

Deathbed Tax Planning

Ben Franklin said only two things in life are certain: death and taxes. When a family member is elderly or seriously ill, both death and taxes are all too certain. Although you can't reduce the emotional impact of a family member's death, you can reduce the tax impact with proper planning.

The term "deathbed planning" is often used to describe implementing or fine tuning an elderly or seriously ill person's estate plan. Time is limited, yet a number of planning techniques can reduce or minimize taxes and enhance the estate that is left for the family.

Of course the welfare and comfort of the dying person should be your primary concern. But it also is important to provide for the orderly transition of his or her estate. This includes such concerns as healthcare powers and living wills, durable powers of attorney, funding living trusts, listing advisors, and taking an inventory of assets and essential documents. You may have time to try to reduce the tax burden, too. You can look for possible tax savings in several places.

Make Lifetime Gifts

Gift tax advantages. Taxable transfers made during life (gifts) are less expensive than those made at death (bequests). Why? For a gift, tax is paid on only the amount of the gift itself. But for bequests, tax is paid on the amount of the bequest plus the amount used to pay the tax on the bequest. In other words, gifts are tax exclusive and bequests are tax inclusive. But, there is often little advantage to making large gifts shortly before death because certain gifts made within three years of death, as well as gift taxes paid within three years of death, are added back to the estate when calculating federal estate tax.

Annual exclusion gifts. One type of gift that isn't added back is the annual exclusion gift, which allows an individual to give \$10,000 per year (\$20,000 if the gifts are split with a spouse) to an unlimited number of recipients tax free. Each such annual exclusion gift may save \$3,700 to \$5,500 in estate taxes, depending on the estate tax bracket. Accordingly, someone who is married with three children, two daughters-in-law and five grandchildren can make deathbed gifts of \$200,000 (\$20,000 x 10 recipients). The assets will remain in the family, and he or she

may save between \$74,000 and \$110,000 in estate taxes. As a bonus, the gifts to grandchildren are not subject to the 55% generation-skipping transfer (GST) tax and do not use any of the \$1 million GST tax exemption.

Gifts of controlling interests. Some gifts can make taxable value disappear. If you hold a controlling interest (for example, 52%) in a family business or venture, a gift of a 3% interest to family members may permit the remaining 49% to be valued for estate tax purposes without a control premium, thus lowering estate taxes.

Gifts between spouses. Gifts between spouses also can be advantageous in equalizing estates to fully use the \$625,000 unified credit equivalent or in equalizing estate tax brackets. All gifts between U.S. citizen spouses are gift and estate tax free. A lifetime qualified terminable interest property trust (QTIP) might help as the vehicle for the gift.

Consider Income Taxes

Capital losses. Many assets in the estate receive a new basis for income tax purposes. Generally, this is a step-up in basis to fair market value as of the date of death. But it can be a step-down in basis if stocks or other

capital assets have a current value less than what you paid for them. Such assets should be sold before death to recognize the losses. The losses can still be used on the income tax return, and any extra losses may carry forward on a spouse's return. Otherwise, the losses are gone and will not be available to the estate.

Deductible contributions. If deductible contributions can be made to an individual retirement account (IRA), profit sharing or other relevant account, make them at this time.

Deductible charitable bequests. Bequests to charity should be advanced and paid now. The estate tax consequence remains the same, but as an additional benefit, the individual will receive a current income tax deduction. If the dying family member cannot change his or her will, the charity should be willing to acknowledge that the gift is an advancement. Also, consider whether a bequest to charity can be satisfied through an IRA or qualified plan beneficiary designation; either can result in significant income tax savings.

Deferred income. In some situations, you can accelerate deferred income to be recognized currently. The income tax paid may be less

than that paid (after credits) by the estate due to the treatment of “income in respect of a decedent” on death.

Examine Business Structures

Preservation of status. A living trust can be an S corporation shareholder for only a limited time, and an estate’s holding period may also be limited. After that time, the shares need to be redeemed or passed to a qualified shareholder, or the corporation will lose its S status. The estate plan should direct proper disposition of the S corporation shares. Special trusts eligible to own S corporation stock, known as qualified subchapter S trusts and electing small business trusts, can be created for minor children or other beneficiaries.

Pass-through taxation. The owners of S corporations, partnerships, limited liability partnerships and limited liability companies are taxed directly on business net earnings, whether or not they receive a distribution from the business. This issue may need to be reviewed in light of the designated beneficiaries of the interests under the estate plan.

Also review your partnership investments. When a partner dies before the end of his or

her taxable year, and the partner and the partnership have the same taxable year, the whole year’s income or loss with respect to that partner’s interest is taxed to that partner’s estate or successor. The income or loss is not pro rated. Accordingly, this can result in an overall tax mismatch of income and deductions. Transferring this partnership interest now into joint tenancy or making provisions for a successor-in-interest under the partnership agreement may make sense.

Deferrals and redemptions. Estates composed primarily of interests in a closely held business may qualify for special tax benefits. If the estate meets certain percentage qualifications and other Internal Revenue Service tests, it can pay part of the estate taxes in installments over 15 years (with interest, of course, but a bargain rate of 4% may apply to at least part of the liability). Also, the estate or beneficiary may be able to redeem part of any corporate stock to pay taxes and administration costs and receive favorable capital gain tax treatment. Analyze the estate to see if it meets these tests.

Review Life Insurance Policies

At this late point, any life insurance owned by the ill person probably will be included in

the estate even if it is transferred. Yet, some planning opportunities may be available and should be discussed with the insurance agent:

Repayment of loans. Paying off any outstanding loans may increase policy dividends. If the dividends are being used to buy term or paid-up additions, in effect, the ill person will be buying more life insurance, even though he or she is not insurable. Also, some state inheritance tax laws give special tax benefits to life insurance proceeds compared with other types of assets. Further, if the estate may have creditor problems, life insurance proceeds may receive favored treatment.

Waiver of premium clause. A premium waiver provision that would come into play during disability will keep the policy in force until death and may also entitle the ill person to a refund of all or part of a recent premium payment.

Consider Other Options

Change of domicile. Let's say you have a terminally ill parent who has a substantial estate and is living in a state with a high inheritance or estate tax. Or, perhaps probate in your parent's state is a particularly expensive procedure. Comfort, care, treatment and

all else being equal, changing your parent's domicile to a state with a less onerous tax or probate procedure may make sense. Domicile may be changed if you meet certain criteria, and may result in significant savings.

Transfer by spouse. Generally, appreciated property receives a step-up in basis in the deceased's estate. The step-up in basis can be important because it can eliminate the capital gains tax on any appreciation. If the spouse dies within a year of receiving a gift of appreciated property and the property passes back to the donor, it will not receive the step-up. Despite this, gifts to an ill spouse should not be overlooked. First, the spouse may survive more than a year. Second, perhaps the transferred property can be allocated to satisfy other bequests, rather than passing back to the transferring spouse.

Raising the Subject

Perhaps the most difficult part of planning in anticipation of death is raising the subject. It is impossible to be distant and detached. Yet, the benefits and tax savings that are available require you to start a discussion. Each person's estate situation is different, and other planning opportunities may become evident only if the subject is addressed.