SUMMIT
FINANCIAL GROUP, LLC

Tax planning: Charitable giving and estate planning

Understanding how the tax law affects charitable giving and estate planning.

Given the complexity of changes to the tax code in the United States, there is much to consider in determining the impact tax legislation will have on each of us with regard to charitable giving and estate planning.

OVERVIEW

Passed in late 2017, tax-reform legislation made sweeping changes to the tax code in the United States, including changes to individual and corporate income tax rates. Known as the Tax Cuts and Jobs Act, the legislation goes into effect in 2018, with many of its provisions set to expire on Jan. 1, 2026.

The legislation includes increases in the standard deductions and the limitation or elimination of many personal deductions. As such, many of us will switch from itemizing to taking the standard deduction. With regard to charitable giving, gifts made after 2017 may not yield a tax benefit, potentially removing an incentive to make annual gifts to charity. But there are still ways to give.

With regard to wealth transfers, the legislation includes increases in the exemptions for gift and estate taxes, as well as the generation-skipping transfer (GST) tax. Given the significant changes, anyone with an estate plan should review it to make sure it still accomplishes its objectives. Many married couples may be able to greatly simplify their estate plans. Also, there could be substantial tax transfer savings from increasing lifetime gifting, whether outright or in trust.

CHARITABLE GIVING

TAX-PLANNING CONSIDERATIONS

Bunching charitable gifts: If you are charitably inclined, but won't have sufficient itemized deductions to exceed the increased standard deduction, you may wish to bunch deductions by making a large charitable gift during a single year, equal to the total donations you would have made over several years. This could help you take advantage of the ability to itemize the year you make the large gift, while in other years you would take the standard deduction.

Giving appreciated securities: Funding charitable gifts with appreciated stocks or mutual funds, rather than cash, yields a bigger tax benefit since you can deduct the full value of securities held more than one year without paying capital gains taxes on the appreciation. If you are donating to a tax-exempt organization, it will not pay capital gains taxes.

IMPORTANT TOPICS

- Appreciated securities
- Donor-advised funds
- Gifts
- Exemption portability
- State estate and gift taxes
- State Gap QTIP Trust
- Generation-skipping transfer (GST) taxes
- Trusts
- Family businesses
- Estate documents

A donor-advised fund: This bunching strategy can work particularly well if you give annually, as you can contribute an amount to a donor-advised fund, claim an immediate income-tax deduction and then make grants in future years according to your original giving plan. Donor-advised funds are ideal when you know you want to give, but haven't yet decided upon worthy recipients. And you can boost your tax savings by giving appreciated securities to a donor-advised fund.

Philanthropy through RMDs: A logical solution for charitably minded people over age 70½ is the IRA qualified charitable distribution (QCD), or so-called IRA charitable rollover. You can transfer up to $100,000 a year from an IRA directly to charity, with the exception of donor advised funds, and have it count toward your annual required minimum distribution (RMD). The distribution is not taxable to you as an RMD, nor is it deductible. And since it's not deductible, you don't have to worry about itemizing, deduction limitations or exceeding the standard deduction threshold.

Give while living: Since only the very largest estates benefit from an estate tax charitable deduction under the new law, charitably inclined people with non-taxable estates should consider the benefits of accelerating charitable bequests by making them prior to death. This could be time sensitive, however, since the increased exemption amount is set to expire on Jan. 1, 2026.

ESTATES

The IRS announced in October 2017 the basic exclusion amount – the exemption amount from estate, gift and generation-skipping tax (GST) – will be $5.6 million, inflation-adjusted for 2018. After the tax legislation, it was believed the 2018 exemption would be doubled to $11.2 million. Due to a calculation error in inflation indexing, the IRS recalculated the 2018 exemption to equal approximately $11.18 million.

The provision almost doubling the exemption to $11.18 million per person is set to expire for individuals whose death occurs after Dec. 31, 2025. On Jan. 1, 2026, the exemption will revert to $5 million, adjusted for inflation after 2011, which would be $5.6 million in 2018.

Since the federal estate tax was not repealed, as some in Congress had hoped, you should continue to take full advantage of the various exclusions and exemptions the law provides, such as the gift tax annual exclusion, the tuition and medical expenses exclusion, and the lifetime gift tax exemption. Whether to gift now or later, and much more, is discussed below.

GIFT PLANNING CONSIDERATIONS

Timing of gifts

You could see substantial transfer tax savings by increasing lifetime gifting, whether outright or in trust, due to the increased exemption. By transferring appreciating assets to children and grandchildren, you benefit by removing from your estate all post-transfer appreciation in the value of the gifted assets.

While lifetime gifting can provide significant estate tax savings, assets gifted during lifetime don't get a basis step-up at death. Review your assets to determine the most appropriate for lifetime gifting, which could be cash or high-basis assets, and measure potential capital gain consequences against any transfer tax savings.

Annual gift tax exclusion

Consider the long-term benefits of utilizing the gift tax annual exclusion every year, to the extent you are financially secure and comfortable making gifts. Over the long haul, this significantly reduces estate taxes by shrinking your estate each year by the tax-free gifts. While many wait until the end of the year to use the annual gift tax exclusion, it is actually more effective from a tax planning perspective to make annual gifts earlier in the year.

Lifetime exemption

The larger exemption affords an incredible opportunity to make substantial gifts, and future appreciation on assets gifted during life avoids federal and state death taxes. With this limited window of opportunity, not to mention uncertainty as to future legislative changes, you should consider using the higher exemptions before they are lost.

Even if you have used all or most of your exemption in previous years, you can now make additional tax-free gifts to non-spouse beneficiaries – up to $11.18 million, minus any exemption used.

Tuition and medical expenses

Consider making unlimited tax-free gifts for tuition and/or medical expenses for family members or friends. As long as the gifts are made directly to the healthcare provider or educational institution, the payments don't count against your annual gift tax exclusion, nor are they limited to the annual exclusion amount. Also, these transfers are not considered for GST tax purposes.

Appreciated stock

While people often want to make annual exclusion gifts with appreciated marketable securities, consult with your tax advisor first, as it may be better for you to sell the securities, pay the tax and make the gift in cash. Since the recipient doesn't have to pay income tax, the net gift is larger. You may have capital losses to shelter the gain, and payment of the income tax reduces your taxable estate.

Exemption clawback

While the increased exemption creates tremendous planning opportunities, the question of a clawback remains, as in 2012. Can the IRS recapture, or claw back, the additional $5.6 million of exemption if you used the entire $11.18 million exemption, but die after the exemption sunsets on Jan. 1, 2026? While the statutory language does not eliminate the possibility of a clawback, it states the Secretary shall prescribe regulations as necessary or appropriate to carry out the intended purpose. However, it is not clear from the statute alone whether Congress intends the clawback to occur.

Since congressional intent is not clear and there's no telling what could happen, you should use caution regarding the potential risk of a clawback before making large gifts and using the additional exemption, and consult with your tax and legal advisors.

EXEMPTION PORTABILITY

While the increased exemption, coupled with spousal portability, allows married couples to shelter up to $22.36 million from federal estate tax without having to rely on complicated testamentary bypass and marital trusts, many couples may be considering simplifying their estate plans by removing these so-called AB trust provisions in favor of a portability-based estate plan. Before rushing to a simpler plan, you should consult with a qualified estate attorney to fully evaluate and understand your options. We address estate documents later in this paper.

If your spouse is deceased and you carried over, or ported, his or her unused exemption, you should consider using the increased amount to make lifetime gifts before any potential legislative changes.

In the event your spouse dies, given the recent increase in the exemption, you may no longer be willing to incur the additional costs to obtain the benefit of portability. However, in the event the estate tax law sunsets in 2026, loss of portability from failure to file an estate tax return for the first deceased spouse could cause estate tax on the surviving spouse's death, particularly if the federal exemption later decreases to pre-2018 or lower levels.

STATE ESTATE AND GIFT TAXES

If you reside in a state with an estate tax, but not a state gift tax, you should consider making large lifetime gifts to reduce state estate taxes, since the increased federal exemption amount will sunset. Consider also whether the potential estate tax savings from lifetime gifts outweighs the loss of the basis step-up for assets held at death.

STATE GAP QTIP TRUST

In situations where the state estate tax exemption has not increased in line with the federal exemption, especially given the recent doubling of the federal exemption, and this difference, or gap, has not been properly addressed in the estate documents, married couples could face a substantial and unexpected state estate tax liability at the first spouse's death. You should work with your legal counsel to revise your wills or, if applicable, living trusts, to maximize the use of the state exemption and marital deduction.

GENERATION-SKIPPING TRANSFER (GST) TAXES

You may wish to consider applying the increased generation-skipping transfer (GST) exemption to an existing trust that might not have had a proper allocation of GST exemption in the past, or if the previous exemption was not sufficient to make the trust fully GST-exempt.

The increased GST exemption provides an opportunity to make substantial and highly tax-efficient generational transfers, with respect to the GST tax. With this limited window of opportunity, you should consider using this higher GST exemption before it is lost.

TRUSTS

Grantor retained annuity trust (GRAT): This popular wealth transfer strategy, when combined with the substantial increase in the exemption, can transfer high-income producing or rapidly appreciating assets, such as a closely held business interest or investment real estate, out of the estate on a discounted basis. The grantor, which is you, transfers an asset to a grantor trust, but retains the right to receive a fixed annual payment from the trust for a term of years, usually a percentage of the initial value of the trust assets. The GRAT can even be structured so the annuity payment back to the grantor is large enough to eliminate or minimize the taxable gift, a so-called zeroed-out GRAT. You should review the cash flows of assets and consult with your tax and legal advisors to determine whether the strategy is appropriate.

Installment sale to a grantor trust: This sophisticated wealth transfer technique, in conjunction with the increased exemption, can be an extremely effective way to transfer a high-income producing or rapidly appreciating asset, such as a closely held business interest or investment real estate, with little or no gift or estate tax. The grantor, which is you, sells assets to a grantor trust in exchange for an installment note. Due to the grantor income tax rules, the income of the trust is taxed to the grantor, the sale of an appreciated asset by the grantor to the trust is a non-taxable transaction, and the grantor's payment of income taxes on the trust income is not a taxable gift from the grantor to the trust beneficiaries. Income generated in the trust is applied to principal and interest on the note. Due to favorable interest rates on intra-family loans, interest payments are minimized, leaving more assets in trust for beneficiaries. Review your asset cash flows and discuss with your tax and legal advisors to determine whether this strategy is appropriate.

Asset protection trust: A surviving spouse could use the ported exemption, detailed above, to fund a self-settled asset protection trust, also known as a domestic asset protection trust (DAPT). By utilizing a DAPT, the surviving spouse could access the transferred wealth.

Dynasty trusts: With a dynasty trust, you can make substantial gifts using your increased exemptions to this trust, to which lifetime gift and GST exemptions may be allocated, exempting the trust assets from further transfer taxation for the term of the trust. Throughout your lifetime, a dynasty trust can be structured as a grantor trust for income tax purposes, so you are taxed on the trust income. And your payment of income taxes on trust income tax further reduces your taxable estate over the years. Dynasty trusts with life insurance can further leverage transfer tax exemptions.

Simplified transactions: If you previously used GRATs, you may find that larger transfer-tax exemptions allow for simpler trust transactions without the need for leveraging provided by GRATs. Likewise, if you are interested in wealth transfer planning, but prefer simplicity, you may favor skipping complex strategies in favor of a straightforward gift to a trust.

FAMILY BUSINESSES

Privately held stock: You may want to consider transferring stock in your family business to a dynastic GST-exempt trust. Retaining personal ownership of the stock leaves you or the business exposed to potential estate and GST taxes, as well as remarriage and creditor risks, and may not be prudent or acceptable to the family. Use of a dynastic trust can substantially extend these protections for many generations.

Valuation discounts: You can use discounting techniques, which are back in vogue since the proposed Section 2704 Treasury regulations, which would have arguably eliminated the use of valuation discounts in transferring interests in family-controlled entities, were withdrawn last year and thus continue to be highly effective in the current low interest-rate environment, to further leverage wealth transferred via the increased transfer-tax exemption amounts.

ESTATE DOCUMENTS

Review estate plans: Given the significant changes to the transfer tax laws, you should review your estate plan with your tax and legal advisors to ensure it still accomplishes your objectives. This includes reviewing wills, living trusts and existing lifetime tax-planning strategies. Recall that while these favorable changes are scheduled to sunset on Jan. 1, 2026, absent future legislative action, it is possible changes could occur sooner. Thus, flexibility in estate plans is more important than ever.

Married couples with nontaxable estates: The substantial increase in the estate tax exemption to $11.2 million per person could lead to the increased use of portability-based estate plans, such as simple or I-love-you wills, in which the first spouse's estate passes outright entirely to the surviving spouse, in favor of the traditional default bypass and marital trust, or AB trust, estate planners have used since the 1980s. The problem stems from the lack of flexibility, in terms of post-mortem planning, for AB trust plans for married couples with non-taxable estates. Since the bypass trust must be created at the first death and these assets are not eligible for a basis step-up at the second spouse's death, this can in fact result in income tax due in the future when the appreciated assets of the bypass trust are sold, where both income and estate tax at the second death could have been completely avoided. If you have a non-taxable estate, consult with your tax and legal advisors immediately regarding more flexible alternative estate plans.

Bypass trusts: As noted, bypass, or credit-shelter, trust planning is still appropriate generally for married couples with taxable estates. However, if your estate plans contain federal credit shelter formula bequests, you should immediately consult with your legal counsel.

Let's work together with your tax and legal professionals to determine how the legislation affects you directly.

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