THE ESTATE PLANNER

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Big tax changes are in the works

What do they mean for your estate plan?

With apologies to Benjamin Franklin, little is certain about death and taxes these days. The Biden administration and several lawmakers have proposed gift, estate and income tax changes that — if they become law — may have a significant impact on your estate plan.

As of this writing, it's not yet clear which of these proposals will receive a vote in Congress or whether any of them, if enacted, will apply retroactively. But it's a good idea to consult your estate planning advisor to discuss the potential impact of these changes and consider strategies for minimizing any negative effects.

Reduced exemptions, higher tax rates

Currently, the federal gift and estate tax exemption is $11.7 million ($23.4 million for married couples), with a top tax rate of 40%. Proposals in Congress would reduce the exemption amount to $3.5 million for estate taxes and $1 million for gift taxes. In addition, the top tax rate would be increased to 45%, with some proposals calling for graduated rates reaching as high as 65% for the wealthiest families.

Although there are no guarantees, it's generally believed that exemption amounts will not be cut retroactively. Rather, any changes would likely apply prospectively from the date they're signed into law, or possibly earlier (for example, the date the bill clears the appropriate House or Senate committee).

Still, given the uncertainty over when tax legislation will be passed, families that wish to take advantage of current exemption levels to transfer substantial amounts of wealth to their heirs tax-free should act soon. Another reason to move quickly is that in addition to reducing exemptions, there are proposals

to curtail the use of several popular wealth-transfer techniques. (See "Planning techniques may be limited soon," on page 3.)

Elimination of stepped-up basis

Estate planning often focuses on avoiding or minimizing gift and estate taxes, but income taxes can also have a significant impact on the cost of transferring wealth. Under current law, transfers at death have an advantage: When your heirs inherit investment property or other appreciated assets, they receive a stepped-up basis — that is, their basis in an asset is its fair market value at the time of your death. That means they can turn around and sell the assets without triggering taxable capital gains. Assets transferred by gift, however, retain your basis, which can result in a substantial tax liability if the assets are sold.

Suppose, for example, that Jon bought stock in 2001 for $200,000, and that when he dies in 2021, the stock's value has grown to $1 million. His daughter, Kayla, inherits the stock and, by virtue of the stepped-up basis, is able to sell it immediately without owing any capital gains taxes. If, instead, Jon had given the stock to Kayla during his life, she

Planning techniques may be limited soon

Several legislative proposals would limit the use of popular (and powerful) wealth transfer techniques. They include:

Valuation discounts. Transfers of minority interests in closely held businesses are generally entitled to valuation discounts for lack of control and marketability. Some lawmakers have proposed eliminating these discounts, with limited exceptions, for interests in family-owned businesses.

Gift tax annual exclusion. Currently, individuals are entitled to make tax-free gifts of $15,000 per donee to an unlimited number of recipients every year, allowing donors with large families to transfer substantial amounts of wealth without triggering gift taxes or tapping their lifetime exemption. The Biden administration has proposed capping the aggregate amount of annual exclusion gifts at $50,000.

GRATs. Grantor retained annuity trusts (GRATs) enable donors to remove appreciating assets from their estates and shift future growth to their beneficiaries with little or no gift tax. Recent proposals would make GRATs less effective by imposing a minimum 10-year term and reducing grantors' ability to avoid gift tax.

Grantor trusts. These trusts make it possible to remove assets from your estate while treating you, the grantor, as the owner for income tax purposes. This allows you to pay the trust's income taxes without triggering additional gift taxes. Proposed legislation would discourage the use of these trusts by including them in the grantor's estate.

It's likely that should any of these proposals become law, transactions conducted beforehand would be grandfathered. So, families that wish to take advantage of these techniques while they're available should act soon.

would receive his $200,000 basis, resulting in an $800,000 capital gain if she sells the stock in 2021.

Keep in mind, however, that if Jon is affluent enough that gift and estate taxes are a concern, holding onto the stock until death would increase his estate tax liability. So, in determining the optimal strategy, it's important to weigh the potential income tax savings against the potential estate tax cost.

The Biden administration proposes to dramatically reduce the stepped-up basis, which would require many families to rethink their wealth transfer strategies. Not only would this proposal impact the income tax advantage of holding assets until death, but — subject to certain exemptions — it would also tax heirs on unrealized capital gains at death, regardless of whether they sell the assets. In other words, heirs would no longer be able to defer all capital gains until they sell the inherited assets. So, presuming the exemption wouldn't apply to the assets in the above example, Kayla would owe taxes on $800,000 in gain, even if she holds onto the stock.

Consult your advisor

By the time you read this, there may have been further progress on the proposals discussed in this article, and alternative proposals may also have been introduced. Be sure to consult your estate planning advisor to learn about the latest developments and to evaluate your estate planning options. ▮

Letter of instruction

Express final wishes to heirs using your own words

An estate plan is a legal document, and because of that its language can be rather technical. If you wish to communicate your estate planning intentions in plain language, consider writing a letter of instruction to your family and including it with your plan.

What to address

A letter of instruction is an informal document providing your loved ones and friends with vital information about personal and financial matters to be addressed after your death. Bear in mind that the letter, unlike a valid will, isn't legally binding. But the informal nature allows you to easily revise it whenever you see fit.

What should be included in the letter? It will vary, depending on your personal circumstances, but here are some common elements:

Documents and financial assets. Start by stating the location of your will. Then list the location of other important documents, such as powers of attorney, trusts, living wills and health care directives. Also, provide information on your birth certificate, Social Security benefits, marriage licenses (and, if any, divorce documents), and military paperwork.

A letter of instruction typically includes details regarding your funeral and burial arrangements.

Next, create an inventory spreadsheet of all your assets, their location, account numbers and relevant contact information. This may include, but isn't necessarily limited to, items such as checking and savings accounts; retirement plans and IRAs; health and accident insurance plans; business insurance; life and disability income insurance; records of Social Security and VA benefits; and stocks, bonds, mutual funds and other investments.

And don't forget about liabilities. Provide information on mortgages, debts and other obligations your family should be aware of.

Funeral and burial arrangements. A letter of instruction typically includes details regarding your funeral and burial arrangements. This can be helpful to grieving family members. If you prefer to be cremated rather than buried, make that clear. In addition, details can include whom you'd like to have preside over the service, the setting and even music selections.

List the people you want to be notified when you pass away, and include their contact information, if available. Finally, write down your wishes for donations to specific charities to be made in your memory.

Digital information. As many of your accounts likely have been transitioned to digital formats, including bank accounts, securities and retirement plans, it's important that you recognize this change in your letter of instruction or update a previously written letter.

Be sure to include usernames and passwords for digital accounts — especially financial accounts — as well as social media accounts, key sites and links, and all electronic devices, such as computers, tablets and phones.

Personal items. It's not unusual for family members to quarrel over personal effects that you don't specifically designate in your will. Your letter can spell out who'll receive random personal effects, including collections, as well as other items that may have little or no monetary value, but plenty of sentimental value.

Ease emotional turmoil

It can be difficult to think about writing such a letter — no one likes to contemplate his or her own death. But once you get started, you may find that most of the letter "writes itself."

Also, take comfort in knowing that you're alleviating stress and probably preventing later family disputes. Finally, try to ensure that the letter doesn't conflict with other parts of your estate plan, particularly your will, and lead to confusion.

Revise your letter when necessary

A letter of instruction can offer peace of mind to your family members during their time of grieving. But, like a will or living trust, be sure to update your letter periodically to reflect significant changes in your life. Also, keep the letter in a safe place where the people whom you want to have read it can easily find it. Contact your estate planning advisor with questions on how your letter should reflect your estate plan's goals. ▮

Deducting a trust's charitable donations

If you're charitably inclined, it may be desirable to donate assets held in a trust. Perhaps you're not ready to let go of assets you hold individually. Or maybe the tax benefits of donating trust property would be more attractive than an individual donation. Before making such a donation, it's important to understand the differences, for tax purposes, between individual and trust donations and the circumstances under which donations by a trust are deductible.

Tax treatment of individual donations

Generally, you're permitted to deduct charitable donations for income tax purposes only if you itemize. (Although COVID-19-related legislation established a $300 charitable deduction for certain cash gifts by non-itemizers in 2020 and 2021.)

Itemized charitable deductions for cash gifts to public charities generally are limited to 50% of adjusted gross income (AGI), while cash gifts to private foundations are limited to 30% of AGI.

The Tax Cuts and Jobs Act increased the limit for cash gifts to public charities to 60% through 2025 and COVID-19-related legislation increased it to 100% for certain cash gifts to public charities in 2020 and 2021.

Noncash donations generally are limited to 30% of AGI for donations to public charities and 20% for donations to private foundations. If you donate appreciated long-term capital gain property to a public charity, you're generally entitled to deduct its full fair market value, but with the exception of publicly traded stock, deductions for similar donations to private foundations are limited to your cost basis in the property. Deductions for ordinary income property (including short-term capital gain property) are limited to your cost basis, regardless of the recipient.

Tax treatment of trust donations

The discussion that follows focuses on nongrantor trusts. Because grantor trusts are essentially ignored for income tax purposes, charitable donations by such trusts are treated as if they were made directly by the grantor, subject to the rules applicable to individual donations. Also, this article doesn't discuss trusts that are specifically designed for charitable purposes, such as charitable remainder trusts or charitable lead trusts.

Making charitable donations from a nongrantor trust may have several advantages over individual donations, including the ability to claim a charitable deduction even if you don't itemize deductions on your individual income tax return and to deduct donations to foreign charities. And a trust can deduct up to 100% of its gross taxable income, free of the AGI-based percentage limitations previously discussed.

In addition, trust deductions can be more valuable than individual deductions because the highest tax rates for trust income kick in at much lower income levels. For example, in 2021, trusts reach the highest (37%) tax bracket at only $13,050 of income.

If you're contemplating a charitable donation from a trust, there are a few caveats to keep in mind:

- The trust instrument must authorize charitable donations.
- The donation must be made from (that is, traceable to) the trust's gross taxable income. This includes donations of property acquired with such income, but not property that was contributed to the trust.
- Unlike certain individual charitable donations, deductions for noncash donations by a trust generally are limited to the asset's cost basis.

Special rules apply to trusts that own interests in partnerships or S corporations, as well as to certain older trusts (generally, those created on or before October 9, 1969).

Making the most of charitable deductions

If income limits or restrictions on itemized deductions have hampered your ability to deduct charitable donations, consider making donations from a trust. Your estate planning advisor can help you determine whether this is an option and ensure that you're getting the most bang for your charitable buck.

ESTATE PLANNING RED FLAG

Your trust doesn't provide for removal of a trustee

To ensure that a trust operates as intended, it's critical to appoint a trustee that you can count on to carry out your wishes. But to avoid protracted court battles in the event things don't work out as planned, it's a good idea to give your beneficiaries the right to remove and replace a trustee. Without this option, your beneficiaries' only recourse would be to petition a court to remove the trustee for cause.

The definition of "cause" varies from state to state, but common grounds for removal include:

- Fraud, mismanagement or other misconduct,
- A conflict of interest with one or more beneficiaries,
- Legal incapacity,
- Poor health, or
- Bankruptcy or insolvency if it would affect the trustee's ability to manage the trust.

Not only is it time consuming and expensive to go to court, but most courts are hesitant to remove a trustee that was chosen by the trust's creator.

To avoid this situation, consider including a provision in the trust document that allows your beneficiaries to remove a trustee without cause if they're dissatisfied with his or her performance. Alternatively, you could authorize your beneficiaries to remove a trustee under specific circumstances outlined in the trust document.

If you're concerned about giving your beneficiaries too much power, you can include a list of successor trustees in the trust document. That way, if the beneficiaries end up removing a trustee, the next person on the list takes over automatically, rather than allowing the beneficiaries to choose a successor. Alternatively, or, in addition, you could appoint a "trust protector" with the power to remove and replace trustees and to make certain other decisions regarding management of the trust.

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Change of Plans:

When to update your estate planning documents

Estate planning helps people prepare for unplanned possibilities. But, even the best estate plans can't help you if you think of it as a one-time event.

Life and circumstances change over time, and your estate planning documents need to change with them to ensure they reflect your current goals and continue to offer you the protections you want and need most.

Some of the most common – and overlooked – reasons to change your estate planning documents include the following:

1. **Beneficiaries change.** It is not uncommon for clients to forget they named individuals who no longer occupy an important place in their lives to receive significant bequests of property in their wills or trusts.
2. **You get married/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 your estate?
3. **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 important. Similarly, you should also review the trustees named to manage a child's inheritance.
4. **Change of assets or liabilities.** A significant change in the value of your estate since the plan was drafted should cause a review.
5. **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.
6. **Executors or trustees become inappropriate.** Carefully reconsider the people you appointed to act on your behalf. Has anyone aged, moved away, passed away or are no longer the "right" fit? Are they still willing to perform the jobs as you'd like them done? Determine who is the best choice for these positions today.
7. **You need a health proxy.** Determine who will make medical decisions for you and enforce your wishes with regards to life support should you become incapacitated.
8. **You move to a new state.** Each state has its own laws. Work with your attorney to establish proof that you changed your residency or your estate may be fully taxable in your former state. Also, establish powers of attorney and advance medical directives in the new state in case you become disabled there.
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.
10. **New tax laws are in place.** Tax laws are always changing. Discuss the effect of any new tax laws on your estate plan.

We recommend that clients review their estate planning documents every three years to ensure that they are current. If you or someone you know needs an estate plan or a plan review, call us at: 312.900.0150.

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