THE ESTATE PLANNER

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Annual exclusion gifts

A deceptively powerful estate planning strategy

In 2021, the federal lifetime gift and estate tax exemption amount is a whopping $11.7 million. So, for most people, it may seem like planning for gift and estate taxes is unnecessary. But even if your net worth is only a fraction of the current exemption amount, there are good reasons to adopt strategies — such as making regular annual exclusion gifts — to reduce the size of your taxable estate.

What is the annual exclusion?

The annual exclusion allows you to make yearly tax-free gifts up to $15,000 per person to any number of recipients. If you're married, you and your spouse can give up to $30,000 per recipient tax-free. And you can make these gifts without using up any of your federal lifetime exemption amount. You can also make direct payments of tuition or medical expenses on behalf of your loved ones without using your annual exclusion. (See "Don't overlook tuition and medical expenses" on page 3.)

The annual exclusion amount may not seem all that significant, but along with a regular program of lifetime giving, the benefits can add up quickly. Consider this example: John, a widower, has four children and 10 grandchildren. Starting in 2021, he gives each child and grandchild annual exclusion gifts of $15,000 each, for a total of $210,000 per year. By 2025, he has reduced his taxable estate by $1.05 million, plus any appreciation on the transferred assets, without using any of his lifetime exemption amount. If he also makes direct payments of tuition or medical expenses for any of his children or grandchildren, he can further reduce the size of his estate.

Why make annual gifts?

That's all well and good, you may be thinking, but what's the point? If there's little chance that your estate's worth will even approach the lifetime exemption amount, is there any advantage to making tax-free annual exclusion gifts? The answer, for many people, is yes.

The most important reason for annual gifting is to protect yourself against the risk that the exemption amount will be drastically reduced in the near future, potentially exposing a portion of your wealth to gift and estate taxes overnight. A "sunset" provision in the

Don't overlook tuition and medical expenses

In addition to annual exclusion gifts, you can also avoid gift tax on any amount of direct tuition or medical expenses you pay on behalf of your loved ones, without using any of your lifetime gift and estate tax exemption. To qualify for exclusion, payments must be made directly to the educational institution or medical provider. The exclusion applies to tuition at any grade level, but not to room and board, supplies, or other nontuition educational expenses. Medical expenses qualify only to the extent that they're not reimbursed by insurance.

Consider talking to your loved ones before making annual exclusion gifts to find out what they plan to use the money for. If it will go toward tuition or medical expenses, consider paying those expenses directly to maximize the amount you can transfer tax-free.

Tax Cuts and Jobs Act, which doubled the exemption amount to its current level, calls for it to return to its previous level in 2026.

So, without any action by lawmakers, the exemption will drop to $5 million-plus (adjusted for inflation) after 2025. But President Biden's tax proposals call for the exemption to be reduced even further, to $3.5 million in bequests at death and only $1 million in lifetime gifts.

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Going back to our example, suppose that John dies in 2026, leaving an estate worth $3.5 million, and that the exemption amount in 2026 has been reduced to $3.5 million. John's estate is shielded from estate taxes by the exemption, but had he not transferred wealth to his family through regular annual exclusion gifts, his estate would have been $1.05 million higher (plus any appreciation on the assets he retained), resulting in an estate tax liability of at least $420,000 at the current 40% rate.

A program of annual exclusion gifts offers nontax benefits as well. These include the chance to watch your loved ones enjoy sharing your wealth and the opportunity to help shape your heirs' behavior (by conditioning gifts on staying in school, for example).

Should you consider larger gifts?

The current lifetime exemption amount creates a window of opportunity for affluent families to transfer significant amounts of wealth tax-free. So, if you're willing and able to do so, it may be advantageous to make very large gifts now, before that window closes.

Keep in mind, however, that if you own assets that have appreciated significantly in value, or that you expect to appreciate in the future, gifting them to your heirs may have income tax consequences. Assets transferred by gift retain your tax basis,

which means your heirs would trigger an immediate income tax bill by selling them.

Assets transferred at death, however, receive a "stepped-up basis" equal to their date-of-death market value, eliminating any taxable gain as of that date. Note, however, that one of President Biden's tax proposals would eliminate the stepped-up basis at death.

The gift that keeps on giving

If you're not able to make very large gifts now, consider implementing a program of regular annual exclusion gifts. This strategy will allow you to transfer substantial amounts of wealth tax-free over time, while minimizing the impact of future reductions of the lifetime exemption. Contact your estate planning advisor for more information.

Avoid these 6 estate planning pitfalls

No one likes to contemplate his or her own mortality, but ignoring the need for an estate plan or procrastinating in the creation of one is asking for trouble. If you haven't started the process, don't delay any longer. However, for your estate plan to achieve your goals, there are six pitfalls that must be avoided:

Pitfall #1: You don't understand your estate plan. Surprisingly, this is at the root of many estate planning debacles, despite the guidance of an experienced estate planning advisor.

Simply signing documents, and not knowing what you're signing, or what they mean, could cause problems. This is especially true if you don't follow up with actions you're supposed to take. This doesn't mean you have to be a legal expert, but it's important to grasp the basic concepts. Even though you can always rely on your advisor, knowledge is power.

Pitfall #2: You don't update beneficiary forms. Your will spells out who gets what, where, when and how, but it's often superseded by other documents such as beneficiary forms for retirement plans, annuities and life insurance policies. Therefore, like your will, you must also keep these forms up to date. For example, despite your intentions, retirement plan assets could go to a sibling or parent — or even worse, an ex-spouse — instead of your children or grandchildren. Review beneficiary forms periodically and make any necessary adjustments.

Pitfall #3: You don't properly fund trusts. Frequently, an estate plan will include one or more trusts, including a revocable living trust. The main benefit of a living trust is that assets transferred to the trust don't have to be probated and exposed to public inspection. It's generally recommended that such a trust be used only as a complement to a will, not as a replacement.

However, the trust must be funded with assets, meaning that legal ownership of the assets must be transferred to the trust. For example, if real estate is being transferred, the deed must be changed to reflect this. If you're transferring securities or bank accounts, you should follow the directions provided by the financial institutions. Otherwise, the assets must be probated.

Pitfall #4: You don't properly title assets. Both inside and outside of trusts, the manner in which you own assets can make a big difference. For instance, if you own property as joint tenants with rights of survivorship, the assets will go directly to

the other named person, such as your spouse, on your death.

Not only is titling assets critical; you should review these designations periodically, just as you should your beneficiary designations. Major changes in your personal circumstances or the prevailing laws could dictate a change in the ownership method.

Pitfall #5: You don't coordinate different plan aspects. Typically, there are several moving parts to an estate plan, including a will, a power of attorney, trusts, retirement plan accounts and life insurance policies. Don't look at each one in a vacuum. Even though they have different objectives, consider them to be components that should be coordinated within your overall plan.

For instance, arrange to take distributions from investments — including securities, qualified retirement plans, and traditional and Roth IRAs — in a way that preserves more wealth. Also, naming a revocable living trust as a retirement plan beneficiary could accelerate tax liability.

Pitfall #6: You don't review the plan. It's critical to consider an estate plan as a "living" entity that must be nourished and sustained. Don't allow it to gather dust in a safe deposit box or file cabinet. Consider the impact of major life events such as births, deaths, marriages, divorces, or job changes and relocations, just to name a few.

To help ensure that your estate plan succeeds at reaching your goals and avoids these pitfalls, turn to your estate planning advisor. He or she can provide you with the peace of mind that you've covered all the estate planning bases.

The split annuity: A balanced approach to retirement and estate planning

If you're approaching retirement or have already retired, one of the biggest challenges is balancing the need to maintain your standard of living with your desire to preserve as much wealth as possible for your loved ones. This balance can be difficult to achieve, especially when retirement can last decades. One strategy that can offer greater peace of mind is the split annuity, which creates a current income stream while preserving wealth for the future.

Annuity basics

An annuity is a tax-advantaged investment contract, usually with an insurance company or other financial services provider. You pay either a lump sum or annual premiums, and, in exchange, the provider makes periodic payments to you for a term of years or for life.

For purposes of the split annuity strategy discussed below, we'll focus on "fixed" annuities, which

generally provide a guaranteed minimum rate of return. Other types of annuities include "variable" and "equity-indexed," which may offer greater upside potential but also involve greater risk.

Annuities can be immediate or deferred. As the names suggest, with an immediate annuity, payouts begin right away, while a deferred annuity is designed to begin payouts at a specified date in the future. From a tax perspective, annuity earnings are tax-deferred — that is, they grow tax-free until they're paid out or withdrawn. A portion of each payment is subject to ordinary income taxes, and a portion is treated as a tax-free return of principal (premiums). The ability to accumulate earnings on a tax-deferred basis allows deferred annuities to grow more quickly than comparable taxable accounts, which helps make up for their usually modest interest rates.

Annuities offer some flexibility to withdraw or reallocate the funds should your circumstances change. But keep in mind that — depending on how much you withdraw and when — you may be subject to surrender or early withdrawal charges. Most annuities provide some exceptions to these charges under certain circumstances, such as withdrawals attributable to disability, loss of employment or death of the annuity owner. Withdrawals before age 59½ may also be subject to 10% tax penalties.

Split annuity strategy

A "split annuity" may sound like a single product, but in fact it simply refers to two (or more) annuities, usually funded with a single investment. In a typical split annuity strategy, you use a portion of the funds to purchase an immediate annuity that makes fixed payments to you for a specified term (10 years, for example) and apply the remaining funds to a deferred annuity that begins paying out at the end of the initial annuity period.

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Ideally, at the end of the immediate annuity term, the deferred annuity will have accumulated enough earnings so that its value is equal to your original investment. In other words, if the split annuity is designed properly, you'll enjoy a fixed income stream for a term of years while preserving your principal.

At the end of the term, you can reevaluate your options. For example, you might start receiving

payments from the deferred annuity, withdraw some or all its cash value, or reinvest the funds in another split annuity or another investment vehicle. Deferred annuities often allow you to withdraw some of their cash value penalty-free, but depending on how much you withdraw or reinvest, you may be subject to early withdrawal penalties or surrender charges.

A valuable tool for your arsenal

For most people, the split annuity — with its modest interest rates — is no substitute for other retirement and estate planning vehicles that offer superior rates of return. But its ability to provide peace of mind by offering a fixed income stream while preserving principal makes it a potentially attractive supplement to other investment tools.

ESTATE PLANNING RED FLAG

Your college-aged child doesn't have an estate plan

As your child heads off to college, with little or no assets in his or her name, estate planning is probably the last thing on your mind. But while it may be difficult to think about, it's a good idea for your child to have at least a basic plan in place to ensure that his or her wishes are carried out should the unthinkable happen.

Estate planning documents to consider include a:

Health care power of attorney. Also known as a health care proxy or durable medical power of attorney, this document appoints another person — usually a parent — to make health care decisions on your child's behalf in the event he or she is unable to do so. Typically, the document also provides guidance on your child's preferences for using or withholding life-sustaining medical procedures. Children age 18 or older are usually treated as adults, so without a health care power of attorney, you'll have no say in your child's medical treatment should he or she become incapacitated.

HIPAA release. An important complement to a health care power of attorney, this document ensures that health care providers are authorized to share confidential information about your child's medical condition with you.

Financial power of attorney. This document appoints another person — again, usually a parent — to make financial decisions, pay bills and conduct other financial transactions on your child's behalf. The document specifies the conditions under which the representative is authorized to act — if your child is out of the country, for example, or, in the case of a "durable financial power of attorney," if your child becomes incapacitated.

Will. Even if your child has only a small amount of money or other assets (including personal possessions with only sentimental value), it's a good idea to prepare a basic will to ensure he or she has a say over their disposition.

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Estate planning is a complex task that often involves related areas of law, as well as various types of financial services. Our clients frequently face complicated real estate, tax, corporate and pension planning issues that significantly impact their estate plans. So our attorneys work with accountants, financial planners and other advisors to develop and implement strategies that help achieve our clients' diverse goals.

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We welcome the opportunity to discuss your situation and provide the services required to help you achieve your estate planning goals. Please call us today and let us know how we can be of assistance.

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