

# Reduce Taxes Through Deathbed Planning

Ben Franklin said that 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 the implementing or fine tuning the estate plan of an elderly or seriously ill person. Time is limited, yet several planning techniques can reduce or minimize tax and enhance the estate that is left to the family.

Of course, initial attention should be focused on the dying person's welfare and comfort, as well as providing for the orderly transition of the estate. These concerns include health-care powers and living wills, durable powers of attorney, funded living trusts, listing of advisors, inventory of assets, and essential documents. But time may be left to look for ways to reduce the tax burden. Here are some available techniques.

## *Make Lifetime Gifts*

Taxable transfers made during life (gifts) are less expensive than those made at death (bequests). Why? Because gift tax is paid only on the amount of the gift itself. Tax on bequests is paid on both the amount of the bequest and the amount used to pay the tax on the bequest. In other words, gifts are tax exclusive and bequests are tax inclusive. But making gifts shortly before death usually offers little advantage because taxable gifts made within three years of death are added back to the estate when federal estate tax is computed.

Here are some other types of gifts that can offer tax advantages:

**Annual exclusion gifts.** One exception is the annual exclusion gift, which allows someone 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 annual exclusion gift will save \$3,700 to 5,000 in estate tax, depending on the estate tax bracket.

Accordingly, a couple with three children, two daughters-in-law and five grandchildren can make deathbed gifts of \$200,000 (\$20,000 x 10 recipients). The assets remain in the family and between \$74,000 and \$110,000 in estate tax will be saved. As a bonus, 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 a controlling interest is held in a family business or venture (for example, 52%) a gift of a 3% interest to family members can permit the remaining 49% to be valued for estate tax purposes without a control premium, thus lowering estate tax.

**Gifts between spouses.** Gifts between spouses also can be advantageous in equalizing estates to fully use the \$675,000 unified credit equivalent or in equalizing estate tax brackets. All gifts between U.S. citizen spouses are free of gift and estate tax. A lifetime qualified terminable interest property trust (QTIP) might help as the gift vehicle.

### ***Consider Income Tax***

Planning can reduce the tax burden not only for the gift and estate tax. Here are some areas where you can save income tax:

**Capital losses.** Assets in the estate get a new basis for income tax purposes, generally a step-up in basis. But a step-down in basis may also be possible if stocks or other capital assets' current value is less than what was paid for them. Sell them before death to recognize the losses. You can still use the losses on the income tax return and any extra losses may carry forward on a spouse's return. Otherwise, the losses will not be available to the estate.

**Deductible contributions.** If you can, make deductible contributions to an individual retirement account (IRA), profit sharing plan or other relevant account.

**Deductible charitable bequests.** Advance and pay bequests to charity now. The estate tax consequence remains the same, but as an additional benefit, the donor 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.

An alternative is to increase the bequest to a spouse and express in the estate plan a strong desire that the spouse make a lifetime charitable gift. The estate will still use deductions (marital instead of charitable), and the spouse then can take advantage of income tax benefits by making gifts to charity at suitable times.

**Deferred income.** In some situations, you can accelerate deferred income to be recognized currently. The income tax paid should be less than that paid (after credits) by the estate. Here it becomes necessary to make projections and income forecasts.

### ***Examine Business Structures***

Different business structures raise different tax issues. Here are some to consider:

**Preservation of status.** The estate or living trust can be a shareholder of an S corporation

for only two years. The shares then must be redeemed or passed to a qualified shareholder, or the special S corporation status is lost. The estate plan should direct proper disposition of the S corporation shares. You can create special trusts eligible to own S corporation stock — known as qualified subchapter S trusts (QSSTs) and electing small business trusts (ESBTs) — for minor children or other beneficiaries.

**Pass-through taxation.** The owners of some types of business entities are taxed directly on business net earnings, whether or not they receive a distribution from the business. These entities are S corporations, partnerships, limited-liability partnerships and limited-liability companies. You may need to review this in light of the designated beneficiaries of the interests under the estate plan. Can any possible capital losses in these entities be extended so a spouse can use them?

A special situation exists for partnership investments. When a partner dies during the year, all of the income or loss for the whole year with respect to that partner's interest is taxed to that partner's estate or successor. The income or loss is not pro rated. This can accordingly result in an overall tax mismatch of income and losses. Consider transferring

this partnership interest now into joint tenancy or making provisions for a successor-in-interest under the partnership agreement.

**Deferrals and redemptions.** Special tax benefits are available when a large part of the estate consists of interests in closely held businesses. If the estate meets certain percentage qualifications and other IRS tests, it can pay part of the estate tax in installments over 15 years (with interest, of course, but only on a portion and at the bargain rate of 4%). Also, the estate or beneficiary may be able to redeem part of any corporate stock to pay taxes and administrative costs and receive favorable capital gains tax treatment. Analyze the estate to see if it meets these tests.

### ***Review Life Insurance Policies***

At this point, any life insurance owned by the ill person probably will be included in the estate even if it is transferred. Ask the insurance agent if any planning opportunities such as the following are still available:

**Repayment of loans.** If any policy loans are outstanding, investigate the advantages of paying off the loans, which may increase policy dividends. If 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 again may receive favored treatment, so don't let policy death benefits be reduced by an outstanding loan balance.

**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.

### ***Miscellaneous Techniques***

Here are two more techniques to consider:

**Change of domicile.** Let's say your terminally ill parent has a substantial estate and lives in a state with a high inheritance tax or expensive probate. If comfort, care, treatment and all else are equal, moving your parent's domicile to a "friendlier" state with only an estate pick-up tax may be possible and practical. Domicile may be changed upon

meeting some simple criteria. The resulting savings can be significant.

**Transfer by spouse.** Generally, if someone receives a gift of appreciated property and dies within one year, the property will not receive a step-up in basis in the estate if the property passes back to the donor. The step-up in basis can be important because it can eliminate the 28% capital gains tax on the amount of appreciation. Therefore, don't overlook gifts to an ill spouse. First, the spouse may possibly survive more than a year. Second, the transferred property may perhaps be allocated to satisfy other bequests with the transferring spouse being equalized through the marital formula.

### ***Raising the Subject***

Perhaps the most difficult part of planning in anticipation of death is raising the subject.

You can't be distant and detached. Yet the available benefits and tax savings require starting a discussion. Each person's estate situation is different, and other planning opportunities may become evident only if the subject is addressed.

If you would like assistance in this difficult matter, please call us. We can help you review your situation, evaluate alternatives and implement those that will best achieve your goals.