ESTATE PLANNING

Wolters Kluwer

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"What happens to my money and assets after I die?" No matter what your age or income, you need to think about estate planning. If you don't make plans, other people will after you die. Not only could your wishes be ignored or changed – the tax bill could be needlessly large. Even if tax considerations are not an issue, you may need an estate plan to provide for a minor or disabled child or to transfer a family business. And, potential *state* estate taxes may need to be considered.

Minimizing your tax bill takes planning, and recognition that as the tax law changes, your plans may need to as well. Do you want your assets to go to your loved ones and friends, or to the IRS or your state treasurer?

Understanding all of the estate tax consequences is not a do-it-yourself project. There are many exceptions, exceptions to exceptions, elections, allocation rules, etc. This guide will help you understand some of the complex rules. When you talk to a tax professional, he or she will help you plan to optimize your estate planning objectives and minimize any possible federal and state estate tax liability.

FEDERAL ESTATE TAX

Under the federal estate tax, you may be subject to tax if your estate exceeds $5 million, as adjusted for inflation ($5.34 million for decedents dying in 2014) or $10 million, as adjusted for inflation, for a married couple. The maximum federal estate tax rate is 40 percent.

The estate tax law, although complex, allows flexibility and provides various planning techniques and options to help individuals minimize their federal estate tax liability. Some of these techniques and options, such as use of the marital deduction and portability, are discussed below. Your tax professional can help you determine which best fit your situation.

Planning Tip. Many people think the federal estate tax is for the wealthy, and don't realize the full value of their estate, or home. They may have purchased their home 20 or 30 years ago and don't know how much it has appreciated in value. Your home, combined with your investments, savings, and life insurance could push your estate over the federal estate tax threshold. That's why planning today is so important. You have to minimize the potential federal or state tax bite.

STEPPED-UP BASIS

Generally, when you die, your heirs receive a "stepped-up" basis in the property you leave them equal to the property's value on your date of death. If your heirs then sell the property, any gain on the sale is measured using the property's value on your death, not what you paid for the property. Stepped-up basis is very valuable because your heirs escape tax on the appreciated value of the property.

> ***Example.*** In 1992, you bought stock worth $10,000. In your will, you leave the stock to your daughter. At the time of your death, the stock is worth $30,000. Under the stepped-up basis rules, when your daughter sells the stock for $30,000, she will not recognize any taxable gain because her basis in the stock "steps-up" to $30,000 from your $10,000 basis. (By contrast, if you had gifted the shares to her in 1992, a subsequent sale for $30,000 would produce a $20,000 taxable capital gain for your daughter. If your estate is large enough that estate tax is due, however, the $30,000 date-of-death value of the stock would be taxed at the 40-percent estate tax rate making the 1992 gift the better tax result, overall, for the family.)

PORTABILITY

Effective for deaths occurring after 2010, the estate of a decedent who is survived by a spouse can elect to permit the surviving spouse to apply the decedent's unused exclusion (the deceased spousal unused exclusion amount (DSUE)) to the surviving spouse's own transfers during life and at death. This treatment is often referred to as "portability." With portability, the combined estates of a husband and wife can now protect up to a maximum $10 million (plus inflation adjustments) from the estate tax.

> ***Example.*** Andrew and Zoe are married. Andrew dies in 2011, having made taxable transfers of $3 million and having no taxable estate (in 2011, the exclusion was $5 million). An election is made on Andrew's estate tax return to permit Zoe to use Andrew's deceased spousal unused exclusion amount. As of Andrew's death, Zoe has made no taxable gifts. Thereafter, Zoe's applicable exclusion amount is $7.34 million (her $5.34 million basic exclusion amount (plus an inflation factor) plus the $2 million deceased spousal unused exclusion amount from Andrew), which she may use for lifetime gifts or for transfers at death.

Portability is an essential consideration in the estate plans of most high-net worth couples.

MARITAL DEDUCTION

An unlimited gift and estate tax marital deduction allows spouses to transfer property between themselves free of estate tax. To qualify for the estate tax marital deduction, the spouses must have a valid marriage under applicable state law at the time of the decedent's death. The IRS will treat same-sex couples as married for purposes of the marital deduction, as well as portability, provided such couples are legally married in jurisdictions that recognize their marriages regardless of whether the jurisdiction of their residence recognizes same-sex marriages.

The marital deduction has been available in one form or another for many years. With the advent of portability, however, combined use of the marital deduction and portability provides a new degree of estate planning flexibility for many families.

GIFTS

Gifts are often overlooked as estate planning tools but they have some important tax advantages. You can significantly reduce your taxable estate by making gifts. Moreover, many gifts can be made tax free.

Here are some advantages of making gifts:

- Shift income to a child or relative in a lower tax bracket;
- Shift future appreciation permanently out of your income and estate;
- Help family and friends financially;
- Encourage children to take over a family business by giving them interests in the business; and

- Help a church, school, or charity before you die.

When you make a gift, the recipient takes your tax basis in the property. For non-business property, this generally means what you paid for it.

If the recipient sells the property, any gain on the sale will be measured using what you paid for the property, not what the property was worth when he or she received it.

Annual gift tax exclusion. For 2014, you can make tax-free gifts of up to $14,000. This exclusion is available every year (although the amount generally changes). The IRS doesn't care how many people you make gifts to, but if your gift is more than $14,000 to one person, you must inform the IRS by filing a gift tax return (Form 709).

> *Example.* Chloe has $40,000 to distribute to her four grandchildren. On June 1, 2014, Chloe gives each grandchild $10,000. Each gift is below the $14,000 threshold and qualifies for the gift tax exclusion.

Gift splitting. You and your spouse can make separate gifts totaling $28,000 in 2014 to the same person without gift tax repercussions. That's $14,000 from you and $14,000 from your spouse.

> ***Example.*** You and your spouse have four children. You can make a total of $112,000 in tax-free gifts in 2014 if each of you give $14,000 to each of your children.

If you or your spouse makes a gift to a third party, the gift can be considered as made one-half by you and one-half by your spouse. This is known as gift splitting. Both spouses must agree to split the gift.

> ***Example.*** Anne Marie and her husband Andrew agree to split the gifts that they make during 2014. Anne Marie gives her nephew, Justin $21,000 and Andrew gives her niece Rose, $18,000. Although each gift is more than the annual exclusion ($14,000 for 2014), by gift splitting, they can make these gifts without making a taxable gift. Anne Marie's gift to Justin is treated as one-half ($10,500) from Anne Marie and one-half ($10,500) from Andrew. Andrew's gift to Rose is also treated as one-half ($9,000) from Andrew and one-half ($9,000) from Anne Marie. In each case, because one-half of the split gift is not more than the annual exclusion, it is not a taxable gift.

Educational and medical expenses. Gifts made for tuition and medical expenses are tax free regardless of the amount. They are separate from the annual gift tax exclusion of $14,000 for 2014. The payments must be made directly to the provider of the medical services or the educational institution to be tax free.

Federal gift tax. What happens if your gift is more than $14,000? That's when the federal gift tax can apply. You will need to file Form 709 with the IRS and report your gift(s).

Lifetime gift tax exclusion. In addition to the annual gift tax exclusion of $14,000, you are allowed a lifetime gift tax exclusion of $5 million, plus inflation adjustments. Additionally, lifetime transfers between spouses are free from gift tax.

If used properly, gifts can benefit everyone involved. To do so, you must take the time to structure your gifts to minimize the tax consequences.

STATE DEATH TAXES

Prior to 2001, many states imposed an estate tax equal to the maximum state credit that your estate could claim under the federal estate tax law. In states with such a "pick-up" tax, the total estate tax burden did not exceed the federal tax liability. However, the state death tax credit has been repealed. In its place, a deduction for state death taxes paid is allowed. The difference is very important to your estate planning and your heirs.

The change from a credit to a deduction isn't very taxpayer-friendly. A credit is subtracted from the tax itself, resulting in a dollar-for-dollar reduction in your tax liability. A deduction is subtracted from your gross estate, resulting in a reduction in the amount of property subject to tax.

Caution: Because of the high federal estate tax exclusion amount, many states no longer tie their estate tax law to the federal estate tax and have imposed their own state estate taxes often with lower exclusion amounts. As a result, your estate may owe state estate taxes, but not owe federal estate taxes. That's why it is important to take your applicable state law into account when making your estate plan.

ESTATE PLANNING TECHNIQUES

Let's take a look at some popular estate planning techniques that could lower your estate tax bill.

GRATs. A grantor retained annuity trust (GRAT) is a trust that pays you an annuity for a fixed number of years and the remaining assets go to your beneficiaries. The remainder is considered a gift that is made when the trust is created and consists of the amount you contribute to the trust less the value of the annuity payments. Assuming your investments are profitable, the remainder will grow. Because the gift was made when the trust was set up, no gift tax is imposed when the remainder passes to your beneficiaries. The rules for GRATs are very complex and the IRS monitors for abuses.

Planning Note. A low interest rate environment can make GRATs attractive.

Comment. Several bills have been introduced in Congress to place new restrictions on GRATs, largely to help raise revenue to fund other tax cuts. One proposal, which was not enacted by Congress, would have required a GRAT to have a term of at least 10 years. This and other limits on GRATs could be revisited by Congress in 2014.

Defective grantor trusts. You may want to set up a trust while at the same time taking advantage of individual tax rates, which generally are lower than the tax rates for trusts. One way to do this is to deliberately create a trust that is valid under state law but fails the federal tax test for trusts. This causes the income from the trust to be taxed to you. Again, these arrangements are complex. The IRS will deny the claimed tax benefits if it discovers abuses.

Qualified personal residence trusts. One type of grantor retained annuity trust is a qualified personal residence trust (QPRT). Setting up a QPRT is complex and must be done correctly if you are to maximize the tax benefits. While you are alive, you continue to reside in your home, but your residence is placed in a trust. Many people make their children the beneficiaries of the trust.

Family limited partnerships. People use family limited partnerships to maximize a person's annual and lifetime exemptions and because special discount rules can be very valuable. Many times they are used to pass a family business or farm to children.

> **Caution.** The IRS is very concerned about abuse of family limited partnerships and the IRS looks at them very carefully. Some courts also take a tough line. A poorly constructed family limited partnership can be worse than none at all.

Qualified terminal interest property trusts. This type of trust, called QTIP for short, is used when you don't want to transfer assets outright to a spouse, but still want to get the unlimited marital deduction. It may be used in conjunction with some of the other types of trusts already discussed.

Gift-loans. To avoid the federal gift tax, you could make a gift up to the annual exclusion amount ($14,000 for 2014) and give more in the form of a loan. The loan would presumably have been forgiven on your death.

> **Caution.** One danger was that the IRS could determine that the entire transfer was a gift and the loan was a sham. You had to carefully follow all of the rules to show it is a legitimate loan.

Crummey trusts. People set up *Crummey* trusts to transfer assets to their children. A *Crummey* trust – named for the person who first used one – gives the child the minimum access to the assets required by law for the IRS to treat the transfer as a completed gift. Your goal is to keep the assets in the trust until you want your son or daughter to have them.

LIFE INSURANCE

Life insurance is one of the more common estate planning tools. If your beneficiary is your spouse, the proceeds generally go to him or her tax free. Another important purpose of life insurance is to provide liquidity to your estate. Your executor can use the proceeds to pay for burial and other costs as well as the estate tax on assets that your family won't want to sell.

The tax consequences get more complicated when the proceeds go to your estate. One way to avoid taxation is to use a life insurance trust.

Life insurance proceeds are subject to estate tax unless they go to your spouse. Proceeds may be taxed if the insured owned the policy at death or had transferred it within three years of death. Even if the policy was transferred to another, the insured is still considered to own the policy if he or she can:

- Change the policy;
- Borrow against the policy;
- Surrender the policy for its cash value; or
- Pledge the policy for a loan.

Many people use life insurance to pay estate taxes. This way, the bulk of the estate stays intact and isn't lost to taxes.

Life insurance trusts. If a life insurance policy and all policy rights are transferred to a trust and the former owner survives three years, the proceeds can escape estate tax. You can have the trust managed professionally, protecting beneficiaries.

Life insurance trusts can be funded or unfunded. If the trust is funded, you have to transfer cash or other property to pay the premiums on the policy. If it is unfunded, you or someone else has to make periodic contributions to it so the premiums are paid.

> ***Caution.*** Life insurance trusts have been abused and some lawmakers in Congress have proposed legislation banning or severely restricting them.

GENERATION-SKIPPING TRANSFER TAX

The generation-skipping transfer (GST) tax is a tax on the transfer of property to a person who is more than one generation younger than you (for example, your grandson). It was created to close a loophole that allowed very wealthy families to avoid estate tax.

The GST tax applies to three types of transfers:

- Direct skips;
- Taxable terminations of GST tax property; and
- Taxable distributions of GST tax property.

If your assets are large enough that GST tax could be a problem, your professional tax advisor can walk you through each of these types of transfers. The GST tax is very complicated and requires careful long-range planning to minimize tax consequences.

Comment. The maximum GST tax rate is permanently set at 40 percent

CHARITABLE GIVING

Charitable giving is an important part of estate planning. The tax breaks and the various methods of charitable giving combine to give you a variety of options. More recently, deferred charitable gifts have developed as an estate planning tool. They allow you to keep an economic benefit from the gift and get special tax treatment.

Qualified gifts. Your donations must be given to "qualified" charitable organizations. You can deduct your gifts to religious, charitable, scientific, educational and other groups that are incorporated as 501(c)(3) organizations. Gifts to the federal government, state government, and some local governmental bodies also are deductible. If you have any questions about the deductibility of your gift, ask your tax advisor.

Types of gifts. Charitable gifts can be outright gifts of cash or they can take other forms, such as:

- ***Bequests:*** In your will, you bequeath a gift to your favorite charity and your estate gets a charitable deduction.

- ***Life insurance:*** You name a charity as the beneficiary of your life insurance and, when you die, the proceeds go to the charity. You can also make a charity the owner of a life insurance policy on you.
- ***Stocks and other investments:*** You can transfer ownership of stocks, bonds, mutual funds, and other investments to your favorite charity. You can make a contribution of appreciated stock to a qualified charity and deduct the fair market value of stock without recognizing income on the appreciation, provided that any gain would have been long-term capital gain.
- ***Annuities:*** Many charities have gift-annuity programs you can invest in. You get the investment income from your gift during your lifetime.
- ***Trusts:*** Charitable remainder trusts are one type of trust you can set up during your lifetime. You get the

investment income and after you die, the charity gets the assets of the trust.

- ***Private foundations:*** People who want to make very large gifts often create their own private foundations.
- ***Cars, trucks, boats:*** Some charities welcome donations of cars, trucks and boats. The IRS has very strict rules for donations of cars and trucks. Your deduction, if $500 or more, is limited to the price for which the charity ends up selling your car, truck or boat (generally, a low wholesale value). If the charity uses the vehicle, however, you're entitled to deduct the full market value. It is crucial to obtain written confirmation from the charity for the vehicle to claim the deduction.

> **Comment.** Donations of clothing and household items, such as furniture, furnishings, appliances, electronics, and linens must generally be in "good used condition or better" to be deductible. However, donations of clothing or household items for which a taxpayer claims a deduction of more than $500 do not have to meet the "good used condition or better" standard if the taxpayer includes a qualified appraisal of the item with his or her return.

IRA charitable rollover. Prior to 2014, individuals age 70 1/2 and older could distribute tax free up to $100,000 from their IRAs to charitable organizations. The distribution was not reported as income to the taxpayer. Distributions could have been from a traditional or a Roth IRA. This incentive benefitted both individuals who did not otherwise itemize their charitable contributions and individuals who wished to maximize the tax-favored amount they gave to charity in any one year.

> **Caution.** This incentive may be revived for tax years after 2013 under legislation that would extend provisions that had expired. Your tax professional can advise you if this tax break is available.

These are just a few of the many methods you can use to make gifts. Before you make a gift to your favorite charity, ask your tax advisor how you can maximize the tax savings from your gift. If the gift is taxable, you, and not the recipient, are liable for the tax.

> **Caution.** Charitable giving scams are very prevalent, especially on the Internet. Many scams use names similar to legitimate charities or say they are working on behalf of a genuine charity. One of the most common scams involves vehicle donation.

CONCLUSION

The federal estate tax rules, as you've learned, are complex and almost always interact with each other. And, your applicable state law may also come into play. Additionally, individuals have a variety of estate planning techniques to consider when coordinating income tax savings with ways to minimize estate and gift taxes.

Please contact our office if you have any questions. Together, we can start mapping out an estate plan.

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