RAYMOND JAMES

Tax planning: Charitable giving and estate planning

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

OVERVIEW

Two laws, one durable, the other a temporary measure in response to the COVID-19 pandemic (this law expired at the end of 2021), significantly changed several key estate planning and charitable giving provisions that should be considered.

TAX CUTS AND JOBS ACT OF 2017

The Tax Cuts and Jobs Act made sweeping changes to the tax code in the United States, including changes to individual and corporate income tax rates. The law took effect in 2018 and many of its provisions are set to expire on Jan. 1, 2026.

The law significantly increased standard deductions and limited or eliminated many personal deductions. As such, many tax filers switched from itemizing deductions to taking the standard deduction, so fewer Americans can see benefits from charitable giving. But there are still ways to give.

With regard to wealth transfers, the 2017 legislation includes increases in the exemptions for gift and estate taxes, as well as the generation-skipping transfer (GST) tax. Given the significant exemption increases, many married couples were able to greatly simplify their estate plans. However, with the pending sunset of the law after 2025 and the potential for its repeal sooner, those with substantial wealth should consider strategies to prepare for a reduced estate tax exemption.

Giving appreciated securities: Several of the charitable deduction rules favor gifts of cash rather than property or securities. However, funding charitable gifts with appreciated stocks or mutual funds, rather than cash, often yields a larger 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. The deduction limit of 30% of AGI does still apply for gifts to public charities. Donations exceeding this limit may be carried forward up to five years.

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.

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 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 70 1/2 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.

Changes to RMDs

Recent changes from the SECURE Act have increased the age to begin taking an RMD to age 72.

However, IRA owners over age 70 1/2 are still permitted to make a qualified charitable distribution even if they do not have to take an RMD.

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. If the higher estate exemptions do sunset, or get repealed, these charitable gifts will have reduced the taxable estate.

ESTATES

The Tax Cuts and Jobs Act essentially doubled the prior estate tax exemption beginning in 2018. In 2022, the exemption amount from estate, gift and generation-skipping tax (GST) was indexed to $12.06 million per person with an annual exclusion amount of $16,000.

The provision doubling the exemption is set to expire for individuals whose deaths occur after Dec. 31, 2025. On Jan. 1, 2026, the exemption will revert to $5 million, adjusted for inflation after 2011, which would be approximately $6 million (in 2022 dollars). With the prospect of this significant reduction in estate tax exemption, families with significant wealth should consider steps to limit estate tax exposure sooner rather than later. The following strategies may be considered.

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 your 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 confident and comfortable making gifts. You may gift up to $16,000 (in 2022) to each recipient every year without triggering a gift tax or cutting into your lifetime exclusion. A couple could each make annual exclusion gifts, or utilize gift splitting to double the gift amount. Recipients are often family members of decedents, but this is not a requirement of the law. Over the long haul, this strategy significantly reduces estate taxes by shrinking your estate each year by using 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.

Tuition and medical expenses: Consider making unlimited tax-free gifts for tuition 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.

Lifetime exemption: The current large estate and gift tax exemption affords wealthy families an incredible opportunity to make substantial gifts. Gifting assets today removes future appreciation on those assets from the future taxable estate. With this limited window of opportunity, not to mention uncertainty as to future legislative changes, families with substantial wealth should consider using the higher exemptions before they are lost.

Exemption clawback relief: Estate planners had questioned what would happen if a taxpayer made a large gift, effectively using all of their lifetime gift and estate exemptions, then later the exemption was reduced to an amount smaller than what had been gifted. Would this "excess gift" that was within the lifetime exemption when given, but less than the estate exemption at death, be "clawed back" into the taxable estate?

In late 2019, the IRS provided finalized guidance that addressed this concern, giving wealthy families more certainty in taking advantage of the current elevated gift and estate exemptions. If you have the resources to make such a gift, consult your estate attorney about the effectiveness of making a gift at or near the current estate tax exemption amount.

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 PORTABILITY

The increased exemption, coupled with spousal portability, allows married couples to shelter up to $24.12 million (in 2022) from federal estate tax without having to rely on complicated testamentary bypass and marital trusts. This may lead many couples to consider 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.

In the event your spouse has passed away, it is important to file an estate tax return in order to claim the Deceased Spouse Unused Exemption Amount (DSUEA). This is more commonly known as "portability." Even if your estate is well below the current exemption limits, locking in this portable credit may be an important hedge against future estate tax law changes.

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 outweigh 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 living trusts to maximize the use of the state exemption and marital deduction.

GENERATION-SKIPPING TRANSFER 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.

Intentionally defective grantor trust (IDGT): With this strategy, the grantor forms the trust so that he or she remains responsible for the trust's income tax liability, but the assets in the trust are not included in the grantor's estate for estate tax purposes. By transferring assets to the IDGT, the grantor can immediately reduce the value of his or her estate because the grantor has relinquished control over the assets transferred to an irrevocable trust. The grantor can also allocate the lifetime GST exemption to the trust to ensure that the trust assets may be used for future generations without incurring GST tax. It's also worth noting that by paying the IDGT's income tax, the grantor is further reducing his or her estate without incurring additional gifts.

Spousal lifetime access trust (SLAT): This advanced strategy involves transferring significant wealth into a trust and utilizing the lifetime exemption. The grantor forms a trust typically for the benefit of his or her spouse and other beneficiaries, such as children or decedents. The gifting spouse allocates gift tax exemption and possibly GST exemption to the gift to trust. The trust is structured so that the beneficiary spouse can have limited access to trust income and principal; however, the trust is designed so the assets are not included in either spouse's estate for estate tax purposes. Spouses must be advised of the "reciprocal trust doctrine" if both spouses create SLATs. Consult your estate attorney to determine if this strategy is appropriate for your plan.

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 for you.

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 prefer 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 your 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. The use of a dynastic trust can substantially extend these protections for many generations.

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

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 the current estate and gift tax exemptions 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 $12.06 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 postmortem 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 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 trust planning is still generally appropriate for married couples with taxable estates. However, if your estate plan contains a bypass trust clause (also referred to as a family trust or credit shelter trust) that utilizes a formula tied to the federal estate tax exemption, the significant changes in this exemption (both in the past and in the future) could lead to unintended results. You should immediately consult with your legal counsel if this is the case with your estate plan.

Tax and estate planning can be complicated. Let's work together with your tax and legal professionals to determine how current legislation affects you directly.

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