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Tax-Wise Concepts for Effective Planning

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As you navigate the legal will or trust document drafting process, you may wish to leverage taxes and "disinherit Uncle Sam." Consider the impact of taxes (or, even better, the reduction of taxes) in your estate plan design.

For believers, building a good stewardship plan is, first and foremost, a prayerful process, and a distant second is reducing Uncle Sam's tax portion. Tax planning alone does not guarantee a fruitful, Christ-honoring plan of stewardship. As we know, everything belongs to God—*including ourselves*. What makes for a good stewardship plan is a partnership between you and God to determine the best use of what He's entrusted to you.

However, it is appropriate to be informed about the tax considerations as discussed below:

1. Can you avoid income taxes on certain tax-deferred assets being left to your heirs?
   - Building a tax-effective legacy plan
   - Using a charitable remainder trust (CRT)
2. Estate plan designs help reduce federal estate taxes and certain state estate and inheritance taxes.
3. How making qualified charitable distributions from traditional IRAs (tax-deferred funds) while you live can reduce taxable assets in your estate plan.
4. How to avoid capital gains taxes if you have a highly appreciated asset. Should it be sold while you live or be held for your estate?

ITEM #1: ADOPT AN APPROACH THAT AVOIDS INCOME TAXES IN YOUR ESTATE PLAN

A. Building a tax-effective legacy plan

What you need to know:

- **First,** devise your overall estate distribution plan. *To whom do you want your estate to go? Who do you wish to bless with your assets when you go home to heaven?*
  - You are likely to expect to leave some of your estate assets to individuals.
  - You may want to leave some of your estate assets to charitable ministries.
- **Second,** your estate will include your bank, investment and retirement accounts, real estate, life insurance, and other assets. Make a detailed list and add up your total estate assets.
- **Third,** determine the percentage of the total assets you would like to give from your estate to charity.

  Note: Your will does not control all your assets, so it is not as simple as stating your distribution intentions in your will. Beneficiary forms designate distributions from investment and retirement accounts, annuity contracts, and life insurance policies. These accounts and insurance products bypass what your will dictates.

- **Fourth,** passing certain assets on to individuals will incur significant income tax. These assets are usually retirement accounts, such as an IRA, 401k, 403b, deferred compensation plan, thrift savings plan, etc. Generally, all these account funds are tax-deferred, which means an individual inheriting these funds is still responsible for the taxes to Uncle Sam. However, a charity receiving these funds on your passing will not be responsible for the taxes.

  Note: Quantify the amount determined in the third step and designate the equivalent amount for your charity on the respective beneficiary form(s) of your tax-deferred account(s).

Summary: Building a tax-effective plan within your final estate distributions is relatively simple.

– Identify the assets that will incur taxation for your estate plan; distribute these funds to your charities.

– Identify the already-taxed assets to distribute them to your heirs (children, friends, family).

Note: If your heirs or charities receive more or less than you determine in your final estate distribution plan, change the percentage allocation between your individuals and charities. Creating charitable beneficiaries (Kingdom legacy gifts) directly from future taxable retirement accounts to avoid excessive income taxes is a tax-effective plan.

What does this mean while you are in the document creation process? You may prepare your distribution plan within your legal document, so that all the assets that pass through your will upon death will transfer to your heirs (family or friends), incurring no taxes. You would then designate the charitable distribution portion from retirement accounts, also incurring no taxes. As a result, you will have designed a tax-effective plan.

B. Using a Charitable Remainder Trust to Build a Tax-Effective Plan

A unique strategy is a plan design that leverages taxes and increases the inheritance for children and ministry. As previously discussed, significant income taxes are incurred on future distributions from tax-deferred retirement accounts. These taxes will be either your responsibility or your children's via their inheritance. How can Uncle Sam's portion be reduced to design a more tax-effective approach?

A charitable remainder trust (CRT) can provide a larger inheritance for your children and a significant gift to the Lord's work—legacy gifts to the Kingdom you may have only ever dreamed of.

Why use a CRT:

- How do you bless your children (or heirs) financially? How much is enough? How quickly will they spend the inheritance? These are some questions that typically arise in designing an estate plan.
- If a child or heir is walking counter to God's plans and purposes, is spending everything they receive, or could potentially spend funds on items destructive to themselves, should you consider a more financially and spiritually wise approach?
- Prayerfully discerning some of these questions may help you understand the stewardship value of a CRT.

Structure of a CRT:

- The CRT makes annual cash payments equal to five percent (or more) of the current value to children (or heirs) for up to 20 years. This approach builds some financial consistency for children. The children would split the five percent.
- Once an individual or couple passes, their tax-deferred retirement funds (or any portion thereof) will transfer by beneficiary designation to a CRT. This transfer shelters the funds from the heavy federal and state income tax consequences each child or heir would incur when withdrawing funds from the inherited retirement account. This has the potential to save hundreds of thousands of dollars in taxes. In most circumstances, current law requires withdrawals of inherited retirement funds to occur within 10 years. The CRT can last for 20 years. Unfortunately, many heirs do not avail themselves of the 10-year rule, creating unexpected tax consequences, which the CRT avoids.

  At the end of 20 years, the remaining funds in the CRT would pass to your favorite Alliance or non-Alliance ministries, advancing the Kingdom and touching souls for eternity.

ITEM #2: WHAT TO KNOW ABOUT ESTATE TAXES

An effective long-term planning strategy is to build your estate plan legal documents to ensure that estate exemption amounts for both spouses are fully utilized. This strategy may apply for either or both federal and state purposes. Those strategies are sometimes called A/B trusts (also known as bypass or disclaimer trusts). The objective is to use personal exemption amounts for each spouse to avoid estate taxes. The strategy applies to very large estates and may save significant estate taxes. Please obtain the services of a licensed estate planning attorney in your state to review the federal and state estate tax implications.

ITEM #3: IRA DISTRIBUTIONS WHILE LIVING

As previously discussed, certain retirement accounts are tax-deferred until there are distributions, which result in income taxes being due. Your heirs will incur this taxation. Therefore, making distributions during your lifetime will reduce the tax burden on your heirs.

When should you give money from retirement accounts while living? Current law allows you to make distributions, called qualified charitable distributions (QCD), from traditional IRAs when you reach 70½.

When you are 70½, a QCD can be transferred from a traditional IRA directly to your charities. A QCD is sometimes called an IRA charitable rollover. The QCD can be used to comply with the annual required minimum distribution (RMD) from the IRA, which commences at 73. Giving direct IRA distributions to your charities is usually more financially advantageous than deducting the donation on your 1040 tax return. Not everyone can itemize their income tax deductions since the law changed a few years ago. **Therefore, using your IRA funds for your annual charitable contributions instead of your checkbook would be appropriate when RMDs occur, and you would not get the full benefit of contributions as an itemized deduction on your tax return.**

Note: You are limited to $100,000 per year for a QCD.

ITEM #4 – CAPITAL GAINS TAX ISSUE: HOLDING OR SELLING A HIGHLY APPRECIATED ASSET

You may currently be holding a highly appreciated investment in stock or real estate. That means capital gains taxes are due upon the sale of that investment. Such an investment held until your passing would achieve a step-up in its basis. That means the new owner of the investment receives a new tax (cost) basis, which is its market value at the time of transfer. For any number of reasons, you may need to sell or divest yourself of the investment before death. However, holding the investment until death could result in a favorable tax benefit.

If you need to sell the investment while you are alive, a CRT, as previously mentioned, could be a strategy to avoid capital gains taxes.

Please note that this discussion is intended to be educational; you should always make your planning decisions after consulting with your legal and tax professionals.

Orchard Alliance's Gift and Estate Design Team is here to serve and would be pleased to review any or all of the above approaches with you. Please feel free to contact them at Generosity (orchardalliance.org).