THE ESTATE PLANNER

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Basis points

How planning can minimize the impact of income taxes

Until recently, estate planning strategies generally focused on removing as much wealth as possible from one's estate to avoid the bite of federal estate tax. Although there were income tax advantages to retaining assets in an estate, the estate tax costs usually eclipsed any potential income tax savings.

But things have changed: Between 2001 and 2023, the federal gift and estate tax exemption soared from $675,000 to $12.92 million. During that same time, the highest estate tax rate dropped from 55% to 40%. (Note: In 2026, the exemption is scheduled to drop to around $6 million, barring further legislation from Congress.) Today, only the wealthiest of families are exposed to estate tax liability, elevating the importance of income tax planning.

Income vs. estate tax

Here's why income tax matters: If you give an asset to your child or other loved one during your lifetime, your tax basis in the asset carries over to the recipient. If the asset has appreciated significantly in value, that means a sale of the asset will result in a capital gain.

For example, say you bought a piece of real estate 20 years ago for $200,000 and its value has grown to $1 million. If you give the property to your child, who decides to sell it, he or she will be liable for as much as $160,000 in long-term capital gains tax (20% of the $800,000 gain).

In contrast, when an asset is transferred at death — that is, via "bequest, devise or inheritance" — the recipient's basis is "stepped-up" to the asset's date-of-death fair market value. The recipient can turn around and sell the asset tax-free (apart from any tax on post-death gains). Thus, from purely an income tax perspective, it's advantageous to hold on to appreciating assets rather than gifting them during your lifetime.

If there's little chance that your estate will exceed the gift and estate tax exemption, then retaining these assets until death can minimize the impact of income tax on your heirs. However, if your estate is large enough that estate tax liability is a concern,

IRS: No stepped-up basis for assets in grantor trust

The intentionally defective grantor trust (IDGT) is a popular estate planning tool that allows you to remove assets from your estate for estate tax purposes while continuing to be treated as their owner for income tax purposes. A type of irrevocable trust, an IDGT allows you to shield all future appreciation in the assets' value from estate tax, while continuing to pay the trust's income taxes, further reducing the size of your taxable estate.

Some experts have argued that because assets gifted to an IDGT remain taxable to the grantor for income tax purposes, they're entitled to a stepped-up basis in the hands of the beneficiaries. However, in Revenue Ruling 2023-2, the IRS clarified that assets in an IDGT aren't received by bequest, devise or inheritance and, therefore, aren't eligible for a stepped-up basis.

the possibility of income tax savings may be outweighed by the potential estate tax bill.

In that case, a better strategy may be to remove assets from your estate — through outright gifts, irrevocable trusts or other vehicles. Doing so will shield future appreciation in their value from estate tax.

Crunch the numbers

To determine the right strategy for you and your family, you need to do some forecasting. By estimating the potential income and estate tax liabilities associated with various options, you can get an idea of whether you should focus your planning efforts on income tax or estate tax. Of course, if there's little chance that your estate will exceed the exemption (even if it falls in 2026), then it makes sense to adopt strategies that minimize income tax. But for some families, it may be a closer call.

Suppose, for example, that Mark (a single father) owns assets valued at $7 million, including a piece of real estate valued at $1 million with a $200,000 tax basis. If he gives the property to his daughter, Ella, she'll be exposed to $160,000 in income tax if she sells it (assuming she's subject to the 20% long-term capital gains rate). The gift is free of gift tax by virtue of the $12.92 million exemption.

Now, suppose instead that Mark holds on to the property until his death in 2026. At that time, the real estate value has grown to $1.2 million, Mark's taxable estate is $7.5 million, and the estate tax exemption has dropped to $6 million. Ella inherits the real estate with a stepped-up basis of $1.2 million, avoiding $200,000 in capital gains tax. But Mark's estate is subject to $600,000 in estate taxes [40% x ($7.5 million – $6 million)]. Had Mark given Ella the property earlier, she would be potentially liable for $160,000 in income tax but Mark's estate would have been reduced by $1.2 million to $6.3 million, resulting in estate taxes of $120,000 — a $480,000 savings.

Peer into your crystal ball

As the above example shows, unless it's clear that estate tax won't be a concern, determining the right strategy requires some prognosticating. The answer depends on several factors, many of which are uncertain, including how long you'll live, whether (and how much) your assets will appreciate and whether estate tax rates or exemption amounts will be adjusted further by Congress. Your tax and estate planning advisors can help you navigate these uncertainties and design a plan that makes sense for you.

Preserve wealth for future generations with a spendthrift trust

Is protecting your wealth after it's been transferred to beneficiaries just as important to you as reducing the tax liability on the transfers? If so, attaching spendthrift language to a trust can provide you peace of mind that your hard-earned wealth won't be frivolously spent by your heirs or seized by their creditors. Indeed, the benefit of a spendthrift trust is that it restricts a beneficiary's ability to access trust funds.

How does a spendthrift trust restrict access?

Briefly stated, a beneficiary can't tap directly into the principal or transfer rights to it to someone else. This can also deny access to creditors or a divorced spouse of a beneficiary.

Instead, the trust beneficiary relies on the trustee to provide payments based on the trust's terms. This could be in the form of regular periodic payouts or on an "as needed" basis. The trust document will spell out the nature and frequency, if any, of the payments. Once a payment has been made to a beneficiary, the money then becomes fair game to any creditors.

The designation of the trustee can take on even greater significance if you expect to provide this person with broad discretion.

Note that a spendthrift trust isn't designed primarily for tax-reduction purposes. Typically, this trust type is most beneficial when you want to leave money or property to a family member but worry that he or she may squander the inheritance. For example, you might think that the beneficiary doesn't handle money well based on experience or that he or she could easily be defrauded, has had prior run-ins

with creditors, or suffers from an addiction that may result in a substantial loss of funds.

If any of these scenarios is a possibility, a spendthrift trust can provide asset protection. It enables the designated trustee to make funds available for the beneficiary without the risk of misuse or overspending. But that brings up another critical issue.

What's the trustee's role?

Depending on the trust terms, the trustee may be responsible for making scheduled payments or have wide discretion as to whether funds should be paid, how much and when. For instance, the trust may empower the trustee to make set payments or retain discretion over amounts to be paid, or decide if there should even be any payment at all.

Or perhaps the trustee will be directed to pay a specified percentage of the trust assets, so the payouts fluctuate, depending on investment performance. Similarly, the trustee may be authorized to withhold payment upon the occurrence of certain events (for example, if the beneficiary exceeds a debt threshold or declares bankruptcy).

The designation of the trustee can take on even greater significance if you expect to provide this person with broad discretion. Frequently, the trustee will be a CPA, attorney, financial planner or investment advisor, or someone else with the requisite experience and financial know-how. You should also name a successor trustee in the event the designated trustee passes away before the term ends or otherwise becomes incapable of handling the duties.

What are other considerations?

Be aware that the protection offered by a spendthrift trust isn't absolute. Depending on applicable law, it may be possible for government agencies to reach the trust assets — to satisfy a tax obligation, for example.

It's also important to establish how and when the trust should terminate. It could be set up for a term of years or for termination to occur upon a stated event, such as a child reaching the age of majority.

Turn to a professional

Unless you're an experienced legal or financial professional, drafting a spendthrift trust isn't a do-it-yourself proposition. Turn to an experienced estate planning advisor or attorney to ensure your trust satisfies all the legal formalities.

Form over substance

Documenting charitable donations is critical

Taxpayers who itemize deductions are entitled to deduct charitable donations, subject to certain requirements and limitations. One of the requirements is the need to substantiate charitable gifts with documentation that satisfies the tax code and IRS regulations.

This is an area where the IRS takes a "form over substance" approach. A charitable gift may be perfectly legitimate, but if the taxpayer fails to substantiate it properly, the deduction may be lost. Here's a brief overview of the substantiation requirements.

Cash donations

Cash donations, regardless of the amount, must be substantiated with one of the following:

Bank records. This can include bank statements, electronic fund transfer receipts, canceled checks (including scanned images of both sides of a check from the bank's website) or credit card statements; or

Written communication. This can be in the form of a letter or email from the donor organization, showing the donee's name, date of the contribution and the amount of the contribution. A blank pledge card furnished by the donee isn't sufficient.

In addition to the above, cash donations of $250 or more require a contemporaneous written acknowledgement (CWA) from the donee that details the following:

- The amount of the contribution, and
- A description and good faith estimate of the value of any goods or services provided in consideration (in whole or in part) for the donation.

A single document can be used to meet both the written communication and CWA requirements. For the CWA to be "contemporaneous," you must obtain it by the earlier of 1) the extended due date of your tax return for the year the donation is made, or 2) the date you file your return.

A charitable gift may be legitimate, but if the taxpayer fails to substantiate it properly, the deduction may be lost.

If you make charitable donations via payroll deductions, you can substantiate them with a combination of an employer-provided document — such as Form W-2 or pay stub — that shows the amount withheld and paid to the donee, *and* a pledge card or similar document prepared by or at the direction of the donee showing the donee's name.

For a donation of $250 or more by payroll deduction, the pledge card or other document must also state that the donee doesn't provide any goods or services in consideration for the donation.

Noncash donations

Noncash donations of less than $250 must be substantiated with a receipt from the donee showing the donee's name and address, the date of the contribution, and a detailed description of the property. For noncash donations of $250 or more, there are additional substantiation requirements, depending on the size of the donation:

- Donations of $250 to $500 require a CWA.
- Donations over $500, but not more than $5,000, require a CWA and you must complete Section A of Form 8283 and file it with your tax return. Section A includes a description of the property along with its fair market value and the method of determining that value.

- Donations over $5,000 require all the above, plus you must obtain a qualified appraisal of the property and file Section B of Form 8283 (signed by the appraiser and the donee). There may be additional requirements in certain situations. For instance, if you donate art of $20,000 or more, or if any donation is valued over $500,000, you must attach a copy of the appraisal to your return. Note: No appraisal is required for donations of publicly traded securities.

Additional rules may apply for certain types of property, such as vehicles, clothing and household items, or securities.

Complex rules

The regulations on the substantiation of charitable donations are complex, and one misstep can cause you to lose valuable tax deductions. When in doubt, consult your tax advisor to ensure that you're properly following all the rules.

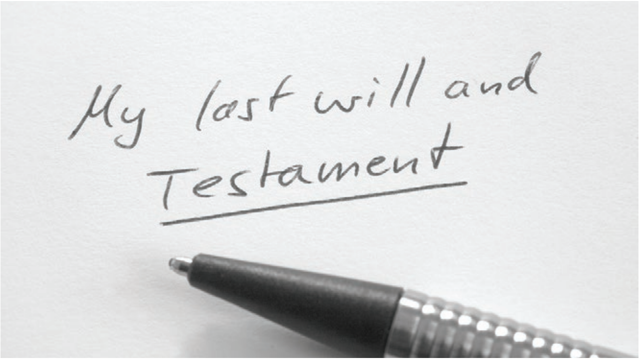
ESTATE PLANNING RED FLAG

You have a holographic will

Aretha Franklin died more than five years ago, but it wasn't until this year that a Michigan jury gave her estate planning wishes some respect, holding that a handwritten document discovered under her couch cushions was a valid will. This case illustrates the dangers of so-called "holographic" wills: They often lead to conflict among family members and lengthy court battles.

Initially, the singer's family thought she had no will, in which case her estate would have been divided equally among her four sons under the laws of intestate succession. A few months after she died, however, the family discovered two handwritten "wills" in her home. The first, dated 2010 and found in a locked cabinet, was signed on each page and notarized. The second, dated 2014, was found in a spiral notebook under her couch cushions and was signed only on the last page. The two documents had conflicting provisions regarding the distribution of her homes, cars, bank accounts, music royalties and other assets, leading to a fight in court among her heirs.

Ultimately, the jury found that the 2014 handwritten document should serve as her will. Michigan, like many states, permits holographic wills. These wills, which need not be witnessed like formal wills, must be signed and dated by the testator and the material portions must be in the testator's handwriting. In addition, there must be evidence (from the language of the document itself or from elsewhere) that the testator intended the document to be his or her last will and testament.



Holographic wills can be quick, cheap and easy, but they can come at a cost. Absent the advice of counsel and the formalities of a traditional will, handwritten wills tend to invite challenges and interfamily conflict. In addition, because they aren't prepared by an attorney, holographic wills tend to be less thorough and often contain ambiguous or unclear language.

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