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Not Worried About Federal Estate Taxes?

Ten Reasons You Still Need an Estate Plan

There is a lot of discussion in the estate planning community about the scheduled sunset of federal estate tax exemption amounts at the end of 2025. If the sunset occurs, federal estate tax exemption amounts will decrease from $12.92 million per individual ($25.84 million for a married couple) in 2023 to approximately $7 million per individual ($14 million for a married couple) in 2026. The potential loss of ~$6 million in federal estate tax exemption per individual (~$12 million for a married couple) has led to a variety of estate planning strategies to lock in the higher current exemption amounts. The benefits of such planning can be significant, but people whose assets fall below those amounts may believe they do not have to worry about estate planning right now. The reality is, in addition to ensuring assets go to the loved ones of their choosing, there are still many estate planning issues people with non-taxable estates should consider.

1. Income Tax Planning

If a decedent's assets are not subject to estate taxes, income tax planning often becomes important. "Basis" is the amount returned tax-free to a person when selling an asset. The taxable amount of an asset sale (i.e., the "realized" gain or loss) is the difference between the sales price and the seller's basis in the asset.

Basis is generally determined in one of the three following ways:

- Purchased assets. When purchasing an asset, the purchaser's basis is determined by the amount paid for the asset. This is referred to as cost basis.
- Gifts. When receiving gifted property, the gift recipient takes the donor's basis in the gifted asset. This is referred to as a carryover basis.
- Inherited assets. When inheriting an asset, basis is the fair market value of the asset on the date of the person's death. This is often referred to as "stepped-up basis." Despite this name, it should be noted that this rule could result in a lower basis if the asset value has decreased. Whether the value of the asset has appreciated or depreciated in the hands of the decedent, stepped-up basis generally means the asset can be sold immediately after the decedent owner's death without any income tax consequences.

For nontaxable estates, it is often best to hold onto appreciated assets until death to obtain stepped-up basis for income tax purposes. For assets that have depreciated in value, it may be better to sell them or gift them before death to lock in a higher income tax basis.

2. State Estate Tax or State Inheritance Tax

In addition to federal estate tax, 17 states currently impose either a state estate tax or a state inheritance tax at a person's death. State estate tax exemption amounts are generally lower than the federal estate tax exemption amount and in many cases are more restrictive. For example, unlike federal law that allows for the first decedent spouse's unused estate tax exemption amount to be carried over and used by the surviving spouse (referred to as "portability"), states generally do not allow portability. This is just one example of why planning for tax at the state level is important, even if an estate is not subject to federal estate tax.

3. Probate Considerations

Probate is a court-administered process of distributing assets to a decedent's heirs. Traditionally, probate has been a lengthy and expensive process. Some states have streamlined probate, thereby decreasing its time and cost. In other states, probate can still be a burdensome process. Revocable trusts are often used in estate planning to distribute assets upon a person's death without having to go through probate . Because trusts do not have to be filed in the county record, they are sometimes preferred by individuals who do not want their personal financial information to become public.

4. Creditor and Divorce Protection

Revocable trusts do not provide creditor protection for the trust grantor (person who funds the trust). However, once the trust becomes irrevocable at the death of the grantor, trust assets are generally protected from claims by a beneficiary's creditors and can help protect trust assets in the event of a beneficiary's divorce. Despite these benefits, many trusts make outright distributions to children during their lifetime. Once distributed out of the trust, the assets are no longer protected from creditor and divorce claims. Maintaining assets in trusts for the life of a beneficiary allows a beneficiary to receive distributions from the trust but helps protect any assets remaining in trust from creditor and divorce claims. If creditor and divorce protection are important, lifetime trusts for beneficiaries should be considered.

5. Beneficiary Designations

Retirement benefits, such as IRAs and pension plans, do not receive a stepped-up income tax basis at the death of the account owner, but they do allow assets to pass free of probate by designating account beneficiaries. Spouses are generally preferred as primary beneficiaries because they are able to receive distributions based on their life expectancy. The 2020 changes to retirement plan distribution rules have made the use of trusts as retirement plan beneficiaries less attractive in most situations. Life insurance can also pass via beneficiary designations but without imbedded income tax consequences.

Beneficiary designations should be reviewed on a regular basis to make sure account assets go to the intended heirs. There are numerous cases of people forgetting to change their beneficiary designations after divorce, leading to assets going to unintended beneficiaries. Many states have attempted to address this by automatically terminating spousal beneficiary designations upon divorce. Despite these state laws, pension plans are governed by ERISA, which preempts state law. ERISA could override the automatic beneficiary terminations for pension plan assets under state law.

6. Powers of Attorney

Wills and trusts are commonly thought of when estate planning is discussed. Although wills and trusts are important documents, they generally benefit a person's heirs. The most important documents for a living person are often their powers of attorney. If a person becomes incapacitated and does not have powers of attorney, courts will likely have to appoint a conservator and/or guardian to handle their financial and medical affairs. This involves regular reporting to the court, which usually requires attorneys and creates unnecessary expense. An agent named in a power of attorney can handle affairs for an incapacitated person without any court intervention. This allows for things to be handled more expediently and without additional cost.

Advance directives provide instruction regarding life-sustaining treatment in the event of a terminal illness. Advance directives can be contained in a health care power of attorney or in a separate living will. The instructions provided in an advance directive can be invaluable guidance to family members already dealing with a stressful situation.

7. Fiduciary Selection

One of the most important decisions for an individual planning their affairs is who to appoint as the administrator of their assets. In a will, that role is referred to as the "Personal Representative" or "Executor/Executrix." In a trust, it is called the trustee. A common example where problems develop in this area is naming a spouse from a second marriage to be trustee of a trust of which children from the first marriage are beneficiaries or remainder beneficiaries. Because circumstances change over time, fiduciary appointments should be reviewed on a periodic basis.

8. New State Residency

Each state has different laws affecting the administration, distribution and taxation of assets at death. A minority of states are community property states, whereas the rest are common law property states. Relocating from a community property state to a common law state (or vice-versa) can impact the distribution of a person's assets. Maximum trust duration, the ability to amend or decant an irrevocable trust, and trust income taxes also often vary by state. Review your estate plan with a qualified professional if you establish residency in another state so you can make sound decisions based on the rules of that state.

9. Special Needs

If any beneficiaries are disabled and receiving (or could ever need) government assistance, your will or trust should contain language to prohibit distributions that could disqualify a beneficiary from government assistance. Beneficiary designations should also be reviewed to avoid outright distributions to a disabled beneficiary or a class of beneficiaries that could include a disabled beneficiary. That will also avoid unintentionally disqualifying a disabled beneficiary from government benefits.

10. Digital Assets

Digital assets, such as cryptocurrency and social media accounts, are often overlooked in the estate planning process. Some websites allow the account owner to designate authorized third parties to have access in the event of the owner's death. A digital executor should also be named in every person's estate planning documents to ensure someone is authorized to access digital accounts upon the owner's death. Without a digital executor, the account owner's family may not be allowed to access the information in their loved one's digital accounts and personal information may remain under the control of the account provider.

Given today's high federal estate tax exemption amounts, many people believe that estate planning is not a concern for them. In reality, in the absence of federal estate taxes, income tax issues often require attention. There are also many nontax reasons to engage in estate planning, such as the issues highlighted above. To ensure assets go the heirs of your choosing and make certain that your assets can be efficiently administrated after death, estate planning is necessary for all adults, regardless of wealth.

If you have any questions about estate planning or what issues to consider in your own estate plan, please contact our specialists in Estate Planning Services at EPS@ceritypartners.com.

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