

# NORTHWEST ESTATE PLANNING

ROUNDTABLE 2011

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# THE FIRST ANNUAL NORTHWEST ESTATE PLANNING ROUNDTABLE 2011

Sensing a rare opportunity, the minds at **Highland Private Wealth Management** and **Financial Resources Group** convened a meeting of industry professionals at the Harbor Club in Bellevue for an informal and candid discussion dubbed the first annual Northwest Estate Planning Roundtable. Attending the roundtable were Douglas Lawrence, a shareholder of Stokes Lawrence; Thomas Gores, a partner at Perkins Coie; Barbara Sherland, a partner in Stoel Rives; Charles Riley, vice president at Lane Powell; Douglas McCallum, a principal at the Financial Resources Group; and John Christianson, CEO of Highland Private Wealth Management.

With all of the significant changes in estate taxation that occurred at the end of last year people want to know what they should be doing. We hope that these notes from the first annual estate planning roundtable will provide some useful and practical insights for practitioners and clients.

So what did our experts make of the 2010 year-end tax law changes?



Barbara Sherland: I think the biggest mover is the five million gift tax exemption, which we have not had before. We have always encouraged our clients to make gifts - it removes subsequent appreciation, avoids Washington estate tax, and if you pay gift tax and survive three years, it removes the gift tax funds from your taxable estate. Now is a golden opportunity - many assets are at reduced values and interest rates are the lowest we've ever seen. I think we are going to see a frenzy of gifts in the next two years.

Douglas Lawrence: The big question is, how to best leverage the use of that exemption, and in my book gets driven by the value of the asset involved. It makes a difference if you're dealing with \$10 million as opposed to \$25 million. Also, the nature of the assets you have makes a difference. You need to look at what people call re-packaging the assets, but in a legitimate business-like manner. You can put some marketable securities together with real estate, especially if you have closely held business interests. Put them in a format where you can maintain control, but at the same time, transfer some of the equity downstream. I think that's a key element for an overall plan.



“ONE: CAN I AFFORD TO DO IT? AND SECONDLY, IS THAT ACTUALLY A GOOD THING FOR MY FAMILY?”

-CHARLES RILEY

**Charles Riley:** Being able to make gifts of up to five million without having to pay any gift tax is going to prompt two things. One: can I afford to do it? And secondly, is that actually a good thing for my family? Is it good for my kids or grandkids if they get that much? What does it mean in terms of their development? I think people are going to have to examine that, just so that the tax issues alone don't end up driving a result that people in the

end go, 'well yeah, I saved a lot of taxes but it wasn't necessarily the right thing for my family.' And I think giving thought to the structure that we use when we make those gifts will be a really important thing.

#### METHODS FOR MAKING GIFTS

While the value of giving was discussed at length at the roundtable, so were the ways to structure those tax-exempt gifts. Examples include making direct gifts of assets to trusts (of which there are several types), or aggregating assets in a limited liability company and then making gifts of units in the company.

**Douglas Lawrence:** A common approach is to use a family limited liability company. Assets are placed into an LLC for a legitimate business purpose, such as

#### GIFT TAX EXEMPTION

Currently \$5 million, this is the amount of money someone can bequeath in a lifetime without incurring taxes on that gift.

#### FEDERAL ESTATE-TAX CHANGES\*

- Exemption raised to \$5 million from \$3.5 million
- Maximum tax rate lowered to 35 percent from 55 percent
- Gift tax exemption raised to \$5 million from \$1 million
- Portability – a spouse can give tax exemption to other spouse

\*Effective until 2013

“YOU CAN GET REALLY CLOSE TO GIVING IT TO THEM OUTRIGHT, LETTING AN INDEPENDENT TRUSTEE DISTRIBUTE IT TO THEM IF THEY WANT TO.”

-BARBARA SHERLAND



providing continuity of management or providing protection from claims of third parties. Using this approach the senior generation can continue to be involved in the operation and management of the company, while interests in the company are transferred to other family members or to trusts for family members.

**Barbara Sherland:** We do a lot of dynasty-type trusts. Being able to allocate \$5 million gift and generation-skipping transfer tax exemptions to a dynasty trust is compelling. The tax savings can be huge and the trust can potentially provide the children with protection against creditors or an ex-spouse. Even if in a perfect world you would make gifts outright to your children, a dynasty trust can be structured so that the children are their own trustees and the sole beneficiaries during their lifetimes. The trust can also allow the children to make gifts from the trust during lifetimes and to direct the disposition of assets following their deaths, with some limitations...

**Thomas Gores:** We see a great deal of that as well. There are benefits to having coordinated asset management, a degree of asset protection as it relates to third party creditors or maybe a marriage that's in trouble or could be in the future, as well as the tax savings. Fortunately there are features you can build into these generation skipping trusts are tantamount to personal ownership at the beneficiary level. It should be emphasized that the trust arrangement does not reflect a lack of confidence in the beneficiaries; it's really helping them facilitate their own planning.

**Charles Riley:** Clients are often struck by the amount of flexibility there is in trust planning. There is a tremendous range of things that people can do. And when you talk about the generation-skipping tax and the potential growth of this over multiple generations, it can be huge. A lot of our time over the next couple years will not be spent simply talking about what the opportunities are. Clients will want to talk about the methods by which

they can do it. We'll be spending a lot of time on that structure question, and the control question – who should be the trustee? I think that's where we can make a real difference in terms of how this wealth stays within the family and works for the family. So, it's going to be an interesting couple of years. I think it's going to be really busy if the first two months are any indication.

## INCENTIVE TRUSTS

One type of trust the panelists discussed in particular was the incentive trust, which is a trust designed to encourage or discourage certain behavior by using benefits from the trust as an incentive. Some incentive trusts might require that a beneficiary complete college or enter a certain profession; some incentive trusts might require a beneficiary to abstain from drugs; some incentive trusts might match a beneficiary's own income with income from the trust. The incentive trust is less common and, our experts pointed out, can contain pitfalls.



## TRUSTEE

An organization or a person put in charge of managing the assets or estate of another person or party. A trustee follows terms set forth in the trust deed and is legally obligated to act in the interests of the beneficiary of the trust.

**Douglas Lawrence:** I have some clients who say 'I really want an incentive trust.' I have others who say, 'I really don't want to be in the position of controlling my children's lives after I am gone.' My experience is that incentive trusts often backfire. I think they are more often a bad idea. When you say 'you have to graduate' or 'I'll match your W-2 income' it creates a huge psychological burden on the children and many of them will rebel against that. There are many unforeseen circumstances that often arise and prevent a child from being able to meet those requirements. As a result we end up doing a lot of non-judicial agreements to change those provisions. I have become more and more enamored of carefully choosing your trustee and giving the trustee broad discretion. It is also very helpful to have a detailed purpose clause that explains what the trust is intended to accomplish. This gives the trustee guidance on the kinds of benefits that should be made available to the trust beneficiaries.

**Thomas Gores:** One thing I have done is have the child serve as a co-trustee at some point, maybe for a period of years and then have them assume responsibility. We seldom do incentive trusts for all the reasons we have described.

**Charles Riley:** The choice of trustee is a really significant part as to how these things play out. I'm also a big fan of a co-trustee. I think we see many more people choosing institutional trustees over time because they are not sure their kids or grandkids are ready to be involved in the management of the trust, and they see that as a mechanism to get them educated in this process.

**Barbara Sherland:** While the trust can be structured so that the beneficiary is also the trustee, you have to be careful with dynasty trusts that you aren't setting up future generations as trust junkies. You want to have enough levers and controls in the trust so that you have good people assuming the trustee position through time.

HOWEVER, MY EXPERIENCE IS THAT INCENTIVE TRUSTS OFTEN BACKFIRE.

-DOUGLAS LAWRENCE

## DYNASTY TRUSTS

Dynasty trusts can also have unintended consequences.

**Douglas Lawrence:** Everyone thinks about these huge pots of money growing. But the number of beneficiaries grows too. And when you start to allocate this big pot of assets among the beneficiaries, their share often isn't that big. What people perceive as the intended benefit for the great, great grandchildren probably isn't near what they were thinking. It can also create a real management nightmare. I like using a corporate fiduciary for these kinds of trusts, but I also want to make sure that there is a means for removing and replacing the corporate fiduciary.

**Charles Riley:** That has become much more common than 20 years ago. Corporate trustees expect it to be inserted into the documents. They don't push back at all on the idea that there is going to be some means of removing them. So I think that will continue to be a big part of doing dynasty trusts.



“FOR EXAMPLE, SOME CLIENTS WHO MADE TAXABLE GIFTS A YEAR AGO WHEN THE TAX RATE WAS AT 45 PERCENT MIGHT BE WISHING THEY COULD HAVE A DO-OVER NOW THAT THE TAX RATE ON GIFTS AND ESTATES IS 35 PERCENT AND THE EXEMPTION IS \$5 MILLION.”

-THOMAS GORES

**Thomas Gores:** Its difficult making long-term plans, plans designed for decades and generations, when the current legislative climate is so unpredictable, especially when it comes to tax law. Exemptions might increase further or be significantly reduced. Tax rates might change unexpectedly. For example, some clients who made taxable gifts a year ago when the tax rate was at 45 percent might be wishing they could have a “do-over” now that the tax rate on gifts and estates is 35 percent and the exemption is \$5,000,000.

**Douglas Lawrence:** The issue is that someone made a gift last year because they wanted to take advantage of the 35-percent gift tax rate, which many expected would never be with us again. And now they find out that the 35-percent rate has been continued for two more years, and more to the point, there is four million dollars more in available gift tax exemption. This year they could make the same transfer without any tax. So they want to say, ‘uh oh, I didn’t really mean that, never mind.’ There is a body of law on the income tax side that says if

#### **DYNASTY TRUST**

Also known as a generation-skipping trust, this instrument allows someone to pass their wealth to future generations of his or her family rather than children, protecting those assets from taxes, creditors, or the consequences of divorce.

you have an income taxable transaction, and you claim a mulligan within the same tax year, the IRS will disregard the transaction. There is no similar body



## PORTABILITY

The ability of a spouse, upon death, to give away his or her estate or gift tax exemption to the other spouse. Portability is not automatically granted but must be requested by the surviving spouse.

“SO THE WIFE ALL OF A SUDDEN GOES FROM \$10 MILLION TO \$6 MILLION DOLLARS IN EXEMPTION. IF YOU READ THE TECHNICAL COMMENTS TO THE BILL, IT SAYS YOU CAN USE ONLY THE LAST SPOUSE’S EXEMPTION.”

-DOUGLAS LAWRENCE

of law on the transfer tax side, the gift tax side. There are some who say that people should be able to unwind the prior gift - that equitable principles will support it. But others, and I would put myself in that category, believe there is no legal support for that approach.

## PORTABILITY

**Barbara Sherland:** Portability - the ability to transfer a deceased spouse’s estate or gift tax exemption to the surviving spouse upon death – is a particularly complex feature of the new tax law, because it is not automatically granted when one spouse dies. The executor of the deceased spouse’s estate must request the transfer within nine months of the

spouse’s death, or the surviving spouse will lose portability.

**Charles Riley:** Making matters more complicated are second or even third marriages. Furthermore, while federal estate taxes are portable, estate taxes in Washington State are not.

**Douglas Lawrence:** What happens when you re-marry and the new spouse dies? The hypothetical husband dies, the wife now has a \$10 million exemption. Wife now marries new husband. Now what happens when this husband, who has only \$1 million, dies? Under the act you lose the benefit of the first spouse’s unused exemption and you now only



have this extra million. So the wife all of a sudden goes from \$10 million to \$6 million dollars in exemption. If you read the technical comments to the bill, it says you can use only the last spouse’s exemption.

**Thomas Gores:** In other words, if a widow with a \$10 million exemption (\$5 million belong to her, \$5 million from her late husband) marries a rich man who has used up his own \$5 million exemption, and that second husband dies from a heart attack on their wedding night, she’s left with only her own \$5 million exemption.

**Charles Riley:** In states like Washington, which have estate taxes that are not portable, bypass trusts are an option. Here's how one works: When the first spouse, for example the husband, dies, the trust is funded up to the tax-free amount (\$2 million in the case of Washington state). The trust distributes income to other family members (usually children) while his widow is alive, then passes on whatever is left to survivors when she dies. Funds in the bypass trust are covered by the exclusion amount and are not taxed when the husband dies, nor are they considered part of the wife's estate, so are not subject to tax when she dies.

**Barbara Sherland:** I think we will be using bypass trusts in Washington because the Washington State Estate tax is not portable.

**Thomas Gores:** There are so many other tax and non-tax reasons for using the bypass trusts, particularly for Washington residents: to shelter future appreciation, for GST (generation-skipping-tax) planning and to control asset disposition. Hopefully portability will not lead people to conclude, 'that's good, now I don't have to do any of that complicated trust planning those lawyers always talk about, because I have a portable exemption.'

**Douglas McCallum:** Right, like 'my spouse will get it anyway, so why does he need a trust?'

### GENERATION SKIPPING TRANSFER TAX

A tax on assets passed in the form of a trust to a family member of a future generation.

**"I THOUGHT WE WOULD BE BUSY FOR THE NEXT SIX MONTHS JUST PACKAGING UP OUR CLIENTS' FILES."**

**-CHARLES RILEY**



## STATE TAXES

Estate planning is more complex in states that levy estate taxes. Washington and Oregon are among 22 states that have an estate tax and/or an inheritance tax. And while the federal exemption is \$5 million, the state exemption is only \$2 million. Washington State, however, does not have a gift tax. At least not yet.

**Barbara Sherland:** Many states are having budget crises. Are they likely to start enacting the state estate taxes across the board? Hawaii did. And, are they going to start looking at gift taxes as a revenue raiser?

**Charles Riley:** I'm assuming that none of us think the Washington State estate tax is going to go away?

**Douglas Lawrence:** I don't, but there was a bill floated at the beginning of the session that would have increased the exemption to \$5 million. It didn't go anywhere.

**Charles Riley:** I think there are going to be a number of people who are going to be looking at moving out of the state, in terms of official residence.

**John Christianson:** Are you getting that question then?

**Everyone:** All the time.

**Douglas Lawrence:** Many of our clients have multiple residences, so a part of our discussion with almost every one of them is, 'do you want to stay in Washington?'

**Thomas Gores:** That's becoming a frequent topic. Many clients have been careful to not spend more than six months in another jurisdiction, but now there is

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-CHARLES RILEY

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an incentive to do it. When we had the initiative on the table for a state income tax, which is the primary deterrent in most other jurisdictions, that would have been eliminated and I think we would have seen a major exodus.

**Charles Riley:** I thought we would be busy for the next six months just packaging up our clients’ files.

## MAKING GIFTS

**Barbara Sherland:** The state of Washington has no gift tax, and the federal gift-tax exemption is currently at an all-time high. Does that mean making a maximum \$5 million gift is a no-brainer for clients with those kinds of assets?

**Thomas Gores:** Unless, say, commercial real estate hasn’t hit the bottom yet. But really I would say absolutely sooner rather than later.

**Douglas Lawrence:** What I am seeing is those clients who are very wealthy are doing the entire \$5 million. For those of moderate wealth, they’re thinking about doing a piece now and perhaps some more later.



**John Christianson:** It seems people are being bombarded with the concept that there is this huge opportunity. So then the pressure starts to build on them.

**Douglas McCallum:** Or maybe you give the gift and then you’re sorry you did because your cash flow gets worse. If you give it to your kids and you have a good relationship with them, is there any reason why the kids can’t give some of it back?

**Douglas Lawrence:** Well that would be a foolish thing to do. That’s why you usually give it to a trust rather than the kids. Then the trustee would have the ability to make loans back to you, or buy assets from you. But what I tell my clients is that you have to be ready to say, ‘this isn’t mine anymore.’ It’s gone; Period.

**Charles Riley:** When I have heard people express regrets about gifts, it’s been less about the economic impact on them; it’s the effect on the people who got the gift, that it altered their lives in a way that wasn’t healthy. And I think that’s more often true with the grandkids who were the beneficiaries of a lot of gifts over the years and then all of a sudden they are like, ‘this working thing isn’t all it’s cracked up to be, and I’ll live on this thing and just not do much.’ That’s where I have heard more regret expressed about gifting plans.

**Charles Riley:** Wealth is a good thing but it can be corrosive too. People need to be thoughtful about that.

**Douglas Lawrence:** I’m becoming more and more enamored of third-party trustees with very broad distribution powers, with purpose guidance. So if they really think that a distribution should be made for something some people would think is an extravagance, maybe that’s ok. At least they have the authority.

**Barbara Sherland:** What about giving the beneficiary the ability to appoint an independent co-trustee?

**Douglas Lawrence:** My concern there is that if the beneficiary is able to appoint the independent co-trustee, they aren’t really independent.



### HOLD BACK CLAUSE

A stipulation in a trust that withholds distribution of assets under certain circumstances.

**Charles Riley:** Do you often put in hold-back clauses?

**Douglas Lawrence:** We do often have those.

**Barbara Sherland:** I have a number of clients with a very large estate who cap the gift to the kids and give the rest to charity...that's a fairly common plan these days.

**Douglas Lawrence:** Depends on how much is enough for the kids. You'll meet with a client in year one and they say 'I want them each to have a million dollars.' A few years later they say, 'I'd like them to have 2.5 million.' Then later, it's like, 'they can barely buy a house for five million dollars.'

“THEY CAP THE GIFT TO THE KIDS AND THE REST GOES TO CHARITY. THAT’S A FAIRLY COMMON PLAN THESE DAYS.”

-BARBARA SHERLAND

**John Christianson:** So if a client has \$15 million and they ask you how much should I leave for my kids, how do you answer that? Do you say it's your call, or do you give them numbers?

**Douglas Lawrence:** I'd say it's their call.

### FUTURE TAX CHANGES

**Barbara Sherland:** Unless the government extends the current tax cuts, they will disappear Dec. 31, 2012. Federal transfer taxes will revert back to 2001 levels, in other words a mere \$1 million exemption on gifts and estates and a 55-percent tax rate...

**Thomas Gores:** There is still a push among quite a number in Congress to do away completely with estate taxes. The estate and gift tax actually represents an insignificant amount of revenue related to the total amount of revenue received by the government, but there are significant political implications.

**Charles Riley:** The Bush-era tax cuts were supposed to do away with the estate tax entirely in 2010, before the Obama cuts were enacted, keeping the death tax in force, albeit at low levels. Despite the ongoing discussions in Congress of repealing the death tax (long the wish of the GOP), most industry professionals don't expect estate taxes to disappear entirely any time soon. Short of getting rid of them, a \$5 million exemption is the most exciting news to come down the pike in quite a while.

**Douglas McCallum:** So what does 2013 look like, for estate taxes?

**Douglas Lawrence:** If nothing happens we are where we were supposed to be this year, which is a one million dollar exemption and a 55-percent top marginal rate. I think there's a good chance we will continue to see a \$5 million dollar exemption. Rates? Maybe they will bump up a little bit.

In 2013, the Presidential election will be done. Either we have Obama back or somebody new. Unless there is a big sea change, which may happen, there is a chance we will still have a Republican-led Congress, and a Republican Congress doesn't like the estate tax. But they also understand the fiscal pressures. So the compromise is keeping things where they are.



“SO MUCH DEPENDS ON THE COMPOSITION OF THE CONGRESS AND WHO THE PRESIDENT IS.”

-CHARLES RILEY

It surprises me that some nationally recognized experts think there is a chance of a full repeal. I think there's a push to revamp the tax code, and revamping the concept of where tax revenue should come from. My bet - we will have an exemption between \$2.5 and \$3 million with rates between 35 and 45 percent.

**Charles Riley:** I'd say the same thing but I think it's less likely the exemption will fall. So much depends on the composition of the Congress and who the President is.

**Barbara Sherland:** I think it will be hard to go back to \$3.5 million. My concern is that we will end up at another extension, so we keep limping along in two-year

planning segments. That's really tough for clients. Permanency of anything would be better than a temporary extension...

**Thomas Gores:** I think we will end up at a \$5 million exemption and the rate will remain the same. But I do think there will be some changes in the law designed to eliminate so called "loopholes" that deal with GRATs (grantor retained annuity trusts), valuation discounts on closely held assets or fractional interests in assets. I think that will be the tradeoff to retaining the same exemption and the 35 percent marginal tax rate. I personally think the chances of repeal are slim at best.

**Douglas McCallum:** So how are we going to get people to get in and take action?



**Charles Riley:** The publicity surrounding the tax act has caused people to come in and look at their documents. If they understand their current document may not carry out their wishes in a way they want, that is a helpful way to get people in the door.

**John Christianson:** Is this the right time? If I'm your client is this one of the moments where I should pick up the phone and call?

**Everyone:** Yes, absolutely.

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