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Estate Planning Red Flag

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Rising rates spark interest in charitable remainder trusts

If you wish to leave a charitable legacy while generating income during your lifetime, a charitable remainder trust (CRT) may be a viable solution. In addition to an income stream, CRTs offer an up-front charitable income tax deduction, as well as a vehicle for disposing of appreciated assets without immediate taxation on the gain. Plus, unlike certain other strategies, CRTs become more attractive as interest rates rise. In the current environment, that makes them particularly effective.

How do CRTs work?

A CRT is an irrevocable trust to which you contribute stock or other assets. The trust pays you (or your spouse or other beneficiaries) income for life or for a term of up to 20 years, then distributes the remaining assets to one or more charities. When you fund the trust, you're entitled to a charitable income tax deduction (subject to applicable limits) equal to the present value of the charitable beneficiaries' remainder interest.

There are two types of CRTs, each with its own pros and cons:

- A charitable remainder annuity trust (CRAT) pays out a fixed percentage (ranging from 5% to 50%) of the trust's initial value and doesn't allow additional contributions once it's funded.
- A charitable remainder unitrust (CRUT) pays out a fixed percentage (ranging from 5% to 50%) of the trust's value, recalculated annually, and allows additional contributions.

CRATs offer the advantage of uniform payouts, regardless of fluctuations in the trust's value. CRUTs, on the other hand, allow payouts to keep pace with inflation because they increase as the trust's value increases. And, as noted, CRUTs allow you to make additional contributions. One potential disadvantage of a CRUT is that payouts shrink if the trust's value declines.

What are the benefits of contributing appreciated property?

A CRT enables you to dispose of highly appreciated assets without triggering an immediate capital gains tax bill. Suppose, for example, that you own $1 million worth of publicly traded stock with a $400,000 tax basis. If you were to sell the stock, you'd owe capital gains tax. The tax could be as high as $120,000 if you're at the 20% rate.

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Keep in mind that you'd likely incur an additional $22,800 of net investment income tax on the gain and, depending on where you live, there may also be state and local tax to consider. If, instead, you contribute the stock to a CRT, the trustee can sell it tax-free (a CRT is a tax-exempt entity) and reinvest the proceeds.

This is a significant benefit, but it doesn't mean that capital gains tax is eliminated (contrary to what some CRT promoters might have you believe). Rather, income earned by the trust is taxable to you or your beneficiaries as it's paid out.

CRT can't be used to eliminate capital gains

Every year, the IRS warns taxpayers of its "Dirty Dozen" tax scams they should avoid. This year, the first scam on its list was "Use of Charitable Remainder Annuity Trust (CRAT) to Eliminate Taxable Gain." In this scam, a taxpayer transfers appreciated property to a CRAT and improperly claims that they qualify for a step-up in basis to fair market value, essentially erasing the gain. The CRAT sells the assets and uses the proceeds to purchase a single premium immediate annuity (SPIA). The beneficiary reports a small portion of the annuity from the trust as income from the SPIA, incorrectly treating the remainder as tax-free return of principal.

The proper treatment is to report payments from the CRAT as a combination of ordinary income from the SPIA and capital gain from the sale of appreciated assets, until both types of income have been exhausted.

For tax purposes, the IRS treats each payout as coming first from ordinary income (up to the trust's current and accumulated ordinary income), followed by capital gains, tax-exempt income and tax-free return of principal. (See "CRT can't be used to eliminate capital gains" above.)

Why do CRTs work better when interest rates are high?

To ensure that a CRT is a legitimate charitable giving vehicle, IRS guidelines require that the present value of the charitable beneficiaries' remainder interest be at least 10% of the trust assets' value when contributed. Calculating the remainder interest's present value is complicated, but it generally involves estimating the present value of annual payouts from the trust and subtracting that amount from the value of the contributed assets.

The computation is affected by several factors, including the length of the trust term (or the beneficiaries' ages, if payouts are made for life), the size of annual payouts and an IRS-prescribed Section 7520 rate. If you need to increase the value of the remainder interest to meet the 10% threshold, you may be able to do so by shortening the trust term or reducing the payout percentage.

In addition, the higher the Sec. 7520 rate at the time of the contribution, the lower the present value of the payouts and, therefore, the larger the remainder interest. In recent years, however, rock-bottom interest rates made it difficult, if not impossible, for many CRTs to qualify. As interest rates rise, it becomes easier to meet the 10% threshold and to increase annual payouts or the trust term without disqualifying the trust.

Now may be the time for a CRT

If you've been exploring options for satisfying your charitable goals while generating an income stream for yourself and your family, now may be an ideal time for a CRT. The Sec. 7520 rate has increased steadily over the last several months, and will likely continue to rise, enhancing the effectiveness of CRTs as a financial planning tool.

Shield life insurance proceeds from estate tax with an ILIT

Life insurance can provide peace of mind, but it's important to not own the policy at death. The policy's proceeds will be included in the taxable estate and may be subject to estate tax. To avoid this result, a common estate planning strategy is to draft an irrevocable life insurance trust (ILIT) to hold the policy.

Avoiding incidents of ownership

Generally, the proceeds of a life insurance policy aren't included in your taxable estate if you don't own the policy. However, life insurance proceeds will be included in your estate if you possess any "incidents of ownership." This goes beyond mere ownership of the policy. If you have the right to amend the policy — say, by changing the beneficiaries — or you can borrow against the cash value, it's treated as an incident of ownership.

The top estate tax rate is currently 40%. Fortunately, with your gift and estate tax exemption, you can shelter up to $12.06 million (for 2022) of the proceeds from federal gift and estate tax. Be aware that without congressional action, after 2025 the exemption is scheduled to revert to $5 million (indexed for inflation).

Typically, you'll designate the ILIT as the primary beneficiary of the life insurance policy.

Furthermore, you may have to contend with estate or inheritance tax at the state level. In any event, the estate tax treatment of life insurance policies is a prime consideration in estate planning, especially for wealthier individuals.

Turning to an ILIT

A common method for avoiding these estate tax complications is to use an ILIT. This may be accomplished by setting up the trust as the owner of the life insurance policy

when the coverage is purchased or by transferring an existing policy to the trust.

For starters, the trust must be "irrevocable," as the name states. In other words, you must relinquish any control over the ILIT, such as the right to revise beneficiaries or revoke the trust. Similarly, if you act as the trustee of the ILIT, this will be treated as an incident of ownership that invalidates the trust. You can, however, name another family member or a knowledgeable professional as the trustee.

Typically, you'll designate the ILIT as the primary beneficiary of the life insurance policy. On your death, the proceeds are deposited into the ILIT and held for distribution to the trust's beneficiaries. In most cases, this will be your spouse, children, grandchildren or other family members. Naming your surviving spouse as the sole beneficiary can be problematic. It may merely delay estate tax liability until the spouse dies (assuming he or she outlives you).

Note that the ILIT must be funded so that it's able to pay the premiums on the policy. Choose a bank account to be used for this purpose.

Avoiding ILIT red flags

There are several pitfalls to watch for when transferring an insurance policy to an ILIT. Significantly, if you transfer an existing policy to the ILIT and die within three years of the transfer, the proceeds will be included in your taxable estate. One way to avoid this is to have the ILIT purchase the policy on your life and then fund the trust with enough money over time to pay the premiums.

Bear in mind that the transfer of an existing policy to an ILIT is considered a taxable gift. Further, subsequent transfers to the trust would also be treated as gifts. The gifts can be sheltered from tax by your available gift and estate tax exemption.

Creating wealth and liquidity

Life insurance is a powerful estate planning tool. It creates an instant source of wealth and liquidity to meet your family's financial needs after you're gone. To shield proceeds from estate tax, consider transferring your policy to an ILIT. Contact your estate planning advisor to determine if an ILIT is right for your estate plan. ▮

Should you use retirement accounts to fund gifts?

If you're like many people, a significant portion of your wealth can be found in IRAs and other tax-deferred retirement accounts. Traditionally, these accounts have been viewed as off limits when it comes to funding lifetime gifts, given the negative income tax implications.

But things are a little different now. Why? Because the federal gift and estate tax exemption — currently $12.06 million — is scheduled to be cut roughly in half at the end of 2025. Faced with the prospect of a higher estate tax bill, many affluent people are establishing irrevocable trusts or implementing other gifting strategies to lock in the higher exemption

amount before it disappears. In some cases, it may make sense to use retirement accounts to fund these gifts, provided the estate tax benefits would outweigh the income tax costs.

Tapping retirement accounts

If you're at least 59½ years old, the 10% early withdrawal penalty doesn't apply. But closing out an IRA will trigger immediate income tax on all deductible contributions and earnings. You'll lose the benefit of continued tax-deferred growth, which is why it's generally best to keep funds in an IRA as long as possible. Also, if you expect to be in a lower tax bracket in retirement, the IRA may be taxed at a higher rate than it would have been if you'd waited.

In today's environment, however, it's important to compare these costs against the potential estate tax savings you'd enjoy by taking advantage of the current exemption amount.

Income taxes vs. estate taxes

For example, consider that Paul has $12 million in an IRA and $4.2 million in a taxable investment account. He's in the 35% tax bracket and no longer contributes to the IRA. Paul dies in 2026, when the estate tax exemption has dropped to $6 million.

The IRA balance has grown to $15 million and the taxable account to $5 million. At a 40% rate, the estate tax (40% of $14 million subject to estate tax) will be $5.6 million, leaving $14.4 million for Paul's heirs.

Suppose, instead, that in 2022, Paul withdraws the IRA balance and uses the taxable account to pay the resulting $4.2 million income tax bill. He gives the $12 million to his family tax-free by virtue of the $12.06 million exemption. The $12 million gift, together with any appreciation in its value, is removed from Paul's taxable estate. Assuming it grows to $15 million by 2026, Paul's heirs end up with $15 million.

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In the above example, the estate tax savings from taking advantage of the current exemption amount outweighed the income tax cost of liquidating the IRA, generating an additional $600,000 for Paul's heirs. Of course, there are many other factors to consider in comparing the two scenarios, including the potential benefits of continued tax-deferral if Paul's heirs inherit the IRA, the income tax implications for Paul's heirs under the two scenarios and the impact of required minimum distributions from the IRA (depending on Paul's age). In addition, there may be other strategies to consider, such as converting the IRA to a Roth IRA.

Crunch the numbers

The right strategy for you depends on your family's particular facts and circumstances. But given the impending reduction in the gift and estate tax exemption amount, it's a good idea to consult with your advisor to crunch the numbers to identify your best options for preserving as much of your wealth as possible.

ESTATE PLANNING RED FLAG

You own property jointly with a child or other family member

There's a common misconception that owning assets jointly with a child or other heir is an effective estate planning shortcut. While this strategy has a certain appeal, it can invite a variety of unwelcome consequences that may quickly outweigh any potential benefits.

Owning an asset — such as real estate, a bank or brokerage account, or a car — with your child as "joint tenants with right of survivorship" offers some advantages. For example, when you die, the asset automatically passes to your child without the need for more sophisticated estate planning tools and without going through probate.

But it can also create a variety of costly headaches, including:

- **Avoidable transfer tax exposure.** If you add your child to the title of property you already own, it may be considered a taxable gift of half the property's value. And when you die, half of the property's value will be included in your taxable estate.
- **Increased income tax.** As a joint owner, your child loses the benefit of the stepped-up basis enjoyed by assets transferred at death, exposing him or her to higher capital gains tax.
- **Exposure to creditors.** The moment your child becomes a joint owner, the property is exposed to claims of the child's creditors.
- **Loss of control.** Adding your child as an owner of certain assets, such as bank or brokerage accounts, enables him or her to dispose of them without your consent or knowledge. And joint ownership of real property prevents you from selling it or borrowing against it without your co-owner's written authorization.
- **Unintended consequences.** If your child predeceases you, the assets will revert back in your name alone, requiring you to come up with another plan for its disposition.
- **Unnecessary risk.** When you die, your child receives the property immediately, regardless of whether he or she has the financial maturity and ability to manage it.

These problems can be mitigated or avoided with one or more properly designed trusts.

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Change of Plans? Give Us a Call

The adage "the more things change the more they stay the same" does not apply to estate planning. When your life plans change your estate plan probably should, too.

By Jonathan W. Michael, Partner

Estate planning helps people prepare for planned—and unplanned—life events. But, even the best estate plans can't help you if you don't keep them up to date.

Life and circumstances change over time, and your estate planning documents need to change with them. It's critical to your peace of mind (and that of those you care about) to ensure your plan reflects your current goals and continues to offer you the protections you want and need most.

We recommend routinely reviewing estate plans at least every three years. But reviews should also occur when your life plans change. Here are some of the most common—and overlooked—reasons to update your estate planning documents.

1. Beneficiaries change or require confirmation. It is not uncommon for clients to forget individuals who no longer occupy an important place in their lives are designated to receive significant bequests in their wills or trusts. Or they might think that simply designating a beneficiary in a will applies to other investments, such as IRAs. Sometimes new interests or activities mean you want to add or remove charities.

2. Birth of a child. While it may seem obvious to update your estate plan to include newly born children, reviewing the guardians for your minor children is also important. Similarly, you should review the trustees named to manage a child's inheritance. You might want to plan for specifics, such as education or special needs.

3. Change of assets or liabilities. A significant change in the value of your estate since the plan was drafted should cause a review. Have you acquired new property or made new investments?

4. Changes in the composition of your estate. If you buy or sell a business or real estate, you should address those changes in your estate plan. Perhaps you launched a new business and need a business succession plan.

5. Executors or trustees are no longer appropriate. Carefully reconsider the people you appointed to act on your behalf. Has anyone aged, moved away, passed away or no longer the "right" fit? Are they still willing to perform the jobs as you'd like them to? Are they still capable? Who is the best choice now and for the future under current circumstances?

6. You need a health or other proxy. Determine who will make medical decisions for you and enforce your wishes with regards to life support should you be incapacitated. A financial power of attorney might also be necessary.

7. You get married or divorced. Ensure that your estate plan has been updated to reflect your marital status. For example, if you divorce, will you still want your ex-spouse to inherit all or part of your estate? Adopted children or a newly blended family might need to be considered. Naming individuals specifically could avoid conflicts, even lawsuits.

8. You move to a new state. Each state has its own laws. It's critical that you establish proof that you did in fact change your residency. Otherwise, your estate may be taxable in your former state. Even seemingly minor differences, such as the number of document witnesses, can become obstacles. New powers of attorney and advance medical directives might be necessary in the new state in case you become disabled there. In such cases, it's crucial that those responsible have the necessary expertise, knowledge, and experience to implement the directives, including complete familiarity with the specific documentation involved.

9. You purchase a second residence out-of-state. Work with your attorney to determine which state should be your principal residence for tax purposes and what other obligations you might incur, if any.

10. New tax laws are in place. Tax laws are always changing. Discuss the effect of any new tax laws on your estate plan. Again, we recommend that clients review their estate planning documents every three years to ensure that they are current.

When it comes to estate planning, the adage "change with the times" is one that does apply. If you or someone you know is concerned about estate planning, please call us at 312.900.0150 or e-mail me directly at jmichael@themichaellawgroup.com. And be sure to visit www.themichaellawgroup.com at any time.