strategies

Deathbed Planning

The thought of discussing the topic of "deathbed planning" is something many families try to avoid. Although this is never a pleasant topic, when the aged or terminally ill person has failed to complete proper planning or to put their financial affairs in good order, the adverse tax, legal and administration consequences can be devastating. With the estate tax consuming almost half of a taxable estate, the payment of any unnecessary estate taxes should be avoided and at times, this requires last minute planning or fine tuning of an existing plan for a very ill relative. Time will be limited and some planning opportunities won't be available to be implemented at the last minute, yet a number of planning techniques can reduce or minimize taxes and enhance the estate that is left to the heirs and limit what "Uncle Sam" will inherit.

First Concern

The primary importance is the health and comfort of the family member. When a person is diagnosed as being terminally ill or upon notice of the person's sudden injury, attention should be directed to locating or preparing the following documents: healthcare power of attorney, living will, durable power of attorney, funded living trust, a list of advisors, a list of people to notify and an inventory of assets and essential documents. This will permit the appropriate persons to be able to make medical and financial decisions on behalf of the seriously ill relative.

Once these documents have been put in order, and if time permits, then attention should be directed to a review of the various assets with the thought of reducing the tax burden on the heirs. Some strategies to consider which may result in tax savings are summarized below.

Gifting Strategies. A gift will have a more favorable tax consequence than the passing of the same asset at death. "Gifts" are lifetime transfers, while an "inheritance" or "bequest" is a transfer made at death. With a taxable estate, these will all generate a transfer tax, either a gift tax on lifetime transfers or an estate tax on after death transfers. The gift tax is paid on only the amount of the gift itself; however, with bequests or after death transfers, the estate tax is paid on the amount of the bequest plus the amount used to pay the tax on the bequest. When time is short, this may be of little or no utility because the IRS does not permit deathbed transfers, and gifts made within three years of death may be added back to the estate for federal estate tax computations.

Annual Exclusion Gifts. One exception to the three year rule is the annual exclusion gift, which permits annual gifts of $12,000 per year ($24,000 if the gifts are split with a spouse) to as many recipients as you wish, all tax free. Every annual exclusion gift will save around $5,500 in estate taxes, depending on the size of the taxable estate. With the compressed estate tax rates, annual exclusion gifts could be significant with larger families. For example, if a terminally ill person who is married and has four children, each with their own spouse and two children, then sixteen annual exclusion gifts of $12,000 each could be made, for a total of $384,000 for the current year, with another $384,000 after January 1st, resulting in estate tax savings of $353,280! The gifted assets will all remain in the family and no gift or estate tax will be incurred since the gifted assets were removed from the estate. Keep in mind that gifts to grandchildren are not subject to the generation-skipping transfer (GST) tax and do not use up any of the $2 million GST tax exemption.

Make a Spousal Gift. If the taxable estate is concentrated in the deathbed patient, then a spousal gift should be considered to take advantage of the ability to equalize the estates to fully use the $2,000,000 applicable exemption amount which may also reduce the estate tax rate with two smaller estates instead of one large estate. Since all gifts between U.S. citizen spouses are gift and estate tax free, this is a no cost solution, and if asset protection or the ability to designate the eventual recipients after the spouse's passing is important, lifetime qualified terminable interest property (QTIP) trusts can be utilized for the spousal gift.

Give Away Any Controlling Interests. The IRS taxes controlling interests at a premium and if a controlling interest exists in a family business, partnership or other venture, then a gift large enough to reduce that person's ownership to a non-controlling interest should be made. This can be as simple as giving away a 2% interest of the 51% shareholder to permit the remaining 49% to be valued for estate tax purposes without a control premium, thereby reducing the overall estate taxes.

Capital losses. Under current law, the assets passing via the estate get a new basis for income tax purposes. This is usually thought of as a "step-up" in basis; however, it could also be a "step-down" in basis if any stocks or other capital assets are worth less now than when they were purchased. Assets with capital losses should be sold before death to realize the losses for income tax purposes. These losses can be carried forward on the spouse's return if they can't all be used in the current year. Otherwise, the losses will be forever lost and will not be available to the estate.

Gifts to Charities. Charitable bequests and gifts should be made now. Although the estate tax effect will remain the same, a current income tax deduction will also be available. When charitable gifts are included in the Will or Trust of a dying family member and if they are not able to change their Will or Trust, then the charitable gift should be made with the consent of the charity that the gift is an "advancement" so that the income tax benefits can be preserved. Additional tax benefits may also be obtained if the charitable bequest can be made from IRD (Income with Respect to Decedent) assets, such as IRA or qualified plans, by changing beneficiary designations which can have significant income tax savings. If this isn't feasible or is not desired, then a second alternative would be to revise the estate plan by adding precatory non-binding language encouraging, but not obligating, the spouse to make the charitable bequests. This will result in no estate tax on the transfer to the spouse due to the unlimited marital deduction (instead of the charitable deduction) and will also permit the spouse to preserve the income tax benefits for the charitable donation as a deduction on the spouse's personal income tax return.

Retirement Contributions. Check to see if any additional and deductible contributions can still be made to any IRA, profit sharing or similar tax-deferred account, as this type of contribution will be lost at death.

Tax Deferred Income. On occasion, a lower tax can be obtained if deferred income is accelerated and recognized during one's lifetime. Typically, the income tax on the personal return would be less than that paid by the estate even after taking any applicable credits into account. This may require the family accountant or tax advisor to make a detailed analysis of the taxable income and the corresponding taxation based on the various options.

Business Entities. An estate or trust is limited to holding Subchapter S stock for a period of time not to exceed two years. The shares will need to be redeemed, sold or passed to a qualified shareholder, otherwise the favorable "S" corporation status will be lost. Business owners need to ensure that their estate plan directs the proper disposition of their Subchapter S shares. Special trusts which are known as Qualified Subchapter S Trusts (QSST) can be created to own S corporation stock and electing small business trusts can also be created for minor children or other beneficiaries.

Partnerships, Limited Liability Companies and Subchapter S Corporations are not taxed directly on their business earnings; instead, the owners or partners are personally taxed on the earnings regardless of whether or not they receive a distribution from the business. It would be prudent to project the anticipated tax burden and to determine who is designated to receive each of these businesses under one's estate plan, and if any capital losses exist, to determine if those losses will be available to the spouse. The death of a partner requires that the partnership books for the deceased partner be closed as of the date of death. The allocation of income or losses at death may result in a mismatch of income or losses because the allocation can be made either on a pro rata basis or based on an exact allocation. The full benefits can be preserved by simply transferring the partnership interest from the deathbed patient into joint tenancy or by amending the partnership agreement to include provisions for a successor in interest. This will most likely require the approval of some or all of the other partners.

Life Insurance

A careful review of all existing life insurance policies should also be made. Due to the rules against deathbed transfers within three years of the date of death, all life insurance owned by the ill person will most likely be included as part of their taxable estate, even if a last minute transfer is attempted. Some strategies and planning opportunities may still exist; however, they will need to be reviewed with the insurance agent and one's legal and tax advisors before any are undertaken.

The existence of policy loans may create a planning opportunity. When loans are outstanding, one should investigate the advantages of paying off the loans, especially when the dividends are used to purchase additional coverage. This can be quite valuable because the terminally ill person is usually unable to obtain any additional insurance. When asset protection is of concern, many states provide creditor protection for life insurance passing to family members, so care must be exercised not to destroy a creditor-protected asset or entity which otherwise would have been unavailable to the creditor. It may therefore be wise to use funds that would be available to the creditor to pay off the policy loans, thereby preserving the full value of the life insurance.

Many policies contain a premium waiver which takes effect upon the insured's disability that, in essence, provides for the payment of the premiums until death. If a policy contains this provision, the insurance agent needs to be notified or the estate may be able to claim a refund for the paid premiums.

Time to Move?

Now for some not so common strategies. Should you find yourself with a terminally ill parent or child with a taxable estate who is living in a state with high income or inheritance taxes or expensive probate proceedings, you may want to consider having them move to another state which imposes no income or inheritance tax. Assuming that proper care can be obtained in multiple states, this may permit the deathbed patient to move closer to family, as well as to significantly reduce both income and inheritance taxes.

Transfers to the Deathbed Spouse

Up until now we have been primarily concerned with estate taxes. Sometimes it is also wise to consider income tax planning. If a person receives a gift of appreciated property and then dies within one year, that property will not receive a step-up in basis if it passes back to the donor. The step-up in basis, if available, will eliminate the 15% capital gains tax on the amount of appreciation. Gifts to an ill spouse should therefore not be overlooked as the ill spouse may survive more than a year. Other planning may be used to balance the assets to obtain both income and estate tax benefits.

For Further Information on Estate Planning or Asset Protection Strategies, Please Contact:

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