Lakin Spears LLP

TRUSTS AND ESTATES GROUP

2019

PLANNING UPDATE

LAKIN SPEARS LLP
ATTORNEYS AT LAW

2019 Estate & Gift Tax Inflation Adjustments

Several important federal gift and estate tax exemptions are adjusted periodically to reflect the rate of inflation. The IRS has announced the following adjustments for 2019:

- **Basic Exclusion** – For 2019, the basic exclusion amount is $11.4 million. The basic exclusion represents the amount that can be transferred during lifetime free of gift tax or at death free of estate tax. This represents the base exclusion of $10 million plus an inflation adjustment of $1.4 million.
- **Generation-Skipping Transfer Tax Exemption** – The amount that may be transferred during lifetime or at death to a grandchild or other "skip person" free of the GST tax has also increased to $11.4 million.
- **Exclusion for Lifetime Gifts to Non-Citizen Spouse** – Lifetime gifts to a spouse who is a U.S. citizen are not subject to gift tax regardless of the amount. Lifetime gifts to a spouse who is not a U.S. citizen are subject to gift tax to the extent the gifts exceed the authorized exclusion in any year. For 2019, this exclusion is $155,000.
- **Annual Gift Tax Exclusion** – The annual exclusion amount for gifts of present interests is unchanged at $15,000.

The marginal estate, gift and GST tax rates remain at 40%.

It is important to note that the Basic Exclusion and the GST Tax Exemption are scheduled to revert (or "sunset") on January 1, 2026 to $5,000,000 plus an inflation adjustment.

For a wealthy taxpayer who wishes to make a large lifetime gift to take advantage of the increased exemptions before they sunset, there has been discussion about whether the portion of the gift that exceeds in value the post-sunset exemptions would be pulled back into the taxpayer's estate at death – this is known as "clawback." In November 2018, the Treasury issued proposed regulations to confirm that, with respect to the Basic Exclusion Amount, clawback will not be a concern and the estate of a taxpayer who utilizes the increased exemption will not be adversely affected. These regulations do not address the GST Tax Exemption, but we expect that a similar approach will be applied to GST taxable gifts and hope that the Treasury will issue similar regulations.

Uniform Trust Decanting Act: Another Option to Modify the Terms of an Irrevocable Trust

Under California law, a trustee is required to administer a trust in accordance with its terms. However, a trustee may find that while administering a trust, its terms are no longer appropriate in light of the current circumstances. In September

2018, California enacted the Uniform Trust Decanting Act (the "statute"), which allows a trustee the limited power to change the terms of a trust without court approval or the consent of the beneficiaries.

Decanting involves the transfer of assets from an existing trust (the "first trust") to a new or modified trust (the "second trust") with terms that better fit the current circumstances of the beneficiaries and trustees. Not all trusts may be decanted; for instance, a trust that is held solely for charitable purposes or specifically prohibits decanting, may not be decanted.

The changes a trustee may make to a trust through decanting depend on the trustee's power to make distributions in the first trust. If a trustee may only make distributions for a beneficiary's health, education, maintenance and support, the trustee is deemed to have "limited distributive discretion;" however, if the trustee has the power to make distributions in his or her unlimited discretion, the trustee is deemed to have "expanded distributive discretion."

A trustee with limited distributive discretion may only change the administrative provisions of the trust, such as the trustee succession and powers of the trustee and cannot materially alter a beneficiary's interest in the trust. A trustee with expanded distributive discretion may change the administrative provisions as well as certain dispositive provisions, such as eliminating a beneficiary, changing the distribution standard, granting a power of appointment to a beneficiary, or extending the duration of the trust. Regardless of whether the trustee has limited or expanded distributive discretion, a trustee must act in accordance with his or her fiduciary duties and the purposes of the first trust when exercising the decanting power.

The statute includes a significant carve out that allows a trustee to create a special needs trust for a beneficiary with a disability, even if the trustee only has limited distributive discretion. This carve out is intended to protect a disabled beneficiary's public benefits, such as Medi-Cal and Supplemental Security Income (SSI).

Regardless of the trustee's distributive discretion, the statute prohibits the trustee from making the following changes in the second trust:

- Including as a current beneficiary a person who is not a current beneficiary of the first trust;
- Including as a remainder beneficiary a person who is not a current beneficiary or a remainder beneficiary of the first trust;
- Reducing or eliminating a beneficiary's interest that has vested; or
- Any change that would disqualify a marital or charitable deduction of the first trust.

Under the statute a trustee may decant a trust without court approval or the consent of the beneficiaries, but prior to decanting, the trustee must give notice to the following persons: the trustor, any beneficiary entitled to income or principal, any holder of a power of appointment, any person who has the power to remove or replace the trustee, the trustees of the first trust and second trust, and the Attorney General, if the trust contains certain charitable interests. The trustee's notice must include specific details that are outlined in the statute.

While the statute allows a trustee to change the terms of an existing trust without going to court, the changes that can be made to the first trust are limited. In many circumstances, going to court to modify an existing trust may still be the better alternative. If you are a trustee of a California trust that you believe has terms that need to be updated, please contact us to discuss the potential changes.

Selecting Beneficiaries of Your Retirement Plan: Should You Designate Your Children or the Trust?

The distribution of your tax-deferred retirement plan (IRA, 401(k), etc.) is controlled by your beneficiary designation form on file with the plan administrator. If your retirement plan is to pass to your child, the simplest approach is to name your child as the direct beneficiary on the beneficiary designation form. This approach allows your child to take advantage of income tax deferral planning after your death via the so-called "inherited" or "stretch" IRA.

Using a traditional IRA as the example, your child, as the beneficiary, will be required to begin withdrawals from the IRA the year after your death. Your child may elect to withdraw the funds in a single lump sum or over his or her remaining life expectancy. A lump sum withdrawal will be taxed to the child entirely as ordinary income in the year of withdrawal. Alternatively, if the child chooses to roll the IRA into an inherited IRA, he or she may take annual minimum withdrawals over his or her life expectancy, allowing amounts retained in the IRA from year to year to continue to grow on a tax-deferred basis. For example, if your child's life expectancy is 40 years, 1/40 of the IRA must be withdrawn in the year after your death. This amount will be taxed to the child entirely as ordinary income, but 39/40 of the IRA remains intact with no income tax consequences until the following year minimum withdrawal. You cannot require that your child choose the deferral option.

But what if your child is not yet age 18 or he or she is not responsible enough to manage the funds after you are gone? There are two types of trusts into which you can direct your retirement plan at your death: a "conduit" trust or an "accumulation" trust. While these trusts come with additional cost and complexity, they do allow you to appoint a trustee to control the retirement plan on behalf of your child while also taking advantage of continued income tax deferral after your death as described above.

With a "conduit" trust, the trustee must pull from the IRA the annual minimum withdrawal amount determined under the life expectancy rules for your child. This amount must be immediately passed through the trust and distributed directly to your child, and income taxes must be paid on this amount. Of the two trust options, the conduit trust is simpler, but you must be comfortable having your child receive the minimum withdrawal amount each year. Even though your child will receive an outright cash distribution from the trust annually, he or she will not be able to elect a lump sum withdrawal of the entire IRA; this decision is in the control of the trustee.

With an "accumulation" trust, the annual minimum withdrawal amount determined under the life expectancy rules for your child must also be withdrawn by the trustee (and is subject to income tax), but funds withdrawn may be retained in the trust and controlled by the trustee for the child's benefit. This type of trust is more challenging to draft because in order for it to work, generally, the trust may not have a beneficiary (even a contingent beneficiary) who is older than your child or that is charity. For example, if your "catastrophe clause" provides for your "heirs" (your parents perhaps) or a charity, this would need to be addressed at the drafting stage. This type of trust is a good option if your child must meet certain income and asset tests to remain eligible for public benefits.

If you direct your retirement plan into a trust for your child that is not a conduit trust or an accumulation trust, the income tax deferral opportunities described above will not be available, and the retirement account will likely need to be fully withdrawn within 5 years of your death. Note that the default 5-year rule

still allows some income tax deferral planning. If you name your spouse, a trust for your spouse or a charity as your beneficiary, or if you have multiple beneficiaries with significantly different ages, additional issues must be considered that are beyond the scope of this article. It is also important to note that not all plan administrators allow for life expectancy deferral. If this is the case, your child will first need to do a direct transfer of the retirement account to a plan administrator that allows for this type of planning.

Many of our clients have substantial wealth in their retirement accounts. Planning for the transfer of these accounts at death is an integral step in the estate planning process. Please contact us if you would like a review of your retirement account beneficiary designations.

More Guidance on Planning for Digital Assets

Digital assets consist of anything that is stored electronically: music and entertainment accounts, photographs, documents stored in cloud storage accounts, cryptocurrencies, digital storefronts, domain names, social media accounts, email accounts, online financial accounts and much more. They may hold great sentimental value or great monetary value.

California recently adopted a law clarifying how digital assets may be administered at your death. The new law, set forth in the California Probate Code sections 870 through 884, makes it clear that you (the "user") may authorize the company that stores your digital asset (the "custodian") to disclose the asset to a designated fiduciary (your trustee or personal representative) or a recipient (under an online tool – see below). Unfortunately, the new law does not apply if you are living but incapacitated.

Under the new law (known as "Cal-RUFADAA"), you may grant or restrict access to your digital assets using one of three different methods that are prioritized under a tiered hierarchy.

Tier 1: Any instructions you provide in an "online tool" will take precedence over any other instructions you may provide. The online tool is provided by the custodian of a digital asset; it allows you to appoint a person who will be able to access and manage the particular digital asset. Conversely, an online tool may allow you to prohibit all access. Google Account Manager and Facebook Legacy Contact are examples of online tools. Note that, at this point, most custodians do not provide an online tool.

Tier 2: If there is no online tool, the instructions to grant or restrict access to these types of assets set forth in your estate planning documents will control access to your digital assets.

Tier 3: If you have not addressed this issue in your estate planning documents, the custodian's default provisions in its "Terms of Service" agreement will control. These agreements are drafted by the custodians and generally grant little or no control or discretion to you.

As you plan your estate and attempt to provide for a smooth transition at your death, it is more important than ever to consider your digital assets. In your estate planning documents, you may have granted access to a digital account to a particular child of yours. But what if you also designated a different child to have access to that account under an online tool? Or perhaps you have done neither of these things – does the Terms of Service agreement allow access by your fiduciary or does it require that your account be deleted by the custodian?

If you have not already done so, you should create (and keep current) an inventory of your digital assets, including usernames, and whether you think the asset may have an independent value (e.g., an unpublished book). Store the inventory in a secure location and let your named fiduciaries know where it is. If you

use a password management tool, or otherwise store your inventory electronically, keep in mind that this itself is a digital asset and you will need to let somebody know how to access it when the need arises. Be cautious of protecting passwords, and keep in mind that even though fiduciaries may not be allowed online access to certain digital assets, the inventory will assist them to gain access as needed later.

As you compile the inventory, note which assets are controlled by an online tool, and think about which assets you would like to have accessed after your death (and by whom). Conversely, if there is a digital asset for which you would like to restrict access or require deletion (due to privacy concerns, for example), that should also be noted. If you wish to leave a digital asset to a particular person at your death, in addition to arranging for access to the asset you must direct the distribution of the asset in your estate planning documents. Review these issues with your estate planning attorney so she can advise you further about any required changes to your estate planning documents.

If you are an executor or trustee administering an estate, you will need to investigate and resolve these issues as they relate to the decedent's digital assets. Do your best to locate the decedent's inventory, if any, and identify all digital assets. Look for digital keys (usually long strings of numbers and letters) and bank statements showing automatic debits and the like. Review your own social media accounts to discover similar accounts held by the decedent.

Once you have identified a custodian, you are required to submit certain documentation to the custodian; the required documentation depends on the type of digital asset. Typically, you will need a death certificate, evidence of your authority as a fiduciary, and evidence of the decedent's consent to disclose the digital asset (or delete the digital account). If the custodian does not respond within 60 days of your request for disclosure (or deletion), you may seek a court order to compel the custodian to cooperate.

While Cal-RUFADAA does not address all the issues that may come up when planning for digital assets, it is a step in the right direction and we are grateful to have a bit more clarity and certainty.

Founded in 1914 in Palo Alto, LAKIN SPEARS, LLP is a law firm built on a long tradition of prompt, efficient and value-added legal service to our clients throughout the Bay Area. The firm specializes in handling trusts and estates, family law, real estate and business matters.

The Trusts & Estates Group provides the full range of legal services in the areas of estate planning, estate and trust administration, gift and philanthropic planning, incapacity planning, guardianships, conservatorships, estate, trust and conservatorship litigation, and estate and gift tax return preparation.

This publication is for general information only and is not specific legal advice or a substitute for advice from qualified counsel.

Please contact us if you have any questions about the information in this newsletter.

Trusts & Estates Group

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