Financial Strategies

AN OPPORTUNITY TO SIMPLIFY YOUR ESTATE PLANNING

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Because of the high exemption amounts in place today, you have a great opportunity not only to update your estate planning documents, but simplify them as well.

UNTIL RECENTLY, many physicians structured their estate planning documents to avoid federal estate taxes on wealth passed to their spouse and children. Over the past four years, estate tax rates have been 40% to 50% and the exemption amount has varied between $600,000 and an unlimited exemption. Currently it stands at $5.43 million per person.

This means that in the case of a married couple, if your plan is set up correctly, you can exempt over $10,000,000. Although 99% of the households are below this high threshold, there are still many opportunities, as well as pitfalls. Thus, planning remains as important as ever.

Over the past 30 years of my practice and until recently, it was common to recommend and structure "by-pass trusts" which are a complex way of placing assets into trust upon the death of the first spouse so as to take advantage of each person's death tax exemption amount. These trusts were required to limit access to the assets by the surviving spouse.

If you have not changed your will recently, these trusts probably are still in place and will become effective upon your demise. Not only are these trusts not useful for most people, they include several substantial drawbacks besides limiting access by the surviving spouse. These trusts carry higher administrative fees and capital gains within the by-pass trusts since you won't enjoy a basis step up.

Because of the high exemption amounts in place today, you have a great opportunity not only to update your estate planning documents, but simplify them as well.

Spouse considerations

Although not universal, it is common for individuals to want their spouse to have access to assets upon his or her demise. If your spouse is honest, has good judgment, financial maturity and will look out for your children, why would you want to limit your spouse's access?

The rules recently changed and now allow the surviving spouse to use the $5.43 million exemption of both spouses upon the death of the survivor, a feature known as "portability."

When you leave assets to your surviving spouse, it does not count as using any of your exemption since there is an unlimited marital deduction for estate tax purposes. So upon the death of the surviving spouse, conditioned on following the rules, both exemptions would be available.

In order to take advantage of this opportunity, however, two important details cannot be overlooked. Upon the first death, even if no federal estate tax is otherwise due, Form 706 still must be filed within nine months of death to preserve the exemption of the first spouse.

Second, if the surviving spouse remarries and the new spouse has used up his or her exemption through lifetime giving or at death, and if the new spouse predeceases them, the surviving spouse would lose the second exemption because you are only entitled to the second exemption through portability of your most recently deceased spouse, not the original spouse.

Selling or gifting assets

In anticipation of death, people sometimes give away real estate, stocks or other assets that have appreciated in value with the thought that they are saving estate taxes. Contrary to popular belief, because of the so-called "step up" in basis, they are actually increasing their tax bill because the exemption amounts mentioned above shelter most estates from federal estate taxes.

If you purchase a vacation home for $500,000, and its fair market value is $1.5 million upon your demise, your heirs receive a new basis of $1.5 million. But if you gift it during your life, the recipient would assume your basis

THE HIGH EXEMPTION AMOUNTS IN PLACE TODAY PRESENT A GREAT OPPORTUNITY NOT ONLY TO UPDATE YOUR ESTATE PLANNING DOCUMENTS, BUT SIMPLIFY THEM AS WELL.

of $500,000. If the property were then later sold for $1.5 million, the recipient would pay a capital gains tax based on the $1 million gain.

Because gifts do not receive a stepped-up basis, it makes great sense to hold on to assets such as real estate, stocks and anything else with unrealized capital gains until your demise so that your heirs receive a stepped-up basis and avoid federal and state capital gains taxes.

In community property states, surviving spouses receive a stepped-up basis on the entire property. In common law states, surviving spouses receive a 50% stepped-up basis on the first death.

For example, if you purchase stock for $200,000 and it is worth $600,000 on the death of the first spouse, the surviving spouse would receive a basis of $400,000 in a common law state, but $600,000 in a community property state. The bottom line is that as death approaches, often it does not make sense to sell or gift assets with unrealized gains.

Living expenses

What happens if you need some of your assets for living expenses and you do not want to sell them because of the capital gains tax? One option is to borrow against the assets, because doing so will not trigger a capital gains tax. Brokerage accounts allow you to borrow against your securities.

Another option is to withdraw funds from a qualified plan, IRA or annuity. Because these assets generally result in ordinary income to you or your heirs, it makes little difference whether you withdraw such funds now or leave them to your heirs since there will be no stepped-up basis.

If it is anticipated that one spouse will die sooner, more assets can be moved into that spouse's name so as to enjoy a larger step-up in basis upon the first death.

RETIREMENT: HOW MUCH IS ENOUGH?

Deciding how much you need in retirement starts with questions and making decisions based on your priorities. What inputs from your life matter? Here are questions to consider:

Q: How much do you want to spend annually to live the life you've dreamed of?

Q: How long will you be retired?

Q: What should we assume for a portfolio rate of return and for inflation?

Q: How much of your portfolio is pre-tax money in 401(k) plans and IRAs, which will be taxed when withdrawn?

Q: Will you receive full Social Security due to them under current projections or will there be changes that result in their payout being reduced or taxed at a higher rate over the next 30 years?

Source: Joel Greenwald, MD, CFP

Such gifts or transfers must occur at least one year prior to death to use this benefit. Only Connecticut has a state gift tax and the federal gift tax can usually be avoided.

Some states still have a state inheritance or estate tax of up to 20% that applies if you are a resident of the state upon your demise. If your wealth is considerable, you might review the option of changing your residence to avoid your current state's death taxes. However, it is important to consider income, real estate and sales taxes, automobile insurance rates and the other benefits and costs of living in a different state.

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