune tied up in the operation. This is compounded by the looming reduction of the federal gift and estate tax exemption beginning in 2026 (absent congressional action).



Fortunately, if you own a small business, you may have an ace up your sleeve: the special use valuation method. With this approach, your executor may be able to secure significant tax savings when your business interest is passed to your heirs. However, the special use valuation method isn't available to everyone. The election can be claimed only for real estate property used in a closely held business or farm that meets certain requirements.

Current lay of the land

It's commonly thought that most small business owners don't have to worry much about federal estate tax relating to their business, if at all. First, the unlimited marital deduction shields from estate tax any amount passed to a spouse. Second, transfers to nonspousal beneficiaries are sheltered from tax by the federal gift and estate tax exemption.

The exemption has grown in leaps and bounds since it was $1 million near the turn of the century. Most recently, the Tax Cuts and Jobs Act (TCJA) doubled the previous exemption amount from $5 million to $10 million, with inflation indexing. For 2022, the amount is $12.06 million (up from $11.7 million in 2021).

To provide even more protection, the exemption is doubled for a married couple to a maximum total of $24.12 million in 2022. Also, the estate of the second spouse to die can use the other spouse's unused exemption under the "portability" provision. This is usually sufficient to cover the assets of most small business owners.

Nevertheless, the $10 million exemption under the TCJA is scheduled to revert to $5 million (plus inflation indexing) after 2025. Thus, based on the current environment, small business owners should take nothing for granted when it comes to estate taxes.

Special use election to the rescue

Significantly, the fair market value of any real estate property you own at death is included in your taxable estate. Generally, the fair market value is determined by the property's "highest and best use." In other words, if the property is raw land that would be worth a small fortune to real estate developers as a mall or a condo complex, the higher value is treated as the "fair market value" for estate tax purposes.

This can often work against business owners and farmers who own real estate in a prime location. Their heirs may have to pay an inflated estate tax. However, there's a potential way out for qualified property owned by closely held businesses and farms. If a special use election is made by the executor and certain requirements are met, the business owner's property is valued according to its current actual use on the owner's death — instead of its highest and best use.

For these purposes, the real estate includes buildings and other structures regularly occupied or owned by the owner or lessee used to operate a closely held business or farm.

To qualify for this estate tax break, the net value of the property must equal at least 50% of the deceased's gross estate and 25% of his or her adjusted gross estate (the gross estate reduced by certain deductible debts, expenses, claims and losses). Also, the deceased must have transferred the business to a qualified heir or heirs (such as his or her children).

Finally, the business must have been owned and operated by the deceased or a close family relative for five out of the last eight years before death.

Bear in mind that the reduction in the estate tax value under this election can't exceed a threshold that's adjusted annually for inflation.

Mechanics of the election

The election to use the special use valuation method is made by your executor on the estate tax return, IRS Form 706. It must be accompanied by a written agreement that's signed by each person with an interest in the property. Once this election is made, it's irrevocable.

The inclusion of the written agreement is critical. Without it, the IRS may challenge the election and will likely prevail in court. Keep this in mind as you develop a plan of action with your executor.

Initially, the threshold was set at $750,000 back in 1978. The maximum for those who die in 2022 is $1.23 million, up from $1.19 million in 2021 (see the sidebar "Mechanics of the election" above).

The recapture provision

There's one other catch to bear in mind. If your heirs sell to outsiders or otherwise dispose of the property within 10 years of your death, or they begin using the property for another purpose, the estate tax savings must be recaptured. As part of the process, the IRS will file a lien to secure its rights during this period. After 10 years has elapsed, the lien is removed.

Accordingly, it's important that all parties fully understand the 10-year recapture provision and comply with all the rules.

Is a special use valuation right for you?

If you own a small business or farm, consider the plusses and minuses of using a special use valuation in your estate plan. Your estate planning advisor can help you determine if it's right for your situation. •

Need to make a "quick fix" to your will?

Executing a codicil may be the answer

For most people, the first step in estate planning is to create a legally enforceable will. If you already have a will in place, consider yourself ahead of the game, but you're far from finished. If, for example, your circumstances have recently changed, your will may be in need of a "quick fix."

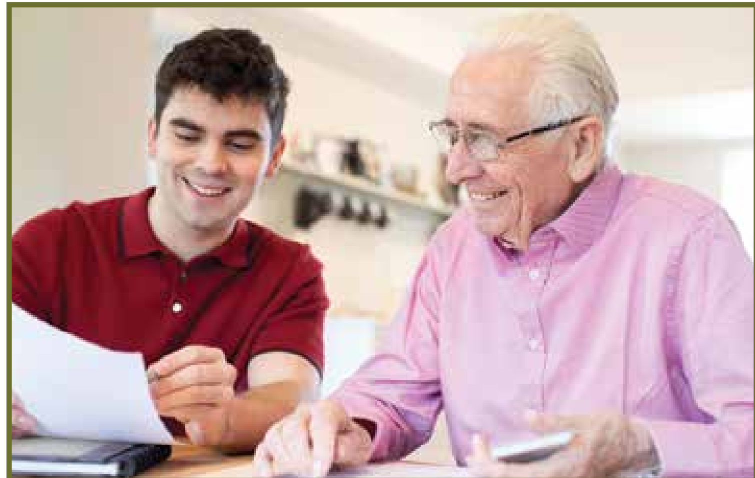
A supplement to an existing will

If you need to make a change to your will does that mean you have to completely re-write it? Not exactly. A simple "codicil" may suffice for a minor change. A codicil is a legal document that's treated as a supplement to an existing will. When your will is subjected to probate, so is the codicil.

Bear in mind that codicils were more prevalent in "days of yore" before personal computers. It was more time-consuming and costly than it is today to replace a will. With a codicil, you only had to address one or two points — not the entire last will and testament. This is no longer a significant factor.

Furthermore, adding a codicil could create confusion relating to other parts of the will. And it's often more convenient for everyone in the family to rely on a single document. As a result, you may redo a will instead of adding a codicil. Nevertheless, using a codicil remains the preferred approach for some people, especially for relatively small changes.

To be legally binding, a codicil must be handled with the same legal formalities as a will. Therefore, it's best to have it prepared by a qualified attorney.



Reasons for updating your will

What situations may trigger a need for an update of a will through a codicil or re-write? Common examples include a:

Birth or death in the family. Maybe you didn't have any children or grandchildren when your will was initially drafted. Now that you do, you may want the newest members of the family to share in your estate. Or perhaps a family member you previously named in your will has passed away. You'll want to remove his or her name from your list of beneficiaries and possibly include other family members who weren't previously named in your will.

Change in executor. In some cases, you may have to select a new executor (or guardian or

trustee). This may occur if the one you named in your will has died or become incapacitated and you haven't made adequate contingency plans. In other instances, you may simply rather assign the job to someone else.

Revalidation. Suppose the witnesses who can verify the signature on your will are no longer alive or can't be located. When it's required, a codicil attested to by new witnesses can revalidate the will.

Tax law change. A new or revised tax law may require you to modify certain provisions to take maximum advantage of the latest rules. In addition, there's significant uncertainty concerning the federal gift and estate tax exemption ($12.06 million in 2022), which is scheduled to revert to its pre-2018 level of $5 million (plus inflation indexing) after 2025.

Other estate tax law changes are being contemplated by some members of Congress. When possible, revise your will to provide maximum flexibility.

What to include in a codicil

For starters, a codicil must have identifying information, including your full legal name, address, the date of the codicil, and a statement indicating that you're of sound mind and not being coerced by someone else. Explain what parts of the will are affected. Use full legal names when referring to beneficiaries, specify dollar amounts or percentages, and describe any property in detail.

To be legally binding, a codicil must be handled with the same legal formalities as a will.

Furthermore, the codicil should state that its provisions supersede what you've written in your will and that all parts of the will not affected by the codicil remain in effect. Sign the codicil and have it witnessed according to state law. Finally, keep it in a secure location along with your will.

Get it done

Life happens and a lot can change in the years since you've first drafted your will. Your estate planning attorney can help draft your codicil. •

Decisions, decisions

Many factors go into deciding when to transfer wealth

A critical estate planning decision is whether to transfer wealth during your lifetime or keep your assets in your estate and transfer your wealth to loved ones after your death. Some say it would be wise to make gifts now to take advantage of the inflation-adjusted $12.06 million gift and estate tax exemption. (Without action from Congress, the exemption amount will be halved after 2025.)

Others caution that giving away wealth during one's lifetime isn't right for everyone. Let's take a closer look at factors to consider when making the decision.

Carryover tax basis and stepped-up basis

The primary advantage of making lifetime gifts is that by removing assets from your estate you shield future appreciation from estate taxes. But there's a tradeoff: Your beneficiary receives a "carryover" tax basis — that is, he or she assumes *your* basis in the asset. If a gifted asset has a low basis relative to its fair market value (FMV), then a sale will trigger capital gains taxes on the difference.

An asset transferred at death, however, receives a "stepped-up basis" equal to its date-of-death FMV. That means the recipient can sell it with little or no capital gains tax liability. So, the question becomes, which strategy has the lower tax cost: transferring an asset by gift (now) or by bequest (later)?

The answer depends on several factors. They include the asset's basis-to-FMV ratio, the likelihood that its value will continue appreciating, your current or potential future exposure to gift and estate taxes, and the recipient's time horizon — that is, how long you expect the recipient to hold the asset after receiving it.

3 examples

To keep things simple, let's always assume that you and your heirs are subject to tax on capital gains at a rate of 23.8% (the top capital gains rate of 20% plus the 3.8% rate on net investment income) and that the gift and estate tax rate is 40% of amounts in excess of the applicable exemption.

Example #1. You have $8 million in publicly traded securities with a $3 million basis and $2 million in other assets. You haven't used any of your exemption amount. If you give the securities to your son, who sells them immediately, he'll owe $1.19 million in capital gains taxes [23.8% × ($8 million - $3 million)]. Suppose, instead, that you hold the securities for life, that the inflation-adjusted exemption in the year you die is $12 million, and that the securities' value has grown to $13 million. If your son inherits the securities, he'll receive a stepped-up basis of $13 million and can sell them tax-free. Your estate will be subject to estate taxes of $400,000 [40% × ($13 million - $12 million exemption)]. In this scenario, holding the securities is the better strategy from a tax perspective.

The primary advantage of making lifetime gifts is that by removing assets from your estate you shield future appreciation from estate taxes.

Example #2. Same facts as in the first example, except that your son plans to hold the securities for life rather than sell them. In this scenario, gifting the securities now is the better strategy because, by holding them, your son avoids capital gains taxes and there's no

estate tax because all future appreciation is removed from your estate.

Example #3. Again, the same facts as in the first example, except that when you die the exemption has dropped to $6 million, so your estate is subject to estate taxes of $2.8 million [40% × ($13 million - $6 million exemption)]. In this scenario, gifting the securities now results in a substantially lower tax bill, even if your son sells them immediately.

Other real-world factors

The previous three examples are highly simplified to illustrate the decision-making process. In the real world, many other factors may affect the overall economics, including an asset's income-earning potential, the applicability of state income and estate taxes, and potential changes in capital gains and gift and estate tax rates. Contact your estate planning advisor for more information. •

ESTATE PLANNING PITFALL

You've overlooked digital assets in your estate plan

Traditionally, an estate plan addresses the tangible assets you own, such as cash and securities, investment real estate, vehicles, and your house. But this is 2022. Increasingly, people are living in a digital world, where prized possessions include online bank accounts, social media accounts and other significant items protected "in the cloud."

It's not enough to just cover tangible personal property in your estate plan. Don't neglect your digital assets.

A better approach is to be proactive. First, collect all the relevant information on your family's behalf. This includes a list of email addresses, usernames and passwords. Because you're periodically required to change passwords for security purposes, try to keep this list updated. Consider using a password manager program for convenience.

Next, address the list of your digital assets in your will and trust documents. Significantly, make sure you assign authority to manage the assets of financial accounts and provide for

their ultimate distribution. In addition, determine who'll be the beneficiaries of digitally stored photographs or music and other items of sentimental value. You don't want to have your kids fighting over these when you're gone.

And don't stop at your will and trusts. Incorporate this concept into a durable power of attorney (POA). If you don't already have a POA in place, now's as good a time as any to create this legal document. It enables a designated party to act on your behalf in a multitude of situations.

Finally, as with other components of your estate plan, review the documents relating to your digital assets on a regular basis.

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Do You Need a Revocable Living Trust?

A revocable living trust ("RLT") is one of the most common estate planning devices nationwide, touted most often as a way to avoid probate. For Washington residents, however, avoiding the probate process should not be the primary purpose for utilizing an estate plan with an RLT because the probate process here is more streamlined than in most other states. This article provides background on RLTs and the Washington probate process and also highlights some important considerations involved in Washington-resident estate planning.

What is a revocable living trust?

An RLT is a type of trust that is created and managed during your life and after your death. It typically only serves its purpose if, after creating the RLT, all of your assets are transferred or re-titled to the RLT. The management of the RLT is governed by the trust document and is carried out by the named Trustee. Typically, while you are living, you are the Trustee and have control over all of your assets owned by the RLT. While you are living and competent, you may revoke or amend the RLT at any time. These powers would also apply if you and your spouse created a joint RLT. Upon your death, the assets owned by the RLT pass as provided in the trust document without the need to start a formal probate matter with the court.

What is probate?

Probate is the legal process of naming a fiduciary who has the authority and duty to pay all of your creditors and taxes and then pass your remaining assets in the manner provided in your Will. In Washington, a personal representative (or executor) acting with "nonintervention powers" may accomplish this process without the need for court approval for every transaction. This is in contrast to states like Oregon, California, New York or Florida, which require court hearings and approval for sales of property, payment of certain fees and the distribution of assets to heirs. Nonintervention powers will be granted to a personal representative in most situations, so long as the estate is solvent and the decedent's Last Will does not preclude the granting of nonintervention powers.

Why you might not need an RLT…

The use of an RLT to avoid an already efficient probate process in Washington may create more burden than it relieves. This is primarily because effectively using an RLT requires the extra step of transferring your assets to the trust. If property is not conveyed to the trust while you are alive, then some of your estate must pass through probate and only some will pass without probate. The process of locating and transferring all of your assets to the RLT can be time consuming and costly, which is why the asset transfers are often not completed.

Assets transferred to the RLT may avoid the probate process at death, but they are still considered owned by you for creditor and estate tax purposes. Using an RLT will not provide for any creditor protection, and any estate tax benefits that are included in the RLT can also be included in a Will.

Why you might want an RLT…

RLTs can still be useful for Washington residents in certain circumstances. For instance, RLTs can provide for a smooth transition for the management of assets in the event of incapacity. Control of accounts already titled in the name of the RLT can be turned over without opening new accounts. In addition, for individuals who would like a financial institution or trust company to manage their assets and pay bills as they age, the institutions will likely require that they do so as Trustee of your RLT. RLTs can also provide people with a certain amount of privacy because an RLT owning all of your assets will not be filed with the court at death. This may avoid unwanted scrutiny of your estate plan. Finally, if you own real property outside of Washington, creating an RLT to own your out-of-state asset (even if you do not put Washington-owned assets in it), can help avoid going through probate in the state where the property is located.

If you have any questions about revocable living trusts, please contact a member of the Stokes Lawrence Estate Planning Group at (206) 626-6000 in Seattle or (509) 853-3000 in Yakima.