1. TRANSFER TAXES: PLANNING TO PAY LESS

a. Probate Avoidance v. Tax Avoidance – Probate avoidance and tax avoidance are distinct concepts; consequently, avoiding probate does not necessarily reduce the transfer tax burden at all.

b. Federal Transfer Taxes

i. Estate Tax – A tax imposed on the right to transfer property at death.

(1) Gross Estate Concept – Based on the total value of all property interests held by the decedent at the time of death, the federal estate tax has a broad sweep.

(a) Individually-owned property

(b) Jointly-owned property

(c) Life insurance (incidents of ownership and the 3-year rule)

(d) Retirement plans

(e) Property given away during life but with "strings" attached (*e.g.*, transfer to a Revocable Living Trust or those made pursuant to the Uniform Transfer to Minors Act).

(f) General Power of Appointment

(2) Tax Rate – The federal estate tax rate is currently 40%.

(3) Applicable Exclusion Amount – The federal estate tax affords each individual with a single, cumulative (so-called "unified") credit (applicable to both the federal estate and gift taxes) that has the effect of exempting (or excluding) a substantial of otherwise taxable transfers. This amount is indexed for inflation; for 2022, it stands at $12.06 million per transferor, and it will increase to $12.92 million in 2023. However, current law also provides that this amount will be reduced effective January 1, 2026 to an amount currently estimated to be $6 - $7 million.

(4) Unlimited Marital Deduction – Any amount passing to a surviving spouse passes free of federal estate tax (subject to special limitations applicable to non-citizen spouses).

(5) Portability – Since January 1, 2011, it is now possible for a surviving spouse to use for gift and/or estate tax purposes the unused portion of his or her predeceased spouse's exclusion

amount. Hence, taken together, a married couple has a total of $24.12 million of federal exclusion amount.

ii. Gift Tax – a "backstop" to the estate tax.

(1) Tax Rate – The federal gift tax rate is the same as that applicable to the estate tax (40%).

(2) Applicable Exclusion Amount – The unified credit for the gift tax is the *same* credit that is available for the federal estate tax. Therefore, to the extent the exclusion amount is used to cover lifetime taxable gifts, it is not also available to offset the estate tax for transfers at death. For example, if one were to use $2 million of exclusion amount to shelter lifetime gifts (and assuming no predeceased spouse), she would only have $10.06 million of federal exclusion amount remaining at death to apply to the estate tax.

(3) Special Gift Tax Opportunities

(a) $16,000 per donee annual exclusion.[1]

(b) Gift-splitting (doubles the annual exclusion for married couples).

(c) Tuition exclusion.

(d) Medical care exclusion.

(4) Other Tax Advantages of Lifetime Gifts

(a) Tax-exclusive tax.

(b) Avoids tax on post-gift appreciation.

(c) Valuation discounting.

iii. Generation-Skipping Transfer ("GST") Tax – a "backstop" to both the state tax and the gift tax.

(1) If applicable, the GST tax is imposed at the highest estate tax rate (currently, 40%).

[1] The gift tax annual exclusion is indexed for inflation; accordingly, the exclusion amount will increase to $17,000 in 2023.

(2) Each individual is entitled to a single GST exemption amount equal to the federal estate tax exclusion amount: currently, $12.06 million, but subject to the same inflation indexing and planned reduction in 2026 as the estate tax exclusion amount.

c. State Transfer Taxes

i. Scope – Some 29 states have no death transfer tax at all. The remaining 21 states, however, have either an estate tax or an inheritance tax or both.

ii. Inheritance Tax – This is a tax imposed on the value of property received by an individual. The rates and applicability vary from state to state. In Maryland, the inheritance tax rate is 10%, but property passing to spouses, children, grandchildren, and some other specified parties is entirele exempted from the inheritance tax.

iii. State-Level Estate Tax – The state estate tax is parallel to, but generally "de-coupled" from, the federal estate tax. The exemption amount and rates vary from state to state. Maryland has an estate tax, as well as an inheritance tax. Unlike the Maryland inheritance tax, family member beneficiaries are not exempted; however, the Maryland estate tax has an exemption amount that allows each decedent to transfer at death $5 million free of any Maryland estate tax. Property in excess of that amount is subject to Maryland estate tax at the rate of 16%.

iv. Federal Deduction – A deduction (but not a credit) is allowed against the federal estate tax for state death tax that is paid.

2. LIFE INSURANCE

a. Uses of Life Insurance in Estate Planning

i. Income replacement.

ii. Source of liquidity for payment of estate tax (and other estate obligations).

b. Types of Life Insurance

i. "Temporary" Insurance – Temporary life insurance is typically called "term insurance," and it comes in a variety of flavors (*e.g.*, straight term, 10-year level term, 15-year level term, etc.).

ii. "Permanent" Insurance – Probably the most familiar form of so-called permanent life insurance is the "whole-life" policy; however, a variety of other types of life insurance might also be classified as permanent as well (*e.g.*, universal life, variable life, etc.).

iii. Selection – In selecting both the type of life insurance coverage and the appropriate insurance company, consideration should be given to the purpose for which the insurance is being purchased and the affordability of the possible products available to meet that particular need.

(1) For this purpose, it is best to consult with a highly-recommended, trustworthy, independent life insurance agent.

(2) *See* **www.naic.org** for a life insurance buyer's guide.

c. The Problem With Life Insurance

i. Estate Tax Inclusion – An insured's gross estate for federal (and state) estate tax purposes will include the full proceeds value of a life insurance policy on the insured's life if the insured possesses at death any "incident of ownership" in the policy.

(1) This result will occur:

(a) Even if someone other than the insured's estate is named as beneficiary; and

(b) Whether or not the incident of ownership is exercisable by the insured alone or in conjunction with any other person.

(2) Of course, the proceeds will be included in the insured's gross estate (regardless of ownership) if the insured's estate is the beneficiary.

ii. "Incident of Ownership"

(1) This term of art is not limited to ownership of the policy in the technical legal sense.

(2) It includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc.

iii. The Three-Year Rule

(1) The value of the proceeds of a life insurance policy on the transferor's life will be included in the transferor's gross estate for federal estate tax purposes if the transferor possessed any "incident

of ownership" in the policy at any time during the three-year period ending on the date of the transferor's death.

(2) Consequently, even if the insured absolutely assigned all incidents of ownership in a policy insuring his or her life, the proceeds of the policy will be included in the insured's gross estate if that assignment occurred within three years prior to the insured's death.

d. Keeping Life Insurance Out of the Gross Estate

i. In order to avoid the inclusion of life insurance proceeds in the insured's gross estate for federal estate tax purposes, one must make certain that:

(1) Someone else other than the insured's estate is named as beneficiary; and

(2) The insured did not hold any incident ownership in the policy either:

(a) At the time of the insured's death; or

(b) At any time during the three-year period ending on the date of the insured's death.

ii. Whom Should Own The Policy?

(1) Insured as Owner – Clearly not a good choice.

(2) Spouse as Owner – Also not a good choice.

(3) Children as Owner

(a) This approach would be effective to remove the value of the life insurance proceeds from both the insured's estate and the insured's spouse's estate.

(b) However, for non-tax reasons, this is generally not an acceptable choice.

(i) If it is a situation involving a married couple, the couple may wish the surviving spouse to enjoy some benefit from the life insurance proceeds during his or her lifetime.

(ii) Even if benefit for the surviving spouse is not an issue, in many cases the children may be minors or otherwise fiscally unready to receive the insurance proceeds outright.

(4) <u>Irrevocable Life Insurance Trust</u> – For estate tax planning purposes, the Irrevocable Life Insurance Trust is most often the ownership vehicle of choice for life insurance policies.