Transamerica℠

Learn the essentials of estate planning today

A go-to guide for estate planning basics

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The importance of estate planning

Transamerica is pleased to provide you with a consolidated reference guide on the basics of estate planning, designed to give you actionable concepts and strategies to implement.

Many people view estate planning as something to be addressed later in life or only after they have accumulated substantial wealth. The reality is that anyone who owns a home, has children, or contributes to a retirement account can benefit from a simple estate planning review. A basic understanding of estate planning can help you take care of the people who are important to you, potentially reduce taxes, and avoid common mistakes.

You are receiving a copy of this guide because your financial professional recognizes the importance of estate planning. We hope you find it to be a useful reference tool in helping you identify potential estate planning issues and solutions.

Please note that the information contained in the guide is not intended to constitute tax or legal advice. Always be sure to consult with your own tax and legal professionals regarding your own personal circumstances.

Preparing for incapacity

The key to preparing for incapacity is to prepare for it before it strikes. If you become incapacitated, it will generally be too late for you to execute the necessary legal documents.

These include not only wills and trusts, but also powers of attorney and advance healthcare directives. Without being prepared, your family may have no other option but to go to court and request the appointment of a guardian.

Guardianship

When someone loses the legal capacity to make decisions, but has not appointed an agent, guardianship may be required. Guardianship is a legal process governed by state law. It allows a court to appoint a person, such as a family member, friend, or professional guardian, to manage the affairs of the incapacitated person. Not only does it give a guardian the power to act on behalf of the incapacitated person (referred to as the "ward"), but it also limits the ward's ability to act on his/her own behalf.

There are two types of guardianship that a court may order:

1. Guardian over the person: The guardian is granted power over the physical well-being of the ward. This type of guardianship is often referred to as a conservatorship and the guardian as a conservator.

2. Guardian over the estate: The guardian is granted power over the financial affairs of the ward.

A court can appoint the same person to serve in both capacities, or appoint separate guardians. States impose a formal legal process over guardianship that is intended to protect the legal rights of the proposed ward. In general, a petition for guardianship follows five steps:

Step 1: An interested party contacts an elder law attorney who prepares and files a petition for guardianship. The petitioner must give notice to all known members of the proposed ward's immediate family. Anyone receiving notice, including the proposed ward, may oppose the petition.

Step 2: The court holds a hearing in which the petitioner presents evidence as to the proposed ward's incapacity.

Step 3: If the petitioner is successful in establishing incapacity, the court will appoint a guardian. The guardian has a fiduciary responsibility to act in the best interest of the ward at all times.

Step 4: The guardian may be required to post a bond, which can add to the legal expense of guardianship. The court can also require periodic reports from the guardian outlining actions taken on behalf of the ward.

Step 5: The guardianship ends when the ward passes away, the ward is no longer incapacitated, the guardian resigns, or the assets of the ward are depleted. In some cases a hearing may be required to terminate the guardianship.

As the court proceedings associated with guardianship can be expensive, time-consuming, and public, many commentators have described guardianship as a "last resort." Nevertheless, it is important to be aware that there is a process available to address incapacity when necessary. As we are about to discuss, proper preparation can eliminate the need for guardianship.

Powers of attorney (POA)

One of the most effective tools you can leverage in preparing for incapacity is a power of attorney. A power of attorney is a legal document in which you ("the principal") can appoint someone else ("an agent") as your legal representative. This gives the agent the legal authority to act on your behalf. A power of attorney can be very broad (giving an agent the legal authority to do anything the principal could do) or very narrow (giving the agent the authority to perform only a single, specific transaction). The powers granted in a power of attorney can vary from state to state, so it is important to work with an attorney in your state to help ensure that a power of attorney meets the principal's needs. In any power of attorney arrangement, the agent has a fiduciary duty to act in the best interest of the principal at all times.

Some of the more common types of powers of attorney include:

General power of attorney: The agent can perform most acts that the principal can perform, such as managing financial accounts. The nature of the powers extended in a general power of attorney are governed by state law. Some states will restrict certain powers, such as the ability to change a beneficiary designation, unless the principal expressly grants the power in the document. A general power of attorney usually terminates when the principal becomes incapacitated, dies, or revokes the power.

Durable power of attorney: The key feature of a durable power of attorney is that it will not terminate when the principal becomes incapacitated. Accordingly, if the goal is to allow the agent to act during the principal's incapacity, any powers of attorney should be clearly identified as durable.

Limited or special power of attorney: The agent has specific, limited powers, such as the authority to sell a particular piece of property or manage a specific bank account.

Durable power of attorney for healthcare: Designates an agent (sometimes called a "proxy") to make healthcare decisions for the principal. A durable power of attorney for healthcare usually does not go into effect until the principal becomes incapacitated. Legal documents relating to healthcare, including a durable power of attorney for healthcare, are often referred to as advance healthcare directives.

Springing durable power of attorney: As the name implies, this type of power "springs" into effect upon the occurrence of a specific event (usually the principal's incapacity). When using a springing power of attorney, it is important to specify not only the type of event that will "spring" the power, but also the process by which the agent will establish that the event has occurred (such as presenting a letter from the principal's treating physician).

Absent language to the contrary, a power of attorney will generally become effective when it is executed. It is possible for a principal to name more than one agent. When this happens, the principal should clearly indicate whether agents may act singly, or whether all agents must agree to act. All powers of attorney terminate at the death of the principal.

⚠ Important

The actual powers included in a general power of attorney (POA) can vary based on state law. To help ensure that the POA gives the agent the powers intended by the principal, we recommend consulting a qualified attorney in your state. In many states, however, a general POA will give the agent authority to:

- Manage real estate
- Manage bank and brokerage accounts
- Manage retirement accounts
- Manage life insurance and annuities
- Operate the principal's business
- Manage household finances

Some states will specifically exclude certain powers in a general POA. If the principal wants his or her agent to have one of these powers, he or she will have to add appropriate language to the POA. These include:

- Creating, amending, or revoking a trust
- Making gifts
- Changing a beneficiary designation
- Disclaiming an inheritance
- Delegating powers given in the POA

Remember that while financial institutions and other persons presented with a notarized POA are generally required to accept it, they are also required to protect the interest of the principal by allowing the agent to do only that which is clearly authorized in the power. It can therefore be helpful for the principal to be very specific about the powers being given to the agent in the POA.

Trusts

Although they are relatively simple and easy to use, one drawback of powers of attorney is that they terminate at the death of the principal. If a principal is seeking an arrangement in which a person will continue to manage assets even after the death of the principal, he or she may want to consider a trust. A properly drafted trust can give a trustee the ability to manage trust assets for multiple generations (See Trusts section on page 18).

One common question is whether a power of attorney allows the agent to carry out the duties of the principal as trustee of a trust. The answer is generally no. Just as a trust does not give the trustee authority beyond the trust agreement, a power of attorney typically does not give an agent the powers of a trustee. If a principal can no longer serve as a trustee, the trust document should provide direction on the appointment of a successor trustee.

Considerations

Communication

Good communication can help any plan function more smoothly. A principal should consider letting all interested parties know who he or she has designated as her agent. This can include financial institutions as well as family members. Some firms will now offer a consent form, authorizing the financial institution to contact a trusted person in the event they cannot contact the principal. It can also be helpful to make sure that your trusted contact person and the agent have a copy of the power of attorney. Your agent should also have access to information about the accounts he or she will need to manage, such as login IDs and passwords for online accounts.

Selecting the right agent

When you name an agent in a power of attorney, you are giving that person almost unlimited access to your property. While agents are legally required to act in your best interest, power of attorney abuse is a very real concern. Accordingly, use great care when selecting your agent. Avoid people who have a history of financial mismanagement or behavioral issues, such as compulsive gambling or drug and alcohol abuse. If possible, name someone who is financially savvy and has experience with the type of activities you will be asking them to manage. Most importantly, select someone you can confide in and trust.

Advance healthcare directives

The term “advance healthcare directive” is a broad term that includes many legal documents related to your healthcare. These documents allow you to not only name an agent for healthcare, but also to provide your agent and medical professionals with important information about your wishes for care. The following are some common advance healthcare directives:

Durable power of attorney for healthcare

This gives your agent the authority to make life and death decisions over your healthcare, including the ability to agree to or refuse medical care, seek admission to or discharge from a hospital, hire and fire healthcare providers, process medical insurance claims, and all related actions. In selecting an agent, choose someone you would trust with your life and who is willing to listen to and respect your wishes for care (Also see the Powers of Attorney section on page 5).

HIPAA authorization

While a durable power of attorney for healthcare can provide an agent with access to medical records, it may not become effective prior to incapacity. If you want your agent to have access to your medical records immediately, it may be necessary to execute a HIPAA (Health Insurance Portability and Accountability Act of 1996) authorization.

Living will

A living will allows you to clearly state your wishes when faced with potentially life-ending medical conditions. A living will can be profoundly helpful to your healthcare agent and medical professionals by letting them know your wishes relative to when you would or would not want life-extending measures such as surgery, feeding tubes, and artificial respiration.

Do not resuscitate order (DNR)

Some people with serious health issues may get to a point where they do not want CPR in the event of cardiac arrest. By executing a DNR order (which must also be signed by a physician), a person can receive a bracelet or other identification that will alert first responders to the person’s wishes. First responders are trained to provide comfort care only to these patients.

A living will can be profoundly helpful to your family as well as your medical professionals.

Probate and wills

The starting point for most estate plans is a review of your will and consideration of how the probate process may impact your legacy planning intentions.

Most individuals understand that a will is drafted to direct how their assets will be distributed upon death, but many people are not familiar with the process of how their assets are actually distributed – the probate process.

Probate

The legal process of distributing and settling an estate in accordance with state law is called the probate process. The probate process includes proving the validity of the will, paying all taxes and debts of the estate, and executing the provisions of the will. During the probate process, the will is used as the primary document to establish the proper beneficiaries of the estate. Also, the probate process allows creditors the opportunity to step forward and make claims against the estate. After debts are settled, the estate will pay state and/or federal estate taxes and may need to pay income taxes before assets are legally transferred to individual beneficiaries. One common aim of estate planning is reducing or eliminating the amount of assets that pass through probate. Several disadvantages to probate include:

Delays

The probate process does not occur instantaneously and there may be a delay before beneficiaries receive or have access to assets.

Lack of privacy

Court filings in a probate proceeding are generally accessible by anyone. In addition, the probate process allows anyone to make a claim against the estate, whether valid or not. This opportunity to make a claim may be viewed by many as a loss of privacy. Creditors may make claims and receive assets instead of loved ones. More often than not, the proper beneficiaries receive assets through probate, but there is always an element of uncertainty in the process.

Expense

Some states assess a probate fee and an attorney may be required to ensure proper disposition of assets from the estate.

Disinheritance

Any time assets go through probate there is the potential that heirs can be disinherited. Directives in the will can be ignored if the will is improperly constructed. Likewise, conflicting wills can arise and the actual intent of the deceased can be superseded.

⚠ Important

The will does not control accounts with beneficiary designations. If there is a conflict between a beneficiary designation and a will, the beneficiary designation overrides the directives of the will. The will should be kept up to date with any life changes such as a divorce, a death in the family, a birth, or a disability in the family. Any significant life changes should trigger a review and update of the will.

Wills

A will is a legal instrument directing disposition of assets after death. The will is the most basic of all estate planning documents and is a primary document to determine who receives assets after death. The will generally applies only to probated assets and is not taken into consideration with regard to certain jointly held assets, accounts with beneficiary designations, and trusts. If someone dies without a valid will, the individual's assets will be distributed via the applicable state's law of intestate succession. These laws follow a prescribed order and priority of who will receive assets from the estate.

Three action steps:

- **Ensure that you have a will**
  - Is it up to date?
  - Ensure the executor has a copy
- **Review the will**
  - Ensure that it fits with your financial strategies and intentions
- **Identify property that does not pass by the will**
  - The will may be superseded by the way assets are owned or through beneficiary designations

Ownership

There are arrangements that bypass the probate process by passing property by operation of law or by contract. Property that is owned jointly with rights of survivorship automatically passes to the surviving joint owner at the death of either owner. Property that is owned through tenancy in common does pass through probate as each owner has a distinct undividable share that can be disposed of as they desire or at their discretion.

Trusts

A person may establish a trust for the sole purpose of avoiding probate. Generally these trusts are revocable, but they may also be irrevocable during the life of the grantor. The trust document specifically lists who receives assets and the trustee who is responsible for transferring assets from the trust directly to the trust beneficiary(ies).

Joint tenants with right of survivorship

Joint ownership structure where each owner's share passes directly to the surviving joint owner at death. This structure provides the convenience of avoiding probate with the property ownership passing automatically to the surviving joint owner.

Tenants in common

Joint ownership of property where each owner holds a distinct undividable share. Owners can sell, exchange, gift, or leave their share to anyone they wish without consent from the other owners. At death, the share of the deceased owner does not pass to the other owners, but rather it is passed through probate and transferred to the deceased owner's appropriate heirs.

Community property

Under community property rules, property interests acquired during marriage are generally considered to be owned equally by each spouse even if owned individually in title. Nine states operate under a community or marital property system: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.* The community or marital property laws for each state can vary significantly.

* Certain states not listed have adopted community property laws, allowing married couples to opt in if they desire.

Joint Tenants With Rights of Survivorship (JTWROS)

Property owner:
Jack Smith and Jill Smith

Jack dies.
Property passes directly to Jill without probate.

Jill Smith becomes the sole owner of the property.

Tenants in common

Property owner:
Jack Smith and Jill Smith

Jack dies.
Jill assumes her portion of the property. Jack's portion passes to his estate and is probated.

Jill retains her interest in the property. Jack's share of the property passes through probate.

⚠ Important

Revocable living trusts are often established for the purpose of avoiding probate. An easy way to identify a revocable trust is that it will often use the Social Security number of the grantor of the trust as its taxpayer ID number.

Beneficiary designations on financial accounts such as variable annuities, 401(k)s, and IRAs override directives by will and avoid probate as long as a beneficiary other than the owner or the owner's estate is designated. You may also wish to avoid leaving the beneficiary designation blank as the assets will generally be payable to the owner's estate, subjecting the asset to probate.

Annuities and qualified plans may limit the death benefit distribution options that are available to beneficiaries. You should consult the annuity contract or the qualified plan's summary plan description (SPD) document for additional information regarding options available to beneficiaries.

Beneficiary designations

A beneficiary designation will generally determine who receives the designated asset and in what order.

The relationship of the beneficiary to the account owner will impact distribution options and taxation. The mechanics of beneficiary designations can also provide for unexpected contingencies, such as who gets the assets if the owner outlives the primary beneficiary or if one of the beneficiaries is deceased. The following provides an overview of some of the terms and considerations for constructing an effective beneficiary designation.

Types of beneficiaries

Spouse

Spouses have considerable flexibility as beneficiaries. When spouses inherit an IRA, Roth IRA, or qualified retirement plan, they can generally choose from the following distribution options:

- Assume ownership or rollover the inherited IRA or inherited qualified plan into an IRA in their own name
  - This option is only available for spouses
  - The IRA is treated as any other IRA owned by the surviving spouse
- Take a lump-sum distribution of the account
- Distribute the account by December 31 of the year containing the 10th anniversary of the owner's death (or, if the owner was over 73, over the longer of the owner's remaining life expectancy or their own life expectancy)
- Treat it as an inherited IRA
  - May be appropriate if the surviving spouse is younger than 59½ and needs access to proceeds
  - Annual RMDs are not required until the deceased spouse would have attained age 73
- Annuitize (available for individual retirement annuities and some qualified plans)
- Starting in 2024, a spouse can elect to be treated as their deceased spouse for RMD purposes (SECURE 2.0 Act)

Non-spouse

When non-spouses inherit an IRA or qualified plan, they do not have the option to treat the IRA as their own. Instead they must begin liquidating the account through one of the options below:

- Take a lump-sum distribution of the account
- Distribute the account by December 31 of the year containing the 10th anniversary of the owner's death
- Annuitize for up to 10 years (available for Individual Retirement Annuities and some qualified plans)
- Eligible designated beneficiaries can setup a qualified stretch. See section "Important: Tax Law Change" on the next page to learn who is classified as an eligible designated beneficiary

Estate, trust, or entity

A beneficiary does not have to be a living person. When a beneficiary is not a living person, distribution options are restricted.

Estate or entity listed as beneficiary:

- Take a lump-sum distribution of the account
- Distribute the account by December 31 of the year containing the fifth anniversary of the owner's death

Trust listed as beneficiary:

- Take a lump-sum distribution of the account
- Distribute the account by December 31 of the year containing the fifth anniversary of the owner's death
- If the trust qualifies as a "look-through trust," the account must be distributed by December 31 of the year containing the 10th anniversary of the owner's death. Otherwise, the account must be distributed by December 31 of the year containing the fifth anniversary of the owner's death
- Distributions are taxable to the trust, unless paid to the trust beneficiary in the same tax year
- If all trust beneficiaries are eligible designated beneficiaries, then they can setup a qualified stretch

⚠ Important: Tax law change

Limited availability of qualified stretch

Under old law, a designated beneficiary (a living person) of an inherited qualified retirement account, such as a 401(k), 403(b), or IRA, had the ability to "stretch" the distributions from that account over their life expectancy as determined by IRS Table 1. The SECURE Act changed the maximum distribution period of these accounts to 10 years, meaning the account has to be liquidated by the end of the 10th year after the death of the original owner. If an original account owner passed away on or after his/her required beginning date, then a designated beneficiary must take RMDs based on the beneficiary's life expectancy during the 10-year delay.

There are exceptions to the 10-year rule for eligible designated beneficiaries. Eligible designated beneficiaries include a surviving spouse, individuals with disabilities, chronically ill individuals, beneficiaries who are less than 10 years younger than the original owner (or the same age or older), and minor children of the account holder. These individuals will still be allowed to take a life expectancy payout, or spousal continuation in the case of a spouse. It is important to note that the exception for minor children only applies while the child is under the age of majority. Unless disabled or chronically ill, once the child reaches the age of majority (age 21), the account will then have to be liquidated by the end of a 10-year window.

Non-natural beneficiaries, such as charities and some trusts, will in some cases still be forced to liquidate over a five-year period. In light of this rule change, trusts that are the beneficiaries of current qualified accounts may need to be reviewed to make sure they align with the new rules.

This new distribution rule will impact the beneficiary of any account in which the original owner died after December 31, 2019, subject to delays for government plans and collectively bargained plans. Beneficiaries that are currently receiving payments based on life expectancy can continue and will not be affected by the new 10-year rule.

Beneficiary designation mechanics

Primary beneficiary

The primary beneficiary is the primary recipient of the proceeds at the owner's death. There can be more than one primary beneficiary, and there are theoretically no limits on the number of primary beneficiaries that can be listed.

Contingent beneficiary

The contingent beneficiary is the party that receives the proceeds at the owner's death if the primary beneficiary(ies) passed away before the owner.

Per capita

If there is more than one primary beneficiary listed and one of them predeceases the owner, under a per capita beneficiary designation the proceeds will be split evenly among the remaining primary beneficiaries. For example, if you own an IRA and designate Andy, Beth, and Chris as beneficiaries and Andy passes away before you, then when you pass away the inheritance is split per capita – 50% to Beth and 50% to Chris.

Per stirpes

If there is more than one primary beneficiary and one of them predeceases the owner, under a per stirpes beneficiary designation the proceeds that would have been passed to the deceased beneficiary would pass to the offspring of the deceased beneficiary. For example, if you own a deferred annuity and designate Andy, Beth, and Chris as beneficiaries and Andy passes away before you, the proceeds that would have passed to Andy would go to Andy's children instead of Beth and Chris. In this situation, Beth and Chris would each receive one-third of the account and the remaining third would pass to Andy's children.

Common beneficiary designation mistakes

Beneficiary designations don't always get the attention they deserve. Mistakes can undermine the best of intentions. The following are some of the most common beneficiary designation mistakes.

Not naming a beneficiary

One of the advantages of having a beneficiary designation is the account passes to the listed beneficiary directly instead of going through probate. If a beneficiary designation is left blank, at death the account passes to the owner's estate subjecting the asset to probate.

Naming an estate as the beneficiary

By naming an estate as the beneficiary, the account pays to the owner's estate and is subject to probate.

Naming minors as beneficiaries

When leaving assets to minor children, you may want to consider naming a custodian per the uniform transfers to minors act (UTMA) for their state of residence. If a minor is listed without such a designation and the owner dies, the company holding the account cannot pay it directly to a minor. To receive the proceeds of the account a guardian must be appointed to act on behalf of the minor. Keep in mind, once the beneficiary reaches the age of majority in his or her state, the guardian/custodian no longer has any control over the account. If long-term control is needed, a trust may be considered.

Not naming contingent beneficiaries

If the primary beneficiary predeceases the owner of the account and no contingent beneficiary is listed, the account pays out to the estate and ends up in probate.

Not updating beneficiaries

Failure to keep a beneficiary designation up to date can result in disinheritance. Beneficiary designations should be reviewed anytime you experience a life-changing event, such as divorce, marriage, disability, birth of a child, a death in the family, or a career change.

⚠ Important information

Companies may vary between per capita and per stirpes (see page 14) as their default distribution option in the case of a beneficiary predeceasing the owner. There is a tendency to default to per capita, but it is suggested to verify with the carrier the default option. If one is preferred over the other, one should designate per capita or per stirpes on the beneficiary designation itself.

For nonqualified annuities, there are both similarities to and differences from the IRA beneficiary distribution rules. For example:

1. When a spouse is the sole beneficiary of a nonqualified annuity, he or she will generally have the option of "spousal continuation." This means that the spouse can assume ownership of the annuity, and name new beneficiaries. This allows the spouse to continue tax deferral over the balance of his or her life. Check with your insurance carrier for details about how spousal continuation works with its annuity.
2. If a non-spouse beneficiary wants to take advantage of life expectancy distributions from a nonqualified annuity, the first distribution must be taken within 12 months of the owner's death. This is a shorter period than that allowed for IRAs, which requires the first stretch distribution to occur by December 31 of the year following the year of death.
3. When a trust is named as the beneficiary of a nonqualified annuity, the "look through" rules available for IRAs do not apply. Life expectancy distributions are not available. The trust must distribute the proceeds within five years from the date of death.

Overlooking per capita or per stirpes distribution

If beneficiary designations are not kept up to date and a beneficiary predeceases the account owner, an understanding of how the account will flow to the remaining beneficiaries can help avoid disinheritance.

Not understanding disclaiming

Disclaiming can be very useful in repairing beneficiary designation mistakes, maximizing estate tax exclusions, and income tax preparation.

Spendthrift beneficiaries

Leaving a large inheritance to beneficiaries who cannot handle it can cause irreparable damage to a legacy and potentially to the beneficiaries themselves. Understanding the use of trusts or restricted beneficiary designations can help protect beneficiaries from themselves.

Unnecessarily naming a trust

Understanding the purpose of the trust can help determine whether designating the trust as beneficiary is necessary. If a trust is listed as beneficiary, ensure its terms match the account owner's wishes on how assets will be distributed.

Disclaiming

It may seem counterintuitive to disclaim what many would consider a windfall. However, there are several valid reasons to disclaim an inheritance:

Correcting a beneficiary designation mistake

Disclaiming may be a useful tool to correct mistakes in a beneficiary designation. For example, an owner may designate a spouse and adult child as beneficiaries. But at the owner's death, the adult child is concerned about the widow's financial security. To address this, he could disclaim his interest, allowing the widow to become the sole beneficiary of the account.

Estate tax considerations

Keeping an asset out of an estate may reduce future estate taxes for the individual disclaiming the asset.

Income tax considerations

For income in respect of a decedent (IRD) assets (such as IRAs and deferred annuities), it may be useful to disclaim assets for income tax reasons. The original recipient may be in a high income tax bracket or wish to keep his or her income low to preserve certain tax deductions or eligibility for benefits that are based on income. Also, a beneficiary may wish to disclaim if the contingent beneficiary is in a lower tax bracket.

Caution

Disclaiming must be done correctly to be effective. You should consult with a qualified attorney to ensure that all steps are properly followed.

Restricted beneficiary designations

A spendthrift beneficiary can undermine an estate plan if left unchecked. For accounts with beneficiary designations, a restricted beneficiary option may be a way to control a spendthrift beneficiary. Restricted beneficiary designations typically allow the account owner to limit or restrict the beneficiary's access to the inherited assets. For example, a restricted beneficiary designation could prohibit the beneficiary from accessing the inherited assets in a lump-sum. If you are concerned about a spendthrift beneficiary or would like to maintain some degree of control over the assets you designate for your beneficiaries, you may want to check with your custodian, plan sponsor, or insurance company to see if a restricted beneficiary designation is available.

Beneficiary designation action steps

Gather statements, wills, and estate planning documents.

Create an organizational tool to keep your important financial and estate planning documents in a consolidated place. This step also allows you an opportunity to express how you wish your estate plan to be arranged so your financial professional can properly guide you on your beneficiary designations.

Diagram the beneficiary designation

By diagramming the beneficiary designation you can identify if your account needs to be listed as per stirpes or per capita, or if other special arrangements need to be made with custodians.

Take into consideration the impact of trusts and spendthrift beneficiaries

Discuss with your attorney the impact of trusts and the purpose behind having the trust. Ask about the capacity of your beneficiaries to responsibly handle an inheritance. Consider all of the options available if you have spendthrift beneficiaries.

Identify designations subject to probate

Keep an eye out for designations that result in assets passing through probate, such as blank beneficiary designations, the estate listed as the beneficiary, or outdated beneficiary designations where the beneficiary is deceased.

Review IRA, roth IRA, qualified plan, and deferred annuity beneficiary designations

These accounts have different post-death distribution options than other accounts. To ensure desired options are preserved, beneficiary designations that list entities or trusts should be reviewed.

Trusts

There are a variety of different types of trusts, each designed to accomplish different estate planning objectives.

The following section will address the fundamental components of trusts, different types of trusts, and some of the most common trusts used in the estate planning process.

Trust strategies

One of the most frequently employed strategies in estate planning is the use of trusts. Generally speaking, trusts are established for one or more of the following reasons:

- Probate avoidance
- Provide for heirs
- Control the distribution of assets
- Protect assets
- Reduce income and transfer taxes
- Fulfill a charitable intent

What is a trust?

A trust is a legal agreement where property is managed by a trustee for the benefit of trust beneficiaries. Under this type of legal arrangement, the grantor transfers ownership of certain assets to the trustee who manages the assets for the benefit of the trust beneficiary(ies).

Parties to a trust

Grantor (trustor)

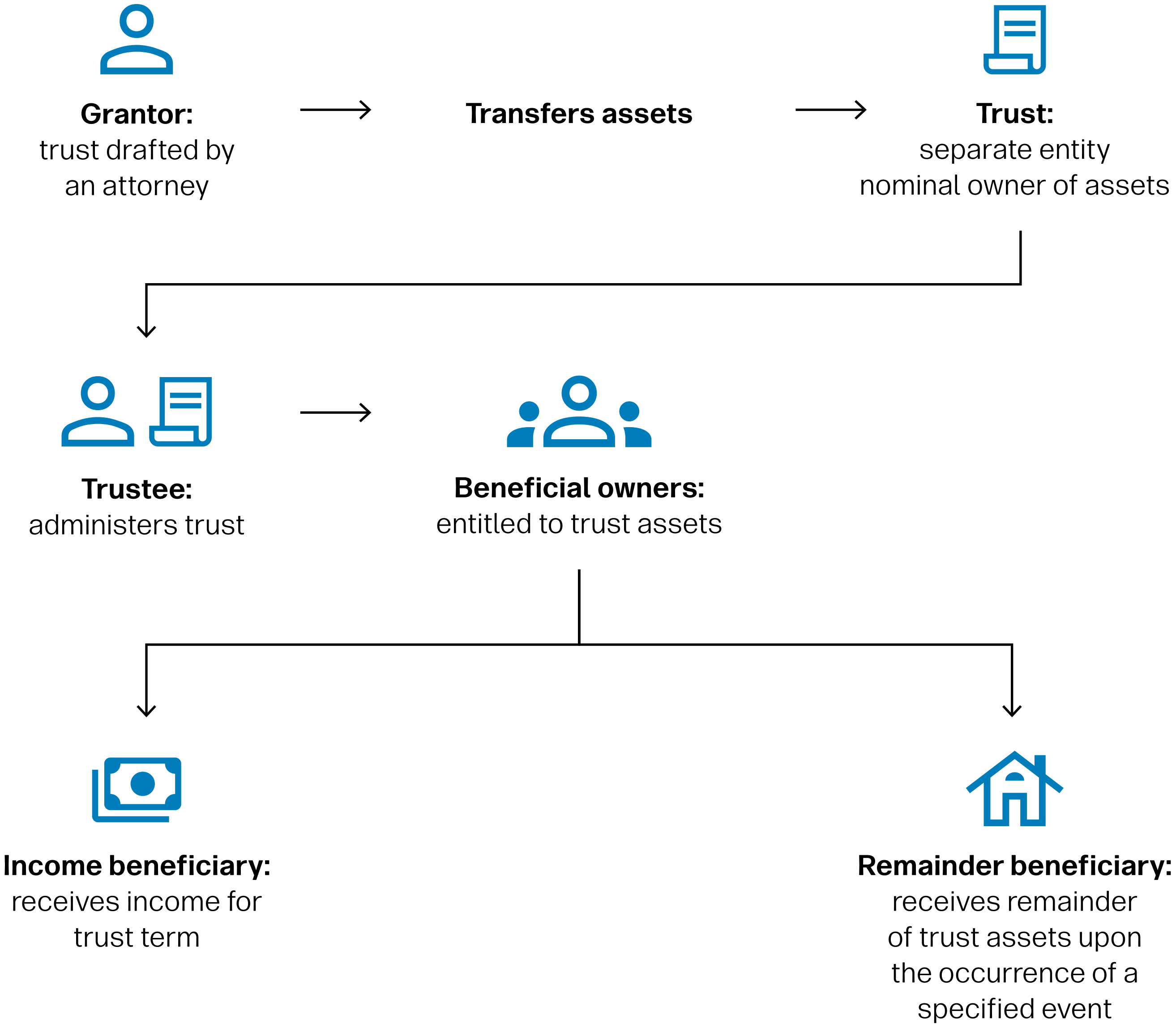
The grantor of the trust is the person who creates the trust (the trust must be drafted by an attorney), establishes the terms of the trust, and contributes property to the trust.

Trustee

The trustee is the fiduciary responsible for executing the directives of the trust and managing trust assets. Managing a trust is a significant responsibility as the trustee is responsible for filing trust tax returns, ensuring compliance with the terms of the trust, responding to requests from trust beneficiaries, ensuring the trust conforms to applicable laws, and ensuring that trust assets are invested in a prudent manner consistent with the trust's objectives. Every trust should also have a successor trustee named. The successor trustee is the individual(s) or entity who assumes the trustee duties if the trustee is unable or unwilling to perform as trustee.

Beneficial owner(s)/beneficiary(ies)

The beneficial owner is the individual or group entitled to trust assets, whether in the form of income or remainder assets. Trusts generally have an income and remainder beneficiary(ies). The income and remainder beneficiary(ies) can be the same person, but likely will be two separate individuals or parties. Other than receiving distributions from the trust as specified in the trust document, the beneficial owners generally have no administrative powers over trust assets. The beneficial owners may be able to persuade the trustee to invest or distribute assets according to their wishes, but the trustee is legally bound to the terms of a trusts. Acquiescing to a beneficiary's demands exposes the trustee to liability if the actions conflict with the directives of the trust.


Grantor:
trust drafted by an attorney
Transfers assets
Trust:
separate entity
nominal owner of assets
Trustee:
administers trust
Beneficial owners:
entitled to trust assets
Income beneficiary:
receives income for trust term
Remainder beneficiary:
receives remainder of trust assets upon the occurrence of a specified event

Revocable and irrevocable trusts

Trusts fall into two broad categories: revocable and irrevocable. If the trust is set up primarily for probate avoidance, with the grantor retaining full interest or ownership in trust assets, the trust is likely revocable. Conversely, if the trust is created to distance the grantor of the trust from the trust assets with respect to their interest and ownership, the trust is likely an irrevocable trust.

Revocable trust

A revocable trust may also be called an inter vivos trust or living trust. The trust is disregarded for the purposes of taxation during the grantor's lifetime. The grantor is treated as the taxable owner of the trust property. There is no separation of trust assets from the grantor since the trust can be revoked or altered at any time by the grantor. Even though the trustee may be a different person than the grantor, the grantor retains all powers under the trust and enjoyment of trust assets. Since the grantor is treated as the taxable owner of the trust assets, the trust is generally established for reasons not connected with taxation, such as:

Probate avoidance - Revocable trusts may be established solely for avoidance of probate. Assets that are placed in a properly drafted revocable trust avoid probate as the trust document itself directs disposition of assets after death.

Estate planning - At the death of the grantor, every revocable trust becomes irrevocable. Revocable trusts may be established to segment the grantor's assets and pre-fund trusts that become effective after death.

Disability - Handling finances in the face of incapacity can be a challenge. Assets may be held in a revocable trust to provide trustee control over these assets if the grantor becomes unable to handle the grantor's affairs.

Irrevocable trust

Separating the grantor from property can serve many objectives, such as shifting the property out of the grantor's estate, shifting the future income tax liability associated with the property away from the grantor, and removing the future appreciation out of the grantor's estate.

Gifting is one way a person can transfer property. However, it may not be feasible or reasonable for the grantor to completely relinquish unfettered control of the property for a number of reasons. An irrevocable trust is a way for an individual to transfer their interest in property and still maintain some degree of control of the asset through the directives of the trust document.

Property transferred to an irrevocable trust is separated from the grantor and may be subject to a transfer tax upon transfer to the trust – gift tax during life, estate tax after death, or generation-skipping transfer tax (GSTT) if the transfer to the trust benefits a skip generation (no transfer tax may be due if the transfer amount is under the applicable exclusion amount). After the transfer is completed, the trust property is typically removed entirely for income tax, estate tax, gift tax, and GSTT purposes from the grantor.

⚠ Important

Many credit shelter trusts, spendthrift trusts, or special needs trusts are first established as revocable trusts. During the life of the grantor, the trust is revocable. At the death of the grantor the trust becomes irrevocable and the provisions regarding the distribution of assets post death become effective.

Examples of irrevocable trusts

- Credit shelter trust (bypass trust, B-trust, CST)
- Qualified terminable interest property trust (QTIP)
- Grantor retained annuity trust (GRAT)
- Intentionally defective grantor trust (IDGT)
- Special needs trust (SNT)
- Charitable remainder trust (CRT)
- Charitable lead trust (CLT)
- Irrevocable life insurance trust (ILIT)
- Irrevocable family trust
- Spendthrift trust
- Generation-skipping trust (GST)
- Spousal lifetime access trusts (SLAT)

An irrevocable trust is a separate taxpaying entity and operates under a different set of income tax rules. To dissuade the use of irrevocable trusts as tax shelters there is a separate, more compressed, income tax rate schedule for irrevocable trusts. The compressed tax rates serve to increase the amount of income tax paid on income retained in the trust.

Common types of irrevocable trusts

Trusts can have a variety of different names, with many different objectives. While this can make the topic somewhat intimidating, remember that all irrevocable trusts basically work in a similar fashion. The trust generally holds assets and passes income to an income beneficiary, and then passes the assets to a remainder beneficiary upon a predetermined event (such as someone's death).
The following are some of the more common types of irrevocable trusts.

Credit shelter trust (CST, bypass trust, unified credit trust, A/B trust, or B trust)

How the trust is created – A CST can be established in more than one way. Keep in mind that the CST usually does not exist until the death of the first spouse and once established is an irrevocable trust.

- **Testamentary** – The trust can be created through the will at death.
- **Revocable trust** – At the death of the grantor, the trust becomes irrevocable and the provisions of the CST become effective.
- **Irrevocable trust** – The CST can be funded during the life of the grantor with a gift of assets to the trust. By establishing the trust during life, trust appreciation is sheltered from future transfer tax.

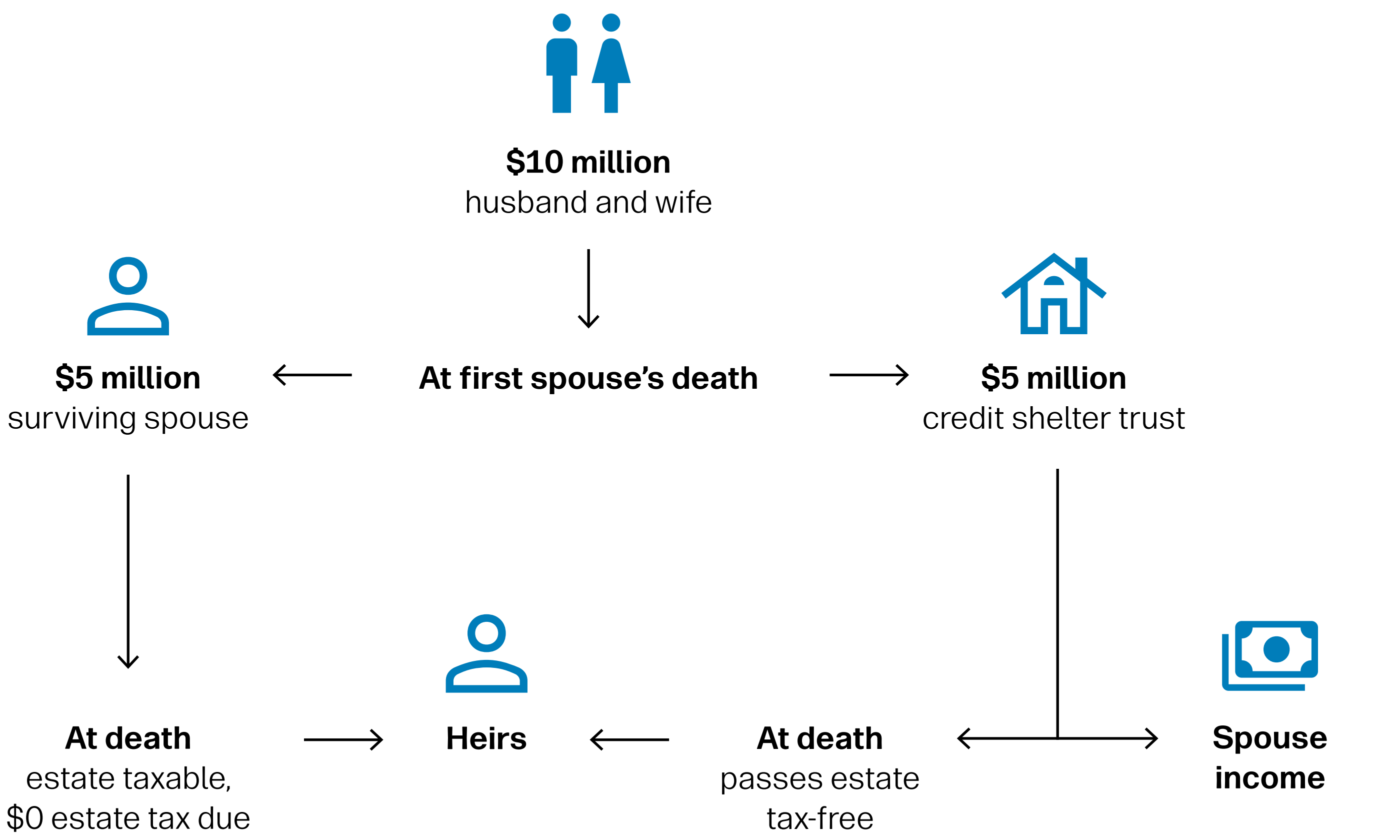
Purpose – Increase spousal estate tax exclusions while providing income to the surviving spouse

Benefits:

- **Increase use of estate tax exclusions**
- **Freeze asset value for estate tax purposes**
- **Provide income to the surviving spouse**

Trust mechanics – At the death of the first spouse an amount up to the current federal estate tax exclusion is transferred to the trust. The surviving spouse is not disinherited from the amount passed to the trust because he or she retains the right to income and can access principal according to an ascertainable standard set by the trust. The ascertainable standard for access to principal is generally referred to as HEMS (health, education, maintenance, and support). At the death of the surviving spouse, the value of the trust, including any growth, is passed to the remainder beneficiaries (most often the children) free of any transfer tax.

Exclusion portability – Under previous estate tax strategies, if assets were passed to a surviving spouse instead of a non-spouse, the estate tax exclusion of the deceased spouse was lost. To avoid losing the unused exclusion, assets were either passed to non-spouse beneficiaries at the first death, or the CST was funded to preserve the exclusion without disinheriting the surviving spouse. Preparing an estate would suggest that assets should not be owned jointly as joint ownership automatically passed the asset to the surviving spouse and did not provide an opportunity to fund the CST. With the introduction of exclusion, portability joint ownership does not preclude the ability to maximize spousal exclusions. Note that to preserve the deceased spouse's unused exclusion, an estate tax return must be filed.



QTIP (Qualified Terminable Interest Property) trust

Purpose – QTIP trusts are set up to provide income to the surviving spouse while avoiding disinheriting the heirs of the deceased spouse. QTIP trusts are often employed in situations of second marriages to protect children or relatives from the first marriage from being disinherited by the surviving spouse from the second marriage.

Benefits:

- **Protect beneficiaries:** Without a QTIP trust, assets would be left directly to the surviving spouse from the second marriage, potentially disinheriting the children or relatives from the first marriage.
- **Estate tax control:** Assets passed to the trust provide control over the surviving spouse, yet still qualify for the estate tax marital deduction.

Trust mechanics – At the death of the first spouse, the QTIP trust is funded. The surviving spouse retains an income interest from the trust during their lifetime. Assets are considered "Qualified Terminable Interest Property" and qualify for the estate tax marital deduction. Thus, no estate tax is due when the assets transfer to the trust. At the death of the surviving spouse, the remaining trust assets are paid to the beneficiaries specified in the trust. The surviving spouse cannot change the beneficiaries under the trust.

Intentionally defective grantor trust (IDGT)

Purpose – An IDGT is designed to exclude trust assets from the grantor's estate while intentionally being drafted to have the grantor taxed on trust income.

Benefits:

- **Avoids trust tax rates:** For tax purposes the grantor and the trust are the same. Any taxable income to the trust passes through to the grantor and is taxed at their income tax rate, not the trust tax rates. The IDGT allows the assets to accumulate in the trust without being forced to distribute trust assets to avoid the compressed trust income tax rates.
- **Assets in the trust pass free of estate tax:** Since the assets accumulate and are taxed at the more favorable individual income tax rates instead of the trust income tax rates, there is a greater potential to accumulate more and pass more assets free of estate tax.

Trust mechanics – When drafting the trust document, the grantor includes provisions that violate one or more of the grantor trust rules. Typically, the grantor retains the right to substitute assets of equivalent value for the assets ceded to the trust. By violating one or more of the grantor trust's rules, the income tax liability shifts to the grantor instead of the trust. Even though the trust is defective for income tax purposes, the trust is still separate for transfer tax purposes, passing free of estate, gift, and GSTT.

A basic understanding of estate planning can help you take care of the people who are important.

⚠ Important

An executor may be given discretionary power to elect amounts to transfer to a QTIP trust. This latitude affords the executor the flexibility to control the amount of assets that qualify for the marital deduction. Conversely, the executor may be able to exclude some assets from the QTIP trust exposing them to estate taxes. The flexibility in this arrangement allows the executor the ability to equalize the estate or maintain the option to have the asset included in the estate and be estate taxable at the first death.

The power of an executor to make or not make discretionary QTIP elections proved very valuable as an estate tax tool in 2010. By electing not to make QTIP elections in 2010, the executor could pass an unlimited amount free of estate tax, instead of using the marital deduction and subjecting the assets to the uncertainty of estate tax laws in the future. Since estate tax laws have changed rapidly, the addition of discretionary QTIP election powers to an estate can add flexibility for the estate executor.

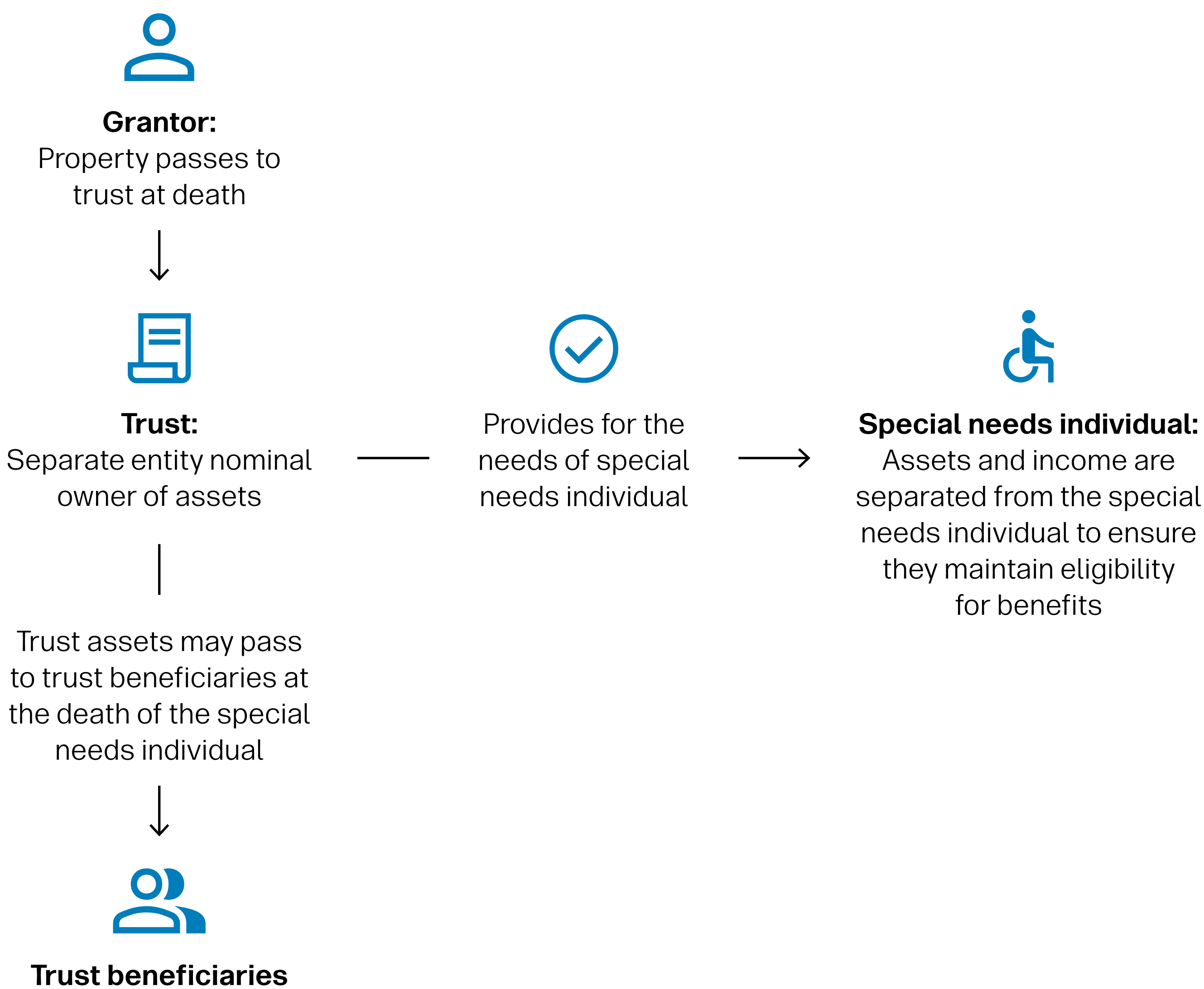
Special needs trust (supplemental needs trust)

Purpose – A trust established to separate assets from a special needs individual for the purpose of maintaining eligibility for asset and income-based benefits.

Benefits:

- Provides control over assets for an individual who may not be able to handle them otherwise
- Ensures the special needs individual maintains eligibility for asset and income-based benefits

Trust mechanics – A special needs trust is funded at the death of an individual who cares for a special needs individual. The assets pass to the trust instead of the special needs individual, which keeps the assets from being owned by the special needs individual. The special needs trust provides for the needs of the special needs person without disqualifying them for benefits, such as SSI and Medicaid.



Charitable remainder trust (CRT)

Purpose – A CRT provides the grantor a way to make a delayed charitable gift while receiving a current income tax deduction, an income stream, a reduction of the taxable estate, and avoidance of capital gains tax on the sale of assets when transferred to and sold by the trust.

Benefits:

- **Income stream:** During the trust term, which can be a specified number of years (not to exceed 20), single life or joint life, the grantor retains an income interest from the trust. The income paid from the trust will vary depending on the income specified in the trust document and the type of CRT selected.
- **Income tax deduction:** The grantor of the CRT receives a current income tax deduction for the future gift to charity at the end of the trust term. The amount of the income tax deduction is based on a calculation of the present value of the remainder interest. The variables used in the present value calculation are the income selected, type of CRT selected, term of the trust, and the current 7520 interest rate. The amount projected to be left to charity according to this calculation is the income tax deduction.
- **Estate reduction:** The remaining assets in the trust are left to a charity and excluded from the taxable estate.
- **Capital gains advantages:** The ideal assets to gift to a CRT are appreciated capital gains assets. The sale of the assets in the trust does not generate a capital gains tax since the CRT is tax-exempt. Instead, the entire proceeds from the assets are able to be repositioned inside the trust.

Taxation – CRTs are tax-exempt. Any taxable income earned by the trust is not currently taxed. Income that pays out of the trust follows a four-tiered accounting system. Four-tiered accounting, sometimes referred to as WIFO (worst-in, first-out) pays income in the following order:

- **Ordinary income**
- **Capital gains income**
- **Tax-exempt income**
- **Trust corpus**

Trust mechanics – Once the trust is drafted, the assets are gifted to the trust. By transferring assets to the trust, the grantor receives an income tax deduction based on the present value of the remainder interest calculated to pass to charity at the end of the trust term. If the asset is not cash, the trustee will sell the asset. If it is a capital gains asset, the sale of the asset by the trust will not result in capital gains tax due to the fact that the trust is tax-exempt. The grantor will receive an income stream from the trust at least annually for the duration of the trust. At the death of the trust income beneficiary or at the end of the trust term, the remainder pays out to the charity or charities listed.

⚠ Important

One objection to the use of a CRT is that the asset passes to a charity instead of the grantor’s heirs. If the grantor is insurable, one solution is to set up an Irrevocable Life Insurance Trust (ILIT) to replace the amount left to charity. When used in conjunction with a CRT, the ILIT is called a Wealth Replacement Trust (WRT).

To qualify as a CRT, the present value calculation must show a remainder interest passing to charity that is at least 10% of the initial gift. The more income the grantor elects to receive, the less likely the CRT will pass this test.

Income taxes and estate taxes

In this section, we'll review the two primary areas of taxation that impact the estate planning process: income taxes and estate taxes. It should be noted that this section is intended as a general overview of trust taxation. You should consult a knowledgeable tax advisor for specific guidance.

Income tax

When assets pass from one individual to another, either at death or by gift, the individual receiving an asset receives not only the asset but also the potential tax liability associated with that asset. For that reason, a careful review of the income tax implications of transferring assets is an important part of the estate-planning process.

Adjusting cost basis: step-up or step-down

Cost basis is the starting point for calculating gain or loss realized on the sale of an asset. Assets owned by a decedent receive a new federal income tax cost basis or adjusted cost basis upon death, which is typically equal to the current fair market value of the assets.* When the fair market value of the asset is higher than the original cost basis of the asset, the cost basis is adjusted or "stepped up" to the current fair market value. Likewise, if the current fair market value of an asset is less than the original cost basis, the new cost basis is adjusted down to the current fair market value.

The step-up or step-down of cost basis is an important tax planning consideration that relates to the sale of assets after death as well as assets that may be held until death. When considering assets that will pass to beneficiaries, the step-up in cost basis is frequently stated as a tax advantage, which it may be if the assets appreciate in value. However, the potential for a step-down in basis should not be overlooked.

A careful analysis of passing assets at death versus gifting assets during life can reveal some important tax planning considerations.

What is cost basis?

Cost basis is the original value of an asset for tax purposes (usually the purchase price), adjusted for stock splits, dividends, and return of capital distributions. This value is used to determine the capital gain, which is equal to the difference between the asset's cost basis and the current market value, also known as "tax basis."

* Does not apply to assets that are considered income in respect of a decedent (IRD)

A simple formula for calculating gain or loss can be expressed as follows:

Amount realized on the sale of an asset − **Cost basis: original value of asset** = **Realized gain or loss**

Income in respect of a decedent (IRD)

IRD is essentially defined as income that the decedent would have included in gross income if he or she had lived. IRD includes tax-deferred gain in an annuity contract, pretax contributions and earnings in IRAs and other qualified retirement plans, income owed to the decedent, or installment payments received after the owner's death. IRD assets do not escape taxation; rather, the estate or beneficiary who receives the IRD will be taxed in the same manner that it would have been taxed to the decedent. IRD assets do not receive a step-up or step-down in basis upon the death of the decedent.

The IRD deduction

When reviewing the tax implications of inherited assets, it is important to understand both the tax treatment of IRD assets as well as the income tax deduction that you may be able to claim to offset any income tax liability you incur upon receipt of the asset. The estate or beneficiary that includes an item of IRD on an income tax return is entitled to an income tax deduction on the same return for the amount of additional federal estate tax that is attributable to the inclusion of that item in the decedent's federal estate tax return.

For example, assume that you inherited an IRA worth $100,000 that consisted entirely of pretax contributions and earnings. If you liquidated the IRA and received the proceeds in cash, the $100,000 would be considered ordinary income in the year received, subject to ordinary income tax. If we further assume that the decedent's estate exceeded the applicable estate tax exclusion amount resulting in estate taxes being paid and $40,000 in estate taxes attributable to the $100,000 IRA, you would be able to claim an income tax deduction (the IRD deduction) of $40,000 as an offset to the $100,000 of ordinary income.

When a substantial portion of your assets are held in retirement plans and IRAs, income tax considerations for the estate and beneficiaries is critically important. Make sure beneficiaries and trustees understand the taxation of IRD assets and do not overlook the IRD deduction when applicable.

The federal estate tax

Transfers of property after death are subject to an estate tax. The estate tax is paid by the estate of the deceased and is assessed against all property interests, tangible and intangible, owned by the deceased at the time of their death.

A distinction must be made between the estate tax and inheritance taxes. An inheritance tax is assessed against the beneficiary's right to receive property, whereas an estate tax is imposed on the transferor's estate for the privilege to transfer property. Individual states may have an inheritance tax or an estate tax on top of the federal estate tax. This section will focus only on the federal estate tax.

Estate tax exclusion

Amount that an individual can pass to a non-spouse beneficiary at death free of estate tax

Terminology note

The terms "estate tax exclusion" and "estate tax credit" are used interchangeably in estate planning. The difference between the two is that the estate tax credit offsets the estate tax due dollar for dollar, whereas the exclusion amount represents the amount of property the credit shelters from the estate tax. The estate and gift tax (discussed later) credit combined is referred to as the unified credit. An individual also has a generation-skipping transfer tax exemption amount which is currently equal to the estate and gift tax exclusion amount.

Exclusion portability

Amounts added to a surviving spouse's estate tax exclusion amount for the unused portion of their deceased spouse's exclusion amount. The portability of the unused estate tax exclusion to the surviving spouse was not available for deaths occurring prior to January 1, 2011.

Unlimited marital deduction

U.S. citizen spouses can transfer an unlimited amount of assets to each other free of estate or gift tax.

Charitable estate tax deduction

Unlimited deduction for amounts passed to charities at death

Form 706

The estate and generation-skipping transfer tax return

Form 709

The gift tax return

⚠ Important

The trust income tax rates are set up to dissuade accumulation of trust assets. Trust beneficiaries may not desire income and instead wish to accumulate assets in the trust. To reduce income tax paid at the trust income tax rate and mitigate ongoing distributions of trust income to income beneficiaries that do not want income, the trustee may place trust assets into investments that:

- **Produce little or no current income:**
  - Capital gains assets that do not generate dividends or short-term capital gains enable the trustee the ability to choose when to recognize taxation by selling the asset as a long-term capital gain. Non-dividend paying, low-turnover mutual funds, ETFs (exchange-traded funds), SMAs (separately managed accounts), and stocks are all investments that may provide the opportunity for long-term capital gains.
- **Are tax-deferred:**
  - Tax-deferred assets provide the trustee with complete control over the taxation because the trustee selects when to recognize taxation through a withdrawal. Tax-deferred assets include life insurance cash values and deferred annuities. Additionally, assets that are tax-deferred do not run the risk of inadvertently generating a dividend or a short-term capital gain.
- **Are tax-free:**
  - By investing in assets that produce tax-free income, the trustee can eliminate the issue of trust taxation altogether. Municipal bond income and life insurance death benefits may provide tax-free income. Before purchasing life insurance, it is necessary to determine if the trust document allows for the purchase of life insurance. The trust may also need to have an insurable interest in the insured.

The net investment income tax and trusts

The net investment income tax (NIIT), also known as the unearned income Medicare contribution tax, assesses an additional 3.8% tax on the lesser of net investment income or excess modified adjusted gross income (MAGI) above certain thresholds for high income individuals. Trusts and estates are assessed the tax on the lesser of undistributed net investment income or excess adjusted gross income (AGI) over the applicable threshold.

NIIT threshold amounts by filing status for 2025

Married filing jointly:
Income over $250,000

Single filers:
Income over $200,000

Trusts and estates:
Income over $15,650

Tax on long-term capital gain and qualified dividends rate of 20% for 2025

Joint filers:
Income over $600,050

Single filers:
Income over $533,400

Trusts:
Income over $15,900

Estates and trusts for 2025

Earned income:
Not over $3,150 – 10% bracket

Earned income:
Over $3,150, but not over $11,450 – 24% bracket

Earned income:
Over $11,450, but not over $15,650 – 35% bracket

Earned income:
Over $15,650 – 37% bracket

Estate tax strategies

According to the IRS, the laws surrounding estate and gift tax are some of the most complex found in the Internal Revenue Code. It is essential that the execution of an estate, gift, or generation-skipping transfer tax strategy be accompanied by consultation with an attorney or certified public accountant (CPA) well-versed in the subject. The advent of recent estate tax law changes, including the portability of exclusion amounts between spouses, has reduced the need for estate tax planning strategies for some individuals.

Once a couple, or individual, has more assets than their estate tax exclusion will cover, other strategies can be employed to mitigate the impact of the estate tax. The main objectives of preparing for the estate tax are to:

1. Provide liquidity to cover the estate tax liability

2. Reduce the size of the taxable estate to reduce the estate tax owed

Life insurance

Life insurance can be one way to generate the necessary liquidity needed to help pay any estate tax that may be due.

Fund an irrevocable life insurance trust (ILIT)

If life insurance is owned by the deceased, it is an asset included in his or her estate for estate tax purposes. The inclusion of the life insurance policy has the effect of increasing the value of the estate, which results in more estate tax due. To avoid inclusion of the life insurance policy in the estate, the owner may wish to hold the life insurance policy in an ILIT. Policies owned in an ILIT are not part of the estate and do not increase the value of the estate for estate tax purposes. ILITs are discussed in greater detail in the Gift Tax section.

Trust

Some family situations may be complex and require the use of a trust to ensure multiple interests, sometimes conflicting, are satisfied while maximizing estate tax exclusions and separation of the grantor from trust assets.

The credit shelter trust (CST) has traditionally been the standard trust used to maximize the estate tax exclusion for spouses without disinheriting a spouse from enjoyment of income from the trust and, in some circumstances, principal from the trust. Trusts can also be used to freeze growth out of an estate through gifts during life.

Charitable planning

Charitable gifting can be a powerful planning tool if used properly in an estate plan. Any gifts made to charity at death are deducted from the gross estate. Likewise, any charitable gifts made during life are excluded from the estate and are free of gift tax.

Gifting

Gifts made during life can reduce the size of an estate. One major benefit of gifting is the exclusion of future growth generated by the gifted asset from the estate.

⚠ Important

A thorough estate plan must take into consideration the impact of state inheritance tax and state estate tax. The rules for these state taxes may vary drastically from the federal transfer tax regime. Many states choose to mirror the rules for the federal transfer tax system for simplicity. However, since the passage of EGTRRA (Economic Growth and Tax Relief Reconciliation Act of 2001) and a progressive increasing of the federal exclusion amount, many states have "decoupled" from the federal rules.

Prior to portability of the estate tax exclusion, many estate planning attorneys would avoid joint ownership and split property between spouses to maximize the use of each spouse's estate tax exclusion amount. With the introduction of exclusion portability, it may be advisable to reevaluate account ownership structures to see if you could benefit from a jointly owned account.

The gift tax

Just like transfers after death are subject to an estate tax, certain transfers made during life are subject to a gift tax.

The two taxes work in tandem, and the gift tax itself is intended to prohibit people from avoiding the estate tax by excessive transfers during life. Gifts made during life can still have a profound impact on the reduction of a taxable estate over time. The gift tax system is complex, so it is important to consult with an attorney, and a thorough understanding of the rules should be gained before executing a gifting strategy.

Annual gift tax exclusion

To reduce reporting on nominal gifts, there is an annual gift tax exclusion amount. This annual exclusion represents the amount of assets a person can transfer on an annual basis to each person without a gift tax or reporting requirement.

To qualify for the annual exclusion, the gift must be a present interest gift.

Present interest gift: An unfettered and immediate transfer of property

Future interest gift: Full use and enjoyment of the property transfers at some point in the future

Lifetime gift tax exclusion

The lifetime gift tax exclusion represents the amount that a person can gift over their lifetime without a gift tax due. Any amount gifted over the annual exclusion requires the donor to complete a gift tax return. Even though a gift tax return is completed, there may be no gift tax due. Amounts gifted in excess of the annual gift tax exclusion reduce the lifetime gift tax exclusion. Only when cumulative lifetime gifts exceed the lifetime gift tax exclusion amount would a gift tax be due.

What is a gift?

A gift is any transfer of property during life without adequate consideration. A gift can be any type of property and does not have to be in cash.

To be a taxable gift the transfer must:

- Result in the owner fully relinquishing ownership and control of the property
- Have been made for less than its value
- Exceed the annual gift tax exclusion
- Have been completed

Note on the gift tax: Unlike the income tax, the gift tax is a tax assessed against the person gifting the asset (donor) and not the person receiving the asset (donee).

Marital deductions and gift splitting

Marital deduction

Gifts between U.S. citizen spouses during life are free from gift tax regardless of amount. Special rules apply to gifts to non-U.S. citizen spouses.

Gift splitting

A married couple can aggregate their gift tax exclusion. The ability to split gifts allows one spouse to give twice the annual exclusion amount to each donee per year. As long as the spouse consents to split gifts, the presumption is that the gifted amount constitutes a 50% gift from each spouse. A gift tax return is required for spouses making split gifts.

⚠ Important

It may be more advantageous to transfer capital gains assets at death rather than through a gift. At death, capital gains assets are eligible for a step-up in cost basis. If the value of the asset is significantly higher than the cost, the beneficiary's cost basis is adjusted to the current value. This "step-up" can also be a "step-down" as the cost basis is adjusted at death to the current value, whether higher or lower.

Nontaxable (gift tax) transactions

Some transfers of property are excluded from the gift tax rules, such as:

- Qualified disclaimers
- Education tuition paid directly to the institution
- Medical care expenses paid directly to the institution
- Contributions to political organizations
- Charitable contributions
- Promises to make a gift
- Certain transfers in the course of ordinary business
- Bad bargains
- Incomplete gifts
- Loans with appropriate interest rate terms

Note: Special rules apply to each of these exclusions from gift tax.

Gift tax considerations should not be limited to only the annual gift tax exclusion and the lifetime gift tax exclusion, but may include other avenues of gifting as well. You may reduce the size of your estate by giving money through nontaxable transfers. Payment of education tuition for another person, regardless of amount, is a nontaxable transfer. With escalating education expenses, the gifting of tuition for children or grandchildren can accomplish both educational and wealth transfer objectives. The direct payment of someone else's medical expenses and contributions to political causes are also generally exempt from gift taxes. Keep in mind that these types of gifts must be made to the applicable entity or institution and not the individual intended to benefit from the transfer.

Basis of gifted property

If the gift is of appreciated capital gains property then the donor's original basis carries over to the donee.

What needs to be filed?

No filing is required for gifts under the annual gift tax exclusion.

Any split gifts or gifts over the annual gift tax exclusion per person require the filing of a gift tax return, IRS Form 709.

During periods of low interest rates a loan may be an acceptable alternative to a taxable gift of property. The interest rate of a loan between family members must be equal to or greater than the Applicable Federal Rate (AFR) in order to avoid treatment as a gift.

Gift tax strategies

Carefully planned gifts can have a positive impact on an estate plan by reducing estate tax and providing a legacy while alive.

Systematic gifting

Gifts or split gifts of the annual exclusion amount cumulatively over time can substantially reduce the size of the taxable estate. Since the annual gift tax exclusion is applied separately to each donee, the higher the number of donees the more the donor can give away each year. The annual gift tax exclusion does not impact the unified credit, so any gifts passed through the annual exclusion have the effect of reducing the estate dollar for dollar.

Lifetime gifts to trusts

Shifting the appreciation of an asset out of the owner's estate is a primary advantage of lifetime gifts. However, it may not be feasible for someone to make a gift outright. The donee may be a spendthrift or lack the capacity to handle a gift.

A trust may be necessary in any circumstance where the donor wishes to provide direction to the trustee as to how the trust assets should be handled with respect to the donee(s). Any transfer to an irrevocable trust during life over the annual gift tax exclusion amount is considered a taxable gift and will reduce the lifetime gift tax exclusion amount. One major advantage to this strategy is the freezing of any growth attributed to the gift from the grantor.

Irrevocable life insurance trusts

Life insurance can be a problematic asset to own due to the way it is valued in the estate. For estate tax purposes the life insurance death benefit is the value included in the taxable estate, not the cash value. Life insurance death benefits can be very large and can inflate the size of the estate.

To avoid the inclusion of the life insurance death benefit in the estate, you may want to consider owning life insurance in an irrevocable life insurance trust (ILIT). Life insurance premiums are generally paid by the donor through the use of the annual gift tax exclusion. Since only present interest gifts can qualify for the annual gift tax exclusion, the use of a Crummey power is necessary to establish the gift to the ILIT as a present interest gift and not the future gift of a life insurance benefit.

A Crummey power allows the beneficiary of the trust to demand the lesser of the annual exclusion amount per donor, the amount contributed, or in some cases the greater of $5,000 or 5% of the trust's assets at the time of withdrawal. This ability is expressed to each trust beneficiary in the form of a Crummey letter, which notifies each trust beneficiary of their right to demand money from the trust. A Crummey power allows the annual gift to be withdrawn within a specified time period before being added to the trust, allowing it to be treated as a completed gift.

Probate reduction

Lifetime gifts also have the advantage of reducing the amount of assets transferred at death subject to probate. As discussed in the Beneficiary Designation section, probate can cause delays and can be costly. By gifting assets during life, fewer assets are subject to administrative fees for transfers after death.

⚠ Important

Growing gifted assets should be a priority after completing a gift. Investments providing an opportunity for growth should be considered.

Spouses should consider splitting gifts to increase the amount that can be passed to specified donees each year.

You may own an existing life insurance policy that you may desire to transfer to an ILIT to avoid inclusion in the estate. If you transfer existing life insurance policies to an ILIT, you should contact the current life insurance carrier to ascertain the value of the policy for gift tax purposes. The transfer also needs to occur more than three years before death to avoid inclusion of the policy in your estate. If you die before three years after transferring the policy, the value is brought back into your estate due to your original incidence of ownership in the policy (IRC 2035).

Charitable giving

As discussed previously, you can give an unlimited amount to charity without any gift tax due. Charitable gifts reduce the size of the estate on any funds donated during life. Unlike charitable bequests at death, charitable gifts during life come with the added advantage of recognition for making the gift. Charitable gifts may provide an income tax deduction for the benefit of the donor as well.

Benefits of gifting

A coordinated gifting program is a primary element in an effective estate plan. The benefits of gifting go far beyond estate reduction.

Income tax shifting: Assets that currently generate income may be appropriate assets to gift. If the donor is in a high income tax bracket and the donee is in a low income tax bracket, the future income tax liability can be shifted to the donee's lower tax rate by gifting the asset. This may reduce the donor's adjusted gross income and may make them eligible for deductions and tax credits they were previously not eligible for due to high income. A review of the Kiddie Tax rules is recommended for donees who are minors.

Estate reduction: The most obvious advantage of gifting is the reduction of the taxable estate. It is important to note that only gifts below the annual exclusion will truly reduce the estate tax due. Gifts made using the lifetime gift tax exclusion are not taxable at the time they are made but will reduce the unified credit amount. Therefore, from an estate tax standpoint it does not matter if the gift occurred during life or the asset was passed after death – the unified credit is reduced by the same amount. However, gifts made during life using the lifetime gift exclusion can shift future growth out of the estate thereby reducing the ultimate estate tax due.

Appreciation shifting: Assets with high growth potential may increase the size of the owner's estate over time. By gifting an asset with high growth potential, the individual can freeze the future growth of the asset out of their estate.

Valuation discounts: Certain assets may not be valued at fair market value for gifting purposes. These assets can be gifted at a discount making a gifting program more advantageous.

⚠ Important

A gift tax discussion can be paired with a beneficiary designation review with the aim of reducing the amount of assets passed through probate.

One major challenge with large charitable gifts is that they are irrevocable. Once the asset is donated, the owner no longer maintains the enjoyment of the asset or income derived from the asset. If you are making large charitable gifts, it may be advantageous to employ a planned giving strategy. By utilizing a planned giving strategy, such as a charitable gift annuity, charitable lead trust, or charitable remainder trust, you can make the gift but still maintain benefits from the gift.

The generation-skipping transfer tax

The gift tax system is in place to avoid gratuitous transfers during life intended to circumvent the estate tax system. The generation-skipping transfer tax (GSTT) is in place to avoid transfers that skip a generation that result in less estate tax at the death of the skipped generation. As each generation passes away, its estate has the potential to be assessed an estate tax. Therefore, the purpose of the GSTT is to obtain one transfer tax per generation.

What is the GSTT?

The GSTT applies to any taxable transfer made to a transferee considered more than one generation level below the transferor. The GSTT is applied to any transfer – either during life or at death – that passes to a skip beneficiary and is applied in addition to any estate or gift tax owed. Even with the GSTT system in place, there can still be benefits to skipping a generation.

Benefits of skipping a generation

Reduced estate tax for the skipped generation: Just like the estate and gift tax, there is an exclusion amount that shields assets from the GSTT. The federal transfer tax system currently has a unified exemption amount. That means individuals can pass their GSTT exemption amount to a skip generation without it being subject to GSTT or increasing the value of the skipped generation's estate.

Longer stretch period for IRAs and qualified plans:* For non-spousal beneficiaries of IRAs and qualified plans, the longest possible post-death distribution period is the single life expectancy of the beneficiary. Selecting a younger beneficiary provides a longer post-death distribution period and thus a longer period of time to defer tax on the undistributed portion. It may be advantageous to leave IRA and qualified plans assets to grandchildren instead of children to increase the post-death distribution period.

Spendthrift issues: The children may be irresponsible or otherwise unable to handle a sizable inheritance. In these circumstances you may want to consider skipping the children by establishing a spendthrift trust for the benefit of the grandchildren.

The purpose of the GSTT is to obtain one transfer tax per generation.

* A life insurance company may be required to withold and pay generation-skipping transfer tax on life insurance and annuity death benefits of $250,000 or more. See Treasury Regulation 26.2662-1.

Notes:

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