Taxes and Estate Planning: Not one size fits all

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Introduction

When considering your estate planning options taxes are an important part of your estate plan. Without qualified legal counsel that focuses on estate planning guiding you, your plan may not be as tax efficient as it could be and can cause your beneficiaries to incur greater tax liability than they otherwise would have to assume. This article addresses some of the major taxes you should consider as part of your estate plan.

Pennsylvania Inheritance Tax

The Commonwealth of Pennsylvania is only one of six states that still imposes an inheritance tax on its residents. Pennsylvania inheritance tax applies to all assets that you own in whole or in part on your date of death. The rates of inheritance tax in Pennsylvania are as follows: spouses and charities 0% ; lineal descendants (i.e., children and grandchildren) 4.5% ;siblings 12%; and all other beneficiaries 15%. We routinely hear when we meet with clients that they want to avoid paying Pennsylvania inheritance tax. The only way to avoid inheritance tax is to gift assets away greater than one year from your date of death. If a gift is made within one year from your date of death, then the gifted amounts are included in your estate for the purposes of calculating inheritance tax.

While avoiding Pennsylvania inheritance tax is an understandable goal, it is often times better for your estate beneficiaries to pay inheritance tax on certain assets in order to preserve favorable capital gains tax treatment which is discussed later in this article. That being said, for the right type of assets, it may make sense to make a gift of the assets if you can estimate what the capital gains tax treatment will look like for you and your beneficiaries.

Federal Estate and Gift Tax Credit Amount and Rollback of Credit Amount by the end of 2025

The current unified credit for federal estate and gift tax is $12.06 million per person for 2022 ($24.12 million per married couple) in 2022. Stated another way, you will only be subject to federal estate and/or gift tax if you: (a) give away more than $12.06 million in your lifetime or (b) die with an estate in excess of $12.06 million. The federal government impose a tax rate of up to forty (40%) percent on gifts or estates that exceed $12.06 million. Even if your net worth is in excess of $12.06 million, you can minimize, or potentially eliminate, your federal estate and gift tax liability with proper advanced planning.

A. Annual Exclusion Gifting in 2022: $16,000 per person per calendar year

Gifts can be defined as transfer of assets for less than adequate consideration. In regard to gift tax, the federal government permits you to gift $16,000 to another person, per year, beginning in 2022. This is called the "annual exclusion" amount. It is called this because if total gifts in a calendar year from you to another person do not exceed $16,000 then the gift(s) do not count. If you make a gift to another person in excess of the annual exclusion amount in a calendar year, the amount above the annual exclusion amount must be reported on an IRS Form 709 (gift tax return)by April 15 of the year following the year the gift was made. For example, if you made total gifts to your child of $16,000 in 2022, then you do not need to file an IRS form 709 . Conversely if you made total gifts to your child of $20,000 in 2022 then you must report the amount in excess of the annual exclusion amount (in this case, $4,000) to the IRS on an IRS form 709 by April 15, 2023 (at the same time that you report your taxable income on your IRS form 1040). In the latter example, while a gift tax return will need to be filed, no gift tax amount will be do until and unless you gift more that $12.06 million during your lifetime.

B. Three Year Look Back Rule on Gifts made within Three Years of Death.

Also, in regard to gift tax liability, the federal government has a three year look back rule on gifts made within three years prior to your death. This rule, simply put, states that assets gifted within three years of a person's death must be included in their gross estate for determining federal estate tax liability. Thus, depending on your net worth, gifting assets away at the end of your lifetime may not be enough to avoid federal estate tax liability upon your death. This rule minimizes a person's incentive to transfer property shortly before death to reduced federal estate tax

C. Rollback of Credit Amount by the End of 2025

The $12.06 million unified credit amount is scheduled to "sunset" on December 31, 2025, to half of its then current level. Unless Congress acts before then for those U.S. Citizens dying in 2026, only $6.03 million will be exempted from federal estate and gift tax. The IRS has ruled that beginning in 2026 your estate tax threshold will be the greater of the estate tax threshold then in place and the total taxable gifts you have made during life. While this is still a significant amount, without proper planning you could leave a surprising tax liability for your beneficiaries.

D. Medicaid Does Not Care about Federal and State Gifting Rules

One important note, Medicaid does not care about federal and state gifting rules when it comes to determining eligibility for Medicaid benefits. As past newsletter articles have discussed, Medicaid is an entitlement program that covers the cost of skilled nursing (the present statewide monthly average cost is $14,676) if you are both medically and financially eligible. Medicaid has its own lookback period. Gifts made within five years of application for Medicaid benefits will cause a penalty period to be served before Medicaid benefits will start. During the penalty period you will have to privately pay the nursing home. With proper legal planning the penalty period can be avoided or minimized while also preserving as favorable tax treatment as possible. But, this is another area of the law that you must have qualified legal counsel to guide you.

Capital Gains Tax for Beneficiaries

As discussed earlier, giving away assets, provided you beat the applicable look back periods may cause less federal estate and Pennsylvania inheritance tax liabilities. However, it could cause your beneficiaries to lose a step-up in basis. Step-up in basis refers to a tax policy that looks at the market value of assets at the time a person inherits them instead of the value when the prior owner purchased the assets. For tax purposes, assets that are sold will be taxed for capital gains, and the more the asset value increases, the greater the capital gains taxes will be.

Step-up in basis can greatly reduce the capital gains taxes owed by someone inheriting property or other assets. For example, assume you purchased 100 shares of stock for $10 each, and your beneficiary inherited the shares after your death when the stock shares were worth $20 dollars each. When your beneficiary goes to sell the stocks five years later, they are worth $30 each. Under a step-up in basis, your beneficiary would only pay capital gains taxes on the $10 gains between inheritance date and the stock sell date ($30-$20=$10). If the step-up in basis did not exist, your beneficiary would have to pay capital gains taxes on the $20 gains between purchase price and selling the stocks ($30-$10=$20) at rate of twenty percent! Because a majority of Americans do not have to worry about federal estate and gift tax because their net worth is below the credit amount (presently, $12.06 million) preservation of step-up in basis is a large consideration for many clients—particularly those with highly appreciable assets such as investment accounts and IRAs.

Conclusion

This article shows the myriad of tax considerations that you must consider when creating your estate plan. Minimizing a certain type of tax may cause your or your beneficiaries greater tax liability with another tax. However, with proper legal advice, favorable tax treatment can be accomplished.