

Balancing Act: What Matters Most to You?

When people begin getting their affairs in order through the creation of an estate plan, they often face a delicate balancing act between saving on income and estate taxes, protecting their hard-earned savings from their ultimate beneficiaries' creditors, and providing maximum benefit to their loved ones. Finding the right balance requires careful consideration of the different legal and financial tools available to help you fulfill the vision of your estate plan.

Saving on Income and Estate Taxes

Income and estate taxes can be significant expenses for individuals and their beneficiaries, potentially reducing the amount of money and property that you can pass on to your loved ones. To save on estate taxes, you can consider several strategies, including gifting money and property to your loved ones or creating trusts for their benefit. Alternatively, utilizing tax-advantaged investment accounts can be beneficial for income tax savings.

Gifting money and property during your lifetime can help reduce the amount you own at your death and, in turn, reduce the amount that is subject to estate tax, if done properly. In 2023, the annual gift tax exclusion, which is the maximum amount you can give to someone during the year without any federal gift tax concerns, is \$17,000 per recipient (\$34,000 per recipient for married couples making joint gifts). Likewise, under current law, you could give away up to a total of \$12.92 million during your lifetime before triggering any federal estate tax. By gifting accounts and property to beneficiaries during your lifetime, you can shift any income tax burden from those accounts or pieces of property, if any, to the recipients, who are typically in a lower tax bracket and therefore pay less tax on income generated by the accounts and property. It is important to note that if you give accounts or property to someone during your lifetime, and the accounts or property greatly appreciate in value from when you acquired them, the recipient could end up with a large capital gains bill when they decide to liquidate or sell. Also, if you choose to give accounts and property outright to your loved ones, you will no longer be able to control how the money is spent or the property is used. The money and property may also be subject to your loved ones' creditors or divorcing spouses.

Creating trusts is another strategy for saving on taxes. Trusts are legal entities that hold and manage accounts and property on behalf of beneficiaries, and they can be structured in a variety of ways to minimize taxes. For example, an irrevocable trust, in which the trustmaker typically cannot change the trust, pays its own income tax on the income generated by the trust's accounts and property because it is seen as a separate entity from the trustmaker. Although the trust is responsible for paying the income tax, the trust's accounts and property can grow estate tax-free for the beneficiaries because the trustmaker no longer owns them. The creation of this type of trust may require the use of your annual gift tax exclusion or lifetime gift and estate tax exclusion. Also, because it is seen as a separate entity, certain types of irrevocable trusts can be used to offer you asset protection as it relates to the accounts and property that you have transferred to the trust. However, you will have to give up control over the trust going forward.

Another way you might save on income taxes is to leverage tax-advantaged investment accounts, such as individual retirement accounts (IRAs) and 401(k)s. These accounts allow individuals to defer taxes on their contributions and investment earnings until retirement, when they may be in a lower tax bracket. Other investment accounts such as Roth IRAs and Roth 401(k)s allow individuals to make after-tax contributions, with any subsequent earnings and withdrawals being tax-free.

Protecting Assets from Creditors

Another important consideration in estate planning is protecting your accounts and property from creditors. Creditors have a legal claim to accounts and property, and if accounts and property are not properly protected, creditors may be able to seize them to satisfy a debt or legal judgment against you or a beneficiary.

One way to protect accounts and property from creditors is to create a trust with certain terms. Trusts can be designed to provide a degree of insulation between accounts and property and potential creditors. For example, if your loved one has poor spending habits or creditors, a spendthrift trust could be included in a revocable or irrevocable trust to restrict the family member's access to the trust's accounts and property, making it more difficult for creditors to reach them.

However, a trust with a spendthrift provision alone does not offer a high level of protection from creditors. A discretionary trust can give the trustee discretion over when and how to distribute money and property to the beneficiary, allowing the trustee to avoid distributions that might be vulnerable to seizure by creditors. Another important factor contributing to a trust's level of creditor protection is the identity of the trustee. Ideally, the trustee is an independent party who is not related or subordinate to the beneficiary. A properly drafted and structured discretionary trust restricts the amount of money and property, including income, that the beneficiary has access to. If the income generated from the trust's accounts and property is kept by the trust and not distributed to the beneficiary, that income could be taxed at the trust's income tax rate, unless the trust is designed so the trustmaker is responsible for the tax obligation. Both provisions can be included in a revocable or irrevocable trust.

It is also important to note that trusts and individuals are taxed differently when it comes to income. Individuals are subject to a graduated income tax system, where the tax rate increases as income rises. In 2023, the top marginal tax rate for individuals is 37 percent, for income over \$523,600 for individuals and over \$628,300 for married couples filing jointly. Trusts, on the other hand, are subject to a compressed tax bracket system, where the top marginal tax rate of 37 percent applies to any income over \$13,451. This means that trusts may be subject to a higher tax rate on the same amount of income than an individual in a similar tax bracket.

If you are looking to protect your accounts and property from your own creditors, you would need to consider certain types of irrevocable trusts. As previously mentioned, an irrevocable trust means that you lose control over the accounts and property that are placed in the trust, and the amount paid in income tax could be higher if the income from the trust is not distributed to a beneficiary or the trust is not designed for the trustmaker to be responsible for the income tax obligation.

Giving Beneficiaries Maximum Access

Although saving on taxes and protecting accounts and property from creditors is an important estate planning objective, you may also be concerned whether your beneficiaries have complete access to their inheritance. This can be especially important if you want to support your loved ones' needs and do not want to restrict their access because the future is unknown.

One way to give maximum access to beneficiaries is to structure the estate plan in a way that allows for unhindered or outright distributions to the beneficiaries. This can be accomplished through various means, such as creating a revocable living trust with lenient distribution instructions, allowing the beneficiaries to receive the money and property outright at your death,

or giving them the money and property outright during your lifetime. By giving beneficiaries control over the accounts and property, they can use them as they see fit. However, giving beneficiaries maximum access to their inheritance can also come with risks. For example, beneficiaries may be tempted to spend the money or liquidate the property unwisely, or they may be vulnerable to fraud or manipulation. In addition, giving your beneficiaries maximum control over money and property may increase their exposure to creditors and legal claims, such as divorce.

Conclusion

Balancing competing interests requires careful consideration—what are your goals and priorities? How can you best accomplish them? What are you willing to give up to carry out your plan? Working together, we can help you navigate these complex issues and create an estate plan that achieves your objectives. Give us a call to start or review your estate plan.