

Taxes That Can Impact Your Estate Plan

Estate planning involves deciding how to plan for the management of your money, property, and well-being before your death and how to distribute your money and property after your death. A comprehensive estate plan should consider the impact that taxes can have on your estate and ensure that your estate is distributed in a tax-efficient manner. There are several different types of taxes that can impact you and your estate plan, including individual income tax, estate income tax, trust income tax, gift tax, estate tax, generation-skipping transfer tax, and state inheritance tax.

Federal Individual Income Tax

The federal individual income tax is a graduated tax (the tax rate adjusts based on the amount being taxed) that individuals pay on their personal income. If you currently own income-producing assets such as rental property, stocks, or a business, the income they generate is subject to income tax, and the tax liability can be significant. Alternatively, charitable entities are typically subject to lower tax rates and no capital gains. We can discuss whether transferring accounts and property to a trust or charitable organization would benefit you, where the value of income-producing accounts and property and their future income can be removed from your taxable estate. On the other hand, owning appreciating accounts and property until death will allow them to receive a basis adjustment to their fair market value as of the date of your death, which can eliminate or significantly reduce capital gains taxes if your beneficiaries sell property or liquidate accounts. When considering these planning strategies, it is important to weigh the income and estate tax consequences.

Federal Trust Income Tax

Trusts are legal entities that can hold and manage accounts on behalf of one or more people (beneficiaries). There are several kinds of trusts and their tax treatment varies. As a separate entity, some trusts are subject to their own federal income tax. Trusts reach the highest marginal income tax rate much faster than individuals and most trusts are subject to income tax on any income their accounts and property generate and retain. Also, depending on the trust structure, tax liabilities can impact the value of the trust. Money paid by the trust for income tax liabilities, means there is less money available to the beneficiaries. If the trust distributes money or property to the beneficiaries, the income tax associated with the money or property is then paid by the beneficiaries at their individual income tax rates.

Federal Gift Tax

The federal gift tax is imposed on gifts made during an individual's lifetime. The tax is designed to prevent people from giving away their money and property during their lifetimes to avoid estate taxes at death. The gift tax may impact your estate plan if you wish to make large gifts to family members or other beneficiaries. To minimize the impact of the gift tax, you may want to consider gifting accounts and property in a tax-efficient manner, such as taking advantage of the annual gift tax exclusion.¹ We are happy to discuss with you the legal nuances of your contemplated gifting strategy.

Federal and State Estate Taxes

Estate tax exists at the federal level and in some states, and may be imposed on the value of everything you own or control when you pass away. Estate taxes are based on the total value of all money and property you own at the time of your death, and the tax can be significant. To minimize the impact of estate tax on your estate plan, you may want to consider transferring

¹ It is important to note that Connecticut has their own gift tax.

accounts and property out of your estate by making gifts while you are alive (but beware of the potential gift and generation-skipping transfer tax consequences), by transferring accounts and property to individual beneficiaries, certain types of trusts, or giving money to a charitable organization. You may also be able to take advantage of the large current estate and gift tax exemption, which allows a certain amount of accounts and property to pass tax-free to your beneficiaries. It is important to note that your beneficiaries will receive your tax basis in property transferred to them during your life, so highly appreciated property that is later sold may have significant capital gains tax consequences. Before undertaking any gifting strategy, we can discuss the appropriate structure for your objectives as well as the various income and transfer tax consequences.

State Inheritance Tax

State inheritance tax is imposed on a person's money and property after they pass away, and is based on who inherits the money and property, as opposed to estate tax, which is based upon the overall value of the decedent's accounts and property. Also, while an estate tax is usually paid out of what the decedent owned, an inheritance tax is paid by the person who inherits the money and property. Tax rates and exemptions vary by state, and some states do not have an inheritance tax. We are happy to discuss with you your state's law and what tax obligations your beneficiaries may have at your death.

Bottom Line

There are many different types of taxes that can impact your estate plan and influence your planning decisions. If you are concerned about the impact that taxes may have on your current estate plan, we are happy to meet with you to discuss this and any other questions you may have. With careful planning, we can structure your estate plan in a tax-efficient manner to minimize overall tax liability.