TOOLS OF ESTATE PLANNING FOR TAX SAVINGS

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TOOLS OF ESTATE PLANNING FOR TAX SAVINGS

This outline provides a thumbnail sketch of some common methods (my "Rules") for avoiding taxes on transfers of wealth to beneficiaries.

A. For decedents dying in 2023, the federal estate tax applies with an exemption of $12.92 Million and a flat rate of 40% above that. Unless Congress acts, the law as effective in 2017 will come back in 2026 and thereafter the exemption will be cut in half. There is little prospect at present that the federal estate tax will be repealed permanently. But Congress may make the current exemption permanent or could choose another alternative -- e.g., reinstatement of the terms for estate tax that were in effect for 2009 with a 45% rate and $3.5 Million exemption.

B. At a rate of 40%, each $1 that you can exclude from your taxable estate can save $.40 in federal estate tax.

C. Some states have death taxes, others do not. For example, the District of Columbia and Maryland impose estate taxes on taxable estates of over $4,528,800 and $5,000,000 respectively at marginal rates as high as 16%. Maryland also has an inheritance tax that applies to bequests to some collateral relatives — e.g., nieces, nephews, and cousins — and unrelated individuals. Virginia and Florida, by contrast, have no estate tax. State estate and inheritance taxes are deductible in determining federal estate tax. You should be aware of the death taxes applicable in the states where you reside and own real property, but we will not focus on those taxes in this outline.

D. Your gross estate potentially subject to estate tax includes:

- Everything you own outright
- Life insurance that you control
- Retirement benefits
- Your interests in joint property
- Assets in trust over which you have certain significant controls

However, assets passing outright or in certain trusts to a surviving spouse or to charity would be excluded from tax.

E. There is a gift tax that applies to lifetime transfers. It applies at the same rate as the estate tax but at a lower effective rate. Gifts to a spouse and charity also are not subject to gift tax and certain small gifts and gifts for specified purposes are excluded from taxable gifts. (See Rule 3.) Only a few states — none local — impose a gift tax.

F. The same exemption that applies to estate taxes with respect to transfers at death also applies to gift taxes with respect to transfers during life and at death. For 2023, the

exemption effectively allows each individual to make $12.92 million of otherwise taxable transfers during life without paying federal gift or estate tax. Again, this exemption is set to be cut in half in 2026.

G. Congress also has made the exemption portable between spouses. This means that subject to certain rules and requirements, the unused exemption of a predeceased spouse will be added to the exemption of the surviving spouse. For example, if the first spouse to die uses only $1 Million of a $12.92 Million exemption, the survivor could have an exemption of $24.84 Million comprising the $12.92 Million of his or her own and the $11.92 Million from the deceased spouse. This ability to stack exemptions will not sunset. Note Maryland also allows portability but D.C. does not.

H. Unless otherwise stated, we have assumed in the examples in this outline that the 2023 estate and gift tax law will apply – with a top 40% rate and an exemption sheltering up to $12.92 Million in taxable transfers combined during life and at death.

Accordingly, the ten Rules for saving taxes through estate planning are as follows:

Rule 1: <u>Take Care of Yourself and Your Spouse First</u>.

Remember estate planning usually is intended to save taxes not for you, but for your children, grandchildren, charities, or others who will succeed to your assets. There are things more important than saving tax on your death and foremost among these is to make sure that you have adequately provided for yourself and your spouse. <u>Accordingly, if you are not comfortable with making a gift because you may need the assets for yourself, don't do it</u>.

When you are considering how you will take care of yourself and your spouse, take account of your assets, income, and other available resources (for example, long-term care insurance, disability insurance and life insurance) as well as your anticipated needs.

Rule 2: <u>Use and Preserve Deceased Spouse's Exemption.</u>

A. You can give anything to a spouse outright or in a marital deduction trust (that must pay income to your spouse for his or her life) without incurring tax. However, if you give everything to the surviving spouse, there will be a tax on the taxable estate of the survivor to the extent the taxable estate exceeds the survivor's exemption including the exemption from the deceased spouse allowed by portability.

B. For those whose combined estates are well under the exemption amount, they may avoid federal estate taxes through portability. However, there may be reasons for leaving assets to a spouse in trust, and, in particular as set forth below, in a trust that will be excluded from a surviving spouse's estate. Accordingly, consideration should be given to **<u>allowing</u>** for creation of a **"bypass trust"** (so called because it escapes tax on both spouse's deaths) on the death of the first spouse to die. Remember, the first spouse to die has an exemption that will allow him or her to give the exemption amount to anyone without tax during life or at death. This exemption can be applied to shelter the bypass trust from tax.

(1) The bypass trust can be created at death under a will or revocable trust or by a separate instrument during life.

(2) The surviving spouse can have all of the following rights in the bypass trust without having the trust assets taxed on the surviving spouse's death:

- The surviving spouse can have the right to payment of all income.
- He or she can be allowed to withdraw annually the greater of 5 percent of trust principal or $5,000 for any reason.
- He or she can receive trust principal in the trustee's discretion.
- Provided there are certain restrictions on the purposes for which the assets can be used, he or she can serve as trustee.

Remember, however, the objective of the bypass trust is to exclude assets from the surviving spouse's taxable estate, so do not give more rights to the spouse than necessary.

C. Assets in excess of those passing to the bypass trust can go:

- Outright, or
- In a marital deduction trust to the surviving spouse to avoid tax in the estate of the first spouse to die.

D. Sufficient assets must pass under the deceased spouse's separate name to create a bypass trust.

E. The bypass trust has certain advantages over reliance on a portable exemption. Most importantly, once assets are allocated to a bypass trust they are permanently excluded from taxation in the survivor's estate no matter how much they increase in value. In contrast, the portable exemption will not increase for the survivor. In addition, only a trust will allow a deceased spouse to "skip" assets without tax down to grandchildren. <u>See</u> Rule 7. Note also that portability does not apply in the District of Columbia and certain states at least at present, so the survivor may pay a larger share of such taxes. One possible tax disadvantage to use of a bypass trust is that assets included in a survivor's taxable estate will receive a step-up in basis for income tax purposes. There is no step up for assets held in a bypass trust at a survivor's death. <u>See</u> Rule 5.

F. If you are not sure that you want to require a bypass trust, or whether you want to rely on portability, include provisions in your will or trust instrument affording the surviving spouse the flexibility to create one through a "disclaimer" within nine months after your death.

A "disclaimer" is essentially a refusal to accept property which passes to you under a will or trust or by operation of law (for example, joint tenancy property). To be effective for estate tax purposes, it must be made within nine months after the decedent's death. If property is

disclaimed, it passes under a will as if the disclaiming party had predeceased the person making the will. For the disclaimed property to go into a bypass trust, the bypass trust must be provided for in the will or other governing instrument.

G. If possible include off ramps to allow a bypass trust to be terminated and distributed to the spouse.

H. Be sure there are enough assets available to support the surviving spouse -- i.e., see Rule 1.

Rule 3: Make Non-Taxable Gifts If You Can Afford Them.

A. Currently, each donor can give $17,000 annually in "present-interest" gifts to a donee without incurring gift tax or using up exemptions. (The $17,000 amount is indexed for inflation, but only in $1,000 increments. Thus, a couple with three children can give $102,000 this year to their children ($34,000 per child) without tax consequences. We call these "annual exclusion gifts".

B. In addition to the $17,000 per year, you can pay tuition and medical expenses for a donee without incurring gift tax or using up exemptions. This applies only to tuition and medical expenses that are paid directly to the school or provider by the donor.

C. You can use the annual exclusion to contribute to a college savings or "529" plan for a child or grandchild. The contribution will be treated as a present-interest gift for gift tax purposes, even though the donee may not use the funds for education until later. If the gift causes you to exceed the annual exclusion amount, there is a permissible five-year carry-forward. If you die during the five-year carry-forward period, any amounts not sheltered by the annual exclusion up to the date of your death will be included from your gross estate. But otherwise, any amounts you contribute -- and the income and appreciation on them -- will be out of your estate, will accumulate income tax free, and can be distributed without income tax to pay for the child or grandchild's higher-education expenses and limited secondary school expenses.

D. If the donor will have a taxable estate, each annual exclusion gift can save federal estate tax on the amount of the gift and on the increase in the gift's value through income or appreciation between the date of the gift and the donor's death. Remember too in almost all states gifts in any amount are free from tax.

E. Annual exclusion gifts can be made outright or to a custodian for a minor under the Uniform Transfers to Minors Act or to certain kinds of trusts. They can be made from assets you own in your own name or from a revocable trust you have already created.

F. Such gifts to grandchildren are doubly advantageous since they avoid tax in two generations. See Rule 7.

G. Don't give what you cannot afford. See Rule 1.

Rule 4: Use Annual Exclusion Gifts to Give Away Life Insurance.

A. If you have life insurance or are purchasing life insurance, you can use annual exclusion gifts to shelter the transfer of the ownership of the insurance and the premium payments on the transferred insurance from gift tax. Once transferred, the insurance can avoid inclusion in both spouses' gross estates. The transfer can be to children or, as is more typical, to an insurance trust benefiting the surviving spouse and children.

B. Example: If insurance with a $500,000 death benefit is removed from the taxable estate to an insurance trust, the savings in estate tax could be $200,000 for a federally taxable estate at a 40% rate.

C. Points to remember regarding insurance trusts:

- Consider whether you really need the insurance in the first place. For example, insurance is an excellent way to meet a particular need for college costs or to maintain a surviving spouse after the first spouse dies. It can also be a way to equalize gifts among children (for example, if you want one child to inherit the family real estate, or business, and do not have other assets of equivalent value, you may want to "even up" for your other children with life insurance proceeds). But putting unnecessary life insurance into a trust doesn't necessarily make it a better investment than other assets.

- Insurance trusts require special care. You need a competent attorney to set up the trust; and there probably will be annual costs for trust upkeep.

- Don't forget to examine the quality of your investment in insurance.

Rule 5: Don't Forget About the "Step-Up" in Basis.

A. Ordinarily, when an asset is sold, you pay tax on the difference between your "tax basis" (usually what you paid for it), and the net sales price. The difference is taxed as capital gain for most investment assets.

B. When a person dies, however, the Internal Revenue Code -- partially to offset the burden of estate taxes -- allows a "step-up" in basis of each asset (excluding taxable retirement benefits) included in the gross decedent's estate. The basis typically is stepped up to the fair market value as of the date of death.

EXAMPLE: If a taxpayer owns Microsoft stock which she bought for $10,000 but is worth $100,000, she would be liable for tax on $90,000 in capital gains if she sold it. If she dies before selling the stock, and the stock is sold right away, the tax basis may be stepped up to the fair market value at her death, and there is no capital gain on the sale.

C. If you are considering selling an asset, take into account the possibility that by holding it until your death, the step-up in basis might save substantial income tax for your beneficiaries.

D. This step-up is particularly valuable when the first of two spouses dies, because with proper planning, no estate tax should be payable at the first death, but there will be a step-up in basis on property passing to the surviving spouse.

E. If spouses own property jointly, it generally is considered as owned one-half by each for estate-tax purposes, at the first death, there would be a step-up in basis for the one-half "owned" by the decedent, but the other half would retain the original basis. If the surviving spouse continues to own the property until his or her death, the entire basis would be stepped up at the second death.

F. Note, there have been several recent proposals to eliminate the basis step-up in whole or in part.

Rule 6: <u>It Can be Beneficial to Make Taxable Gifts Using Exemption</u>.

A. A gift during life will remove from your gross estate all income and increase in value from the date of the gift to the date of death.

<u>EXAMPLE</u>: If you give away $100,000 of XYZ stock, and if it has an annual after-tax rate of growth of 6 percent, then after 12 years the stock will be worth about $200,000, and all the increase will have escaped estate tax in your gross estate.

B. With some exceptions (particularly with respect to gifts made within three years of death), the effective rate of tax on property for which gift tax actually is paid is less than the estate tax rate. For a person in the 40 percent estate tax bracket, the savings will be 40 percent of the gift tax paid. This is because gift tax is computed on a tax-exclusive basis, and estate tax is computed on a tax-inclusive basis.

<u>EXAMPLE</u>: If you make a $100,000 taxable gift during your lifetime, and are in the 40% gift tax bracket, you will pay $40,000 in gift tax and the donee will receive $100,000. But if the $140,000 that you would be out of pocket were still in your estate when you die, and you remain in the 40% bracket, your estate will pay about $56,000 in estate tax on the $140,000 and the beneficiary will net only $84,000. The tax savings from making the lifetime gift instead of a testamentary gift is $16,000.

C. Beware of making lifetime gifts of property on which there would be substantial capital gains if it were sold (unless the gift is to charity -- <u>see</u> Rule 10). The donee generally takes the donor's tax basis for income tax purposes. If the donor retains the property until death, the property may take the estate-tax value (usually the value on the date of death) as its basis because of the step-up. Gifts of appreciated property can result in income tax loss that outweighs the estate-tax savings.

<u>EXAMPLE</u>: Donor makes a gift of property worth $100,000 with a tax basis of $10,000. Property is sold by donee immediately following the donor's death.

- The donee may pay $20,000 to $30,000 (or more) in federal and state capital gains taxes leaving the donee with $70,000 to $80,000.

- If the donor had retained the property until death, and left it to the donee in his will, there would have been no gain on the sale, because of the step-up, and the donee would receive the full $100,000.

D. Again, most jurisdictions with an estate tax don't have a gift tax -- e.g., D.C. and Maryland -- so that gifts during life also can reduce their estate taxes.

E. Large taxable gifts should only be made if you can afford them. See Rule 1.

Rule 7: Gifts to Grandchildren Can Have a Double Tax Benefit.

A. Gifts to grandchildren save taxes in both the donor's generation and the generation of the donor's children.

EXAMPLE: If the taxable estates of both a parent and child are in the 40% bracket, the amount ultimately passing to grandchildren through both taxable estates is about 36% of the original value. It will be even less if there is state tax.

B. Gifts during life to grandchildren, especially tax-free gifts (see Rule 3), are most beneficial. A particular favorite is a grandparent's contribution to a 529 plan for a grandchild.

C. There are limits to the tax advantages of large gifts to grandchildren. After a certain point, an additional "generation-skipping transfer tax" becomes payable. However, each person can give up to his "GST exemption" to grandchildren without exceeding these limits. The GST exemption is $12.92 Million for 2023. Such gifts to grandchildren can avoid tax in the children's generation. They can take many forms.

(1) They can be made during life or at death. Again, gifts during life have the benefit of avoiding tax on income or appreciation occurring after the date of the gift.

(2) They can be made outright or in trusts solely for the grandchildren.

(3) Usually, the parent will want his or her children to retain some benefit from the assets. If the parent puts the assets in a trust for the child's life that pays income to the child (and principal if necessary) with distribution to grandchildren on the child's death, the estate tax still will be saved in the child's generation. Also, the trust can be an ultra-safe fund that is protected from claims against the child and managed for the child's benefit.

Rule 8: Consider Creating a "QPRT" or a "GRAT."

A. You can create a "qualified personal residence trust" (or "QPRT") by contributing your principal residence or a vacation home to a trust under which you reserve the sole right to use and enjoyment for a term of years. If you survive the term, the property passes to your beneficiaries (usually children). If you do not survive the term, the property reverts to your estate.

B. The only taxable transfer for estate and gift tax purposes is the original transfer of the right to the property after the term is over. This future right is valued as of the date of the contribution and is further discounted by the possibility of reversion on the donor's death during the term. Thus, the gift value is low. Usually, there is no gift tax to be paid because the gift is covered by the exemption amount.

C. If the donor dies during the term, the residence is a part of the taxable estate, but the original gift is washed out, so the donor is no worse off for tax purposes than if he had not made the gift.

D. The increase in the residence's value after the date of the gift also will be removed from the taxable estate if the transferor survives the term.

E. There can be some concerns regarding capital gains on the ultimate sale of the residence. This plan works very well, however, for a vacation home which is to stay in the family.

F. During the QPRT term, the QPRT is a grantor trust so that the donor is treated for income tax purposes as the owner of the property.

G. Accordingly, with a QPRT, you can "give away" a home for tax purposes and yet keep it for a set period with considerable tax advantages.

EXAMPLE: If you are 60 years old, you could transfer a residence to a QPRT for a 20-year term. You would retain the use and enjoyment of the property during the term and it would revert to your estate if you did not survive the term. The "gift" based on a $500,000 full value for the residence and IRS tables effective for April 2023 would be the $109,330 present value of the remainder interest after the term and not the $500,000 full value.

- If you survive the term, you will have sheltered successfully the difference, or $390,670 from estate tax. At a 40 percent estate tax rate, the tax savings would be about $156,268.
- If the property increases in value at 4 percent per annum during the term, the potential estate-tax savings jumps to about $394,493 or more, if the property continues to increase after the term.
- If you do not survive the term, the property is taxed in your estate and the gift is eliminated so you are right where you would have been had you done nothing.

H. Similar principles apply to gifts of assets to a "Grantor Retained Annuity Trust" or "GRAT." Here, the donor transfers assets, often publicly-traded securities, to a trust and retains the right to an annuity payment from the trust for a term of years. At the end of the term, any residual assets pass to the donor's children.

I. The value of the annuity usually is set as a percentage of the value of the assets when transferred to the GRAT. It can be structured to almost "zero-out" any gift. If the assets

increase in value by more than the IRS assumed rate for the month of transfer (5% for April 2023), there will be a residue remaining for the children at the end of the GRAT's term.

EXAMPLE: You could transfer $1 Million of publicly-traded securities to a GRAT for a seven-year term and retain the right to an annuity of 17.28 percent of the initial value or $172,800 per year. There would be a gift of $110 to be reported. If the assets in the GRAT grew by 7% a year, there would be about $110,367 left for children at the end of seven years.

J. You can serve as trustee of your own GRAT. During the GRAT's term, the taxable income of the GRAT is reported by you on your return (thus conferring an additional benefit on the children). If the assets do not increase as much as the assumed rate, you are little worse off than if you had done nothing.

K. A GRAT is especially advantageous if you have: (1) a large position in a publicly-traded security, (2) an asset that is expected to increase in value significantly in a short period (e.g., through sale or a public offering), or (3) an asset that throws off a large cash flow relative to its value. Note that there are proposals in Congress for limiting use of short-term (*i.e.*, less than 10-year) GRATs.

L. QPRTs are especially advantageous in a high-interest environment; GRATs are more advantageous when rates are low.

Rule 9: Make Gifts to Charity During Life Rather Than at Death.

A. Outright gifts to charity whether during life or at death are not subject to estate or gift tax.

B. However, only lifetime gifts to charity are eligible for an income-tax deduction.

EXAMPLE: If taxpayer gives $10,000 to charity and is in a 40 percent federal and state income tax bracket, then if the contribution had not been made, her taxable income would be $10,000 higher, and $4,000 in additional income taxes would have been paid.

In effect, taxpayer's contribution of $6,000 has been matched with $4,000 from the federal and state governments.

C. Certain arrangements can allow you to receive a charitable deduction for income tax purposes while you still retain current or future enjoyment of the property transferred. Such "planned giving" vehicles as charitable remainder trusts, charitable lead trusts, gift annuities and pooled income funds, as well as the use of donor-advised funds and private foundations, can be of substantial benefit in saving estate and gift taxes, as well as possibly having favorable income tax consequences.

D. In a **charitable remainder trust,** you give cash or other assets to a trust. You receive a flow of income -- usually a fixed percentage of the trust assets each year.

EXAMPLE: This month, you transfer $1 Million to a trust and receive a 6 percent payment each year in quarterly installments. In the first year, the payment would be $60,000. If the assets increase in value annually by 7 percent, at the end of the next year, you would receive $60,506. Under these assumptions, the value of the fund and the annual payout would increase each year for your life.

After your death, and your spouse's death if you so choose, one or more designated charities receive what is left in the trust.

You also receive two tax benefits:

- The trust does not pay tax on capital gains, even if you put in stock with a low basis. (See Rule 10 below.) So, assets in the trust can be sold, invested, and reinvested without being depleted by taxes. The taxes are paid by you over the life of the trust as distributions are made.

- You will receive an income tax deduction for the "present value" of the charity's right to receive the assets after your death. If you were 65, when the trust was established, the deduction would be $395,190.

A 1997 law imposed some limits on this kind of planned giving -- for example, the value of the "remainder" which goes to charity in a charitable remainder trust must now be at least 10% of the value of the property.

E. In a **charitable lead trust**, the roles are reversed -- the charity receives a payment for a term of years and noncharitable beneficiaries receive the trust remainder, if any, left at the end of the term. The taxpayer will receive an income tax deduction for the value of the "lead" interest, or the income distributed to the charity will be deductible from the trust's income. The value of the lead interest also will be a deduction for gift-tax purposes.

EXAMPLE: Under the IRS rate tables applicable for an April 2023 CLAT, you could create a charitable lead annuity trust with $100,000 paying $7,621.14 to charity per year for 20 years without making any gift -- i.e., the annuity zeros out the noncharitable remainder. However, if the trust assets actually grow at 7% per year, there still will be about $88,889 left for your children as the remainder beneficiaries at the end of the term.

Note charitable lead trusts are most advantageous in a low-interest rate environment.

F. You also could establish a **charitable gift annuity.** In this approach, you give cash or securities to the charity, which then promises to pay you a fixed annuity amount for the rest of your life. There is no trust document, and very little paperwork. And you get a charitable income tax deduction.

EXAMPLE: A single individual, age 65, owns $20,000 of Microsoft stock, purchased more than one year ago for $10,000.

- She gives the stock to charity.

- Based on the rates suggested by the American Counsel of Gift Annuities she receives an annual payment of $1,080.

- Each year, about $483 is fully taxable, about $298 is taxable as capital gains, and the other $298 is tax-free.

- She gets a present charitable income tax deduction of $8,127.

G. Consider stacking contributions into a year when you have high income and will not use the standard deduction. Note with a large contribution to a donor-advised fund, you can book the deduction in one year and designate distributions to various charities in future years.

H. Make only charitable gifts you can afford. See Rule 1.

Rule 10: Use Eligible "Income Taxable" Property for Gifts to Charity During Life or at Death.

A. Gifts to churches, most schools, and public charities of publicly-traded securities are deductible for income tax purposes (subject to certain percentage limitations) at their market values even if the values exceed the tax basis.

EXAMPLE: Suppose taxpayer has $10,000 of Microsoft stock for which she paid $1,000 and is in a 25 percent combined federal/state capital gains tax bracket.

- Suppose she decides it is time to sell the Microsoft stock. If she sells it and keeps the money, she would pay about $2,500 in capital gains tax.

B. If she gives the stock to charity, not only does she not have to pay the $2,500, but she saves another $4,000 in income taxes through the charitable deduction, for a total "matching gift" from state and federal governments of $6,500 for her $3,500 net contribution.

C. If possible, make charitable gifts at death using income items like the proceeds of an individual retirement account, other deferred compensation, stock options, or installment notes. The charity, unlike an individual, will pay no tax on the income.

D. If you are age 70-1/2 or older, and especially if you use the standard deduction for income tax purposes, consider making a qualified charitable distribution ("QCD") distribution to charity of up to $100,000 annually from your taxable IRA. The distribution will be excluded from your income but satisfy your required minimum distribution to the extent of the distributions. For 2023 and later, you can make a single QCD of up to $50,000 in the form of a charitable gift annuity but also will satisfy a required minimum distribution in that amount.

CONCLUSION

These rules do not take account of or explain all, or nearly all, of the estate planning techniques available for saving taxes. Moreover, there are as noted, special considerations that apply for 2023.

These rules apply to U.S. citizens and residents -- if either you or your spouse is not a U.S. citizen, the rules are different.

Obviously, each person's situation is unique. The advice and examples may or may not apply to you. For your own planning, you should consult a competent tax advisor.