University of Mississippi
eGrove

Haskins and Sells Publications | Deloitte Collection

1963

Taxes and estate planning -- Estate planning for women

Norman R. Kerth

Follow this and additional works at: https://egrove.olemiss.edu/dl_hs

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
Haskins & Sells Selected Papers, 1963, p. 297-303

This Article is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in Haskins and Sells Publications by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

Taxes and Estate Planning–Estate Planning for Women

by Norman R. Kerth
Partner, New Orleans Office

Presented before the 5th Annual Seminar of The Newcomb Alumnae Association and Estate Planning Committee, Tulane Development Council, New Orleans—March 1963

When we speak of an estate we are not necessarily referring to the property of one who has died. As a matter of fact, almost everyone has an estate while he is still alive. An estate is simply the sum, at any given time, of one's assets, together with their income production, plus the owner's present and probable future earning power. The estate during life may consist only of earning power together with some savings or life insurance.

As the term indicates, estate planning is the arrangement of a person's property during life to accomplish his wishes or objectives concerning his estate most economically.

The most common objective, of course, is to take care of the estate owner and his dependents, particularly after the owner's death. On the other hand, objectives of people vary—one person during his life may want to pass on part of his estate to his children either to test them or to make them financially independent; another may want to make gifts to a favored charity or school for the satisfaction of seeing some worth-while project accomplished during his life; and then there are those who after consideration prefer to rock along and let the chips fall where they may.

The important thing to do is to think about your estate, however small; then make a decision and do something about it. The next important thing is to review your circumstances, periodically, at least every two years, to determine if your planning still meets your objectives.

In the definition above, I mentioned that estate planning attempts to accomplish the estate owner's objectives most economically. Ordinarily, "most economically" means with the least amount of tax, although there are expenses other than taxes. But taxes are important and should be considered by everyone. However, I never attempt to convince any estate owner to do something merely to save taxes.

THE ESTATE PLAN

To begin our estate plan we must assemble facts. These may be grouped as—

1) beneficiaries of the estate and their needs;
2) property or estate available to fill those needs and how it measures up to the income requirements of the beneficiaries; and
3) the estate owner's objectives.

Under beneficiaries we have primary beneficiaries and other beneficiaries. Primary beneficiaries include the estate owner, his spouse, children, and perhaps other close relations and dependents. Other beneficiaries include charitable interests, churches, schools, employees, friends, and more distant relatives. This information is usually compiled in chart form showing name, address, age, income, etc., where applicable, of each person or institution.

Under property are included many kinds of property—stocks, and bonds, real estate, life insurance, business interests, cash in banks, insurance, and tangible property such as art and stamp collections, and personal income.

As mentioned before, the *objectives* of estate owners vary and it is *necessary to determine what these objectives are.* Many persons have never considered how they want to handle their estates during life and how to dispose of them after death and consequently this part of estate planning is frequently the most difficult of the three phases.

The best method of explaining how to minimize taxes is, I believe, by various examples that are not tied into any one plan. It should be realized also that each example will not fit every situation and should be considered individually.

For example, I intend to present a case on the transfer of insurance to a wife. Now, if you went home and told your respective husbands that they should transfer their insurance to you in order to save estate taxes, some of you might have an inferiority complex by the time your husband finished explaining why he wasn't about to transfer his insurance to you.

It is possible to save income tax, estate tax, and gift tax through estate planning. However, to save these taxes you must divest yourself of the property either permanently or for a period. The transfer must be legally complete and meet the test of substance as well as of form.

Gifts

The estate tax is a graduated tax. Now if you are willing to divest yourself of property so that it is not in your estate at your death, it will not be taxed. In other words, if a taxable estate would

be in the $500,000 class and if it is reduced by $100,000, the Federal estate tax would be $32,000 less. Such reduction may be accomplished in an estate by making gifts or contributions. Gifts may be taxable or not taxable, depending on the beneficiary. Gifts to schools, churches, and similar exempt institutions are not taxable, but gifts to individuals generally are. When taxable, gifts for Federal and Louisiana purposes are taxed at graduated rates. The Federal gift tax rates are also shown on the schedule furnished to you. There are certain exemptions and exclusions, however, that are not taxed. Each individual has one specific exemption of $30,000 and an annual exclusion of $3,000 for each donee. Consequently, a husband and wife may give away $60,000 without paying Federal gift tax and $6,000 additional each year to as many otherwise taxable donees as they wish. In our example, a husband and wife would have clear saving of $32,000 in Federal estate tax if they were able to use their $60,000 specific exemptions and make seven annual gifts of $6,000.

The gift tax is cumulative, which means that taxable gifts made in prior years are added to the present taxable gifts to determine the present gift tax. But the gift tax starts at the lowest bracket and the estate tax comes off the highest bracket so there is a net tax saving until the gift tax reaches the bracket to which the estate tax is reduced. Gift tax is about three quarters of the estate tax in comparable brackets. In addition, the gift tax paid reduces the amount of the estate and consequently the estate tax.

The simplest form of estate planning to reduce taxes is to reduce the size of an estate by making gifts each year to take advantage of the annual gift tax exclusion. If a husband and wife have two children and four grandchildren, who will probably inherit, they may make nontaxable gifts to them which would amount in the aggregate to $48,000 a year—$6,000 each to their children, their children's spouses, and to the grandchildren. Over a period of years, the total would reach a sizeable amount, particularly when added to the $30,000 specific exemption each donor has.

In making annual gifts there is one provision in the law that should be noted, namely, gifts in contemplation of death. This means that any gifts made within three years of death are presumed to be made to avoid estate tax and so will be included in the estate. This presumption may be overcome and generally is if it can be shown that the donor was in reasonably good health and not in danger of death when the gifts were made.

It is possible to save income tax as well as estate tax by giving

income-producing property. For example if Mr. M, who has a $1,000,-000 estate and is in the 62% income tax bracket, gives $100,000 of his stocks paying $6,000 in dividends, he would save $3,700 income tax in a year as well as approximately $37,000 estate tax. To determine the net tax saving you should offset the income tax and any gift tax the donee would pay.

Trusts

Another estate planning tool is the trust. Trusts are not so common in Louisiana as in other states because of some peculiarities in Louisiana State laws. However, I think there have been some changes in legal thinking on trusts and I believe they will become more common here. I hope so because trusts are very useful in estate planning.

For example, assume Mr. A who is in the 60% income bracket has been giving an aunt $6,000 a year for her support. For him, $6,000 represents gross income of $15,000 before taxes for which he received only $600 exemption for his dependent aunt. Mr. A could establish a trust, using $125,000 of securities yielding $7,000 annually, which would provide income going to his aunt during her lifetime, with the remainder to his daughter after the aunt's death. The effect of this transfer would be that Mr. A would save about $2,800 net after taxes each year and still support his aunt.

The Multiple Trust

A trust must pay income tax on that part of its income not distributed to the beneficiary or used to pay expenses. So the more trusts the smaller will be each trust's income, and the lower the tax bracket. To avoid the possibility of a high income tax to one trust, it is common to set up several—one, for example, for each child, instead of one in which they would all share. In that way, instead of one trust's having $15,000 of accumulated income in one year, each of three trusts could have $5,000, thus reducing the tax bracket from 47% to 26%, at an annual tax saving of about $3,000.

The Short-Term Trust

Another use of the trust is the so-called short-term trust, which diverts income but returns the principal to the donor. Under the Internal Revenue Code if a man creates a trust for a period of at least ten years or for the life of the income beneficiary, he pays no tax on the income from the trust. Tax law permits this even though the

principal will return to him when the trust ends, if (1) he, as grantor, cannot receive any of the income, and (2) the income is not used to fulfill any of his legal obligations to support the income beneficiary.

For example, Mr. B is in the 50% bracket. He creates three irrevocable trusts, one for each of his children, ages 6, 10, and 13. Into each trust he puts about $25,000 of securities, so that each will accumulate $1,000 a year income. All trusts are to last until the children reach the age of 21 years or for at least ten years. The income of the trusts is to be accumulated until the trusts terminate at which time the accumulated income will be paid to the child if he is alive or to the child's estate if he is not.

The income tax advantage to Mr. B lies in the fact that the trusts' income is not taxed at his high tax rate but is taxed at the lower rate to the trusts because of the smaller income each yields. Consequently, money that Mr. B would otherwise have to pay out in taxes is accumulated in the trusts and finally paid to his children. In this example the annual tax saving would be approximately $1,200. Under this plan, Mr. B would also keep his exemptions for his children if they would otherwise qualify.

Insurance

Sometimes in estate planning, as mentioned earlier, ownership of insurance on the life of the husband is transferred to his wife. Life insurance in which the insured has the incidence of ownership, such as the right to designate beneficiaries, is includible in his estate. If the ownership is transferred to his wife and he gives up his rights under the policy it is not includible in his estate even though the husband continues to pay the premiums. The tax saving may be substantial because insurance is often a large part of the estate. If Mr. C had a $250,000 estate of which $100,000 was insurance, the saving would be $30,000 less any gift tax on the cash value of the policy when it was transferred. The premiums the husband pays are considered gifts, which would be taxable if they, plus other taxable gifts to the wife, exceeded the annual exclusion and specific exemption. The disadvantage is that if the wife predeceases the husband the cash value of the policy is includible in her estate. So it is somewhat of calculated risk.

Contributions During Lifetime

Tax savings are also possible by making contributions during life. For example Mr. D planned to leave some money to his

university in his will. He knew that he would help the school and at the same time reduce his estate tax because of the deduction for this contribution. In discussing his estate planning he was advised that there would be income tax advantages in making some of his contributions while he still lived. For example, Mr. D and his wife file a joint return and have a taxable income of $44,000. By making a contribution now he will decrease his estate and will also have a deduction on his income tax return. Since he is in the 56% income tax bracket, each $100 of contribution decreases his income tax by $56. The net effect, therefore, is that the university receives $100 but Mr. D is only $44 poorer than before.

Instead of giving cash, however, he would be better off giving assets that have appreciated in value. For example, suppose Mr. D contributed stock that cost him $20 some years ago but is now worth $100. He would still be entitled to the $100 contribution, thus saving him $56 in income tax. If instead of contributing the stock, he sells it, he would have to pay a capital gains tax of $20 (25% of the $80 profit). Thus, if the capital gain tax saved is considered, the after-tax cost of such a contribution is only $24 yet the university has received a $100 contribution.

On the other hand, it is better to sell stocks that have depreciated in value and then donate the proceeds to charity because the seller realizes a capital loss for income tax purposes and so reduces his income tax.

Art Objects

Sometimes art objects, stamp collections, books, etc., become an estate problem to the owner. These items may be very valuable and would inflate the size of the estate. On the other hand, his wife and children may not be interested in them and there is a question whether they will bring their full value if sold at a forced sale to raise the cash necessary to pay the estate tax on them. One solution would be for Mr. E to transfer present title to a school or museum, reserving the right to hold the object during his lifetime. Mr. E gives the institution a remainder interest after his life interest. Under the law he can deduct as a charitable contribution the present value of the art object to be transferred in the future. Mr. E gets a charitable deduction on his current income tax, reduces his estate, and keeps the items for his personal enjoyment during his lifetime.

Under a Treasury ruling, an owner of a very valuable item may

spread his donation over a period of years so he would not exceed his charitable deduction limitation. This objective is accomplished by transferring an undivided interest in the item.

SUMMARY

The emphasis in this discussion has been on larger estates and high income tax brackets in estate planning because those areas are most productive of reduction in taxes.

Many things may be done to save taxes, and I have discussed comparatively few of them. In the high brackets all are worth while but are too complicated to justify the saving of a small amount of tax.

This does not mean, however, that a person with a small estate should not be interested in estate planning. In some respects it is more important; the difference is that for small estates there is not the same emphasis on taxes. But planning is important for the small estate because it is necessary to get the maximum out of it to take care of the owner's wishes and responsibilities.

A word of caution: Do not attempt to apply to your own situation any of the examples set forth until you are certain it coincides with what you want and will accomplish your objective without adverse effects—tax-wise or otherwise.