FALL 2021

For Trusted Advisors

Five things you may not know about the federal estate tax basic exclusion.

By Eva Stark, JD, LL.M.

Most high net worth clients or the owners of highly successful businesses are aware that estate taxes could be a potential concern; beyond that, many have no familiarity with even the most rudimentary estate tax concepts, such as the federal estate tax basic exclusion amount. This might lead to missed planning opportunities in some cases.

The following list of general items to know about the federal estate tax basic exclusion amount can help clients gain a better understanding of the workings of federal estate taxes and may help them ask better questions during the planning process.

1 Individuals are generally entitled to a basic exclusion amount for federal estate tax purposes.

The "basic exclusion amount" is the value of taxable gifts that an individual can give to any donee while alive, or to any heir after death, without triggering federal gift or estate taxes. In 2021, the basic exclusion amount is $11.7 million; it is adjusted annually for inflation.

As taxable gifts are made during an individual's lifetime, portions of this amount can be utilized to offset any gift tax due. Once the exclusion amount is exhausted, additional taxable gifts will generally trigger gift tax liability. Upon the individual's death, his or her unused exclusion amount, if any, may be used to shield transfers to heirs from estate tax. Taxable transfers at death that exceed the decedent's unused exclusion amount will generally trigger estate tax.

2 The basic exclusion amount currently includes a temporary "bonus" that will disappear at the end of 2025.

The Tax Cuts and Jobs Act of 2017 (TCJA) doubled the basic exclusion amount, from $5 million under the American Taxpayer Relief Act of 2012, to $10 million, adjusted for inflation. However, certain provisions of the TCJA were not made permanent and are scheduled to sunset on December 31, 2025.

One of the sunsetting provisions is the doubling of the basic exclusion amount. If the "bonus" $5 million (plus inflation adjustment) is not utilized before it expires, it will be lost. Note, too, that federal legislation to change this provision could be enacted prior to 2026. Clients and their advisors should consider taking advantage of this window of opportunity, if feasible, before it closes.

3 Not all gifts diminish an individual's basic exclusion amount.

An individual may gift his or her assets without tapping into or utilizing his or her basic exclusion amount in some cases. For example:

- Transfers to a spouse generally qualify for a marital deduction to gift or estate tax.

- Transfers to qualifying charities generally qualify for a charitable deduction.
- Individuals also are generally entitled to make annual exclusion gifts of $15,000 per year, per donee, in 2021 (or twice that amount if the donor splits gifts with his or her spouse). The annual gift tax exclusion is also adjusted for inflation, but only in $1,000 increments.
- Generally, payments made for qualifying educational or medical expenses on behalf of a donee paid directly to an educational institution or medical provider do not diminish the donor's annual gift tax exclusion (the $15,000) or his or her basic exclusion amount (the $11.7 million).

4 Surviving spouses may utilize their predeceased spouses' unused exclusion, but many caveats exist.

An individual may be able to utilize his or her deceased spouse's unused exclusion in certain circumstances if a "portability" election is made. A portability election may be made on an estate tax return that meets specific requirements. However, one potential concern with reliance on portability is that it is only applicable to a deceased spouse's unused estate tax exclusion, not generation-skipping transfer tax exclusion.

Another potential concern is that a subsequent remarriage of the surviving spouse may affect the amount that may be available for the surviving spouse from the deceased spouse's unused exclusion.

For example, suppose that Bob and Linda are successful business owners with an estate valued at approximately $17 million. Bob, a reluctant planner, dies, leaving everything to Linda outright. A timely portability election is made, which would generally avail his unused exclusion to Linda.

Linda subsequently marries Jim, who is also a successful business owner. Unlike Bob, Jim engaged in significant estate planning and exhausted his basic exclusion amount when he gifted assets to his children from his first marriage.

Linda does not engage in planning to utilize any of Bob's unused exclusion. Jim subsequently dies while married to Linda.

Since the deceased spouse's unused exclusion applies with respect to the last deceased spouse (in this case, Jim, who has no unused exclusion), Linda would now be limited to her own exclusion amount for future gifts (see Treas. Reg. 20.2010-3(b)-(c)), significantly increasing her estate tax liability and diminishing the inheritance of her heirs.

5 State-level transfer tax regimes may be an additional concern.

If an individual is a resident of, or owns property in, a state with a state-level transfer tax, such taxes may apply even if the individual is not subject to federal estate taxation.

The exclusion amount to state-level estate tax varies greatly by state, as does the tax rate. Rules as to portability and the ability to make various elections also differ greatly from state to state.

Conclusion

Estate planning for high net worth clients and business owners who could have a taxable estate can be complex and time consuming. A basic understanding of some general estate tax principles can help clients better engage in the planning process. Clients may wish to explore with their attorneys or other advisors how the general principles presented above might apply in their particular circumstances and what planning opportunities and areas of concern they may create.

Eva Stark, JD, LL.M., joined The Nautilus Group in 2014 to assist with the development of estate and business plans. She also performs advanced tax research. Eva graduated summa cum laude with a BS in economics and finance from The University of Texas at Dallas. She earned her JD, with honors, from Southern Methodist University, where she served as a student attorney and chief counsel at the SMU Federal Taxpayers Clinic. She received her LL.M. in taxation from Georgetown University Law Center. Prior to joining Nautilus, Eva worked in private practice in tax controversy, business law, and litigation.

Transferring "family capital": A new approach to succession planning.

By W. Gibb Dyer

For the past four decades, I have been a consultant to many family business leaders and high-wealth individuals. Most often I have been asked to help them with the challenge of succession, the transferring of ownership, assets, and leadership to the next generation. Early in my career, I focused on helping these individuals with what I considered the "nuts and bolts" of such planning—preparing a will, deciding who should be future owners of the businesses, developing a plan to prepare future leaders, etc. Over time, however, I came to realize that what was most helpful to such leaders was to encourage them to think more broadly about the transition of leadership from one generation to the next. I realized that helping families transfer what I call "family capital" to the next generation was the most important thing that I could do. Family capital is the human, social, and financial resources (and other tangible assets) that are available to individuals or groups as a result of family affiliation.

Here is a brief description of each of the components of family capital:

FAMILY HUMAN CAPITAL refers to the knowledge, skills, and labor that resides within a family. By sharing their experience and expertise, the older generation can help younger family members better understand how to run a business and also impart wisdom that can help them in their everyday lives.

FAMILY SOCIAL CAPITAL refers to the bonds between family members and those outside the family—bankers, customers, suppliers, community leaders, etc.—relationships that can be used to obtain the resources needed to help the family achieve its goals. An example of family social capital's impact on business success is part of the early story of Microsoft. Bill Gates was able to sell his DOS operating system to IBM because his mother knew IBM CEO John R. Opel through their mutual involvement with United Way. As a result of that connection, Bill Gates was able to convince IBM to bundle Microsoft's software with its personal computers. Without the help of Bill's mother, Microsoft might not have been able to gain such a dominant position in the software industry.

FAMILY FINANCIAL CAPITAL and other tangible assets comprise the third aspect of family capital. Families often have money and other assets that can be used to help family members. For example, it's well known that Steve Jobs benefited from his parents' generosity when they allowed him to start Apple in their garage. And in the case of Sam Walton, founder of Walmart, he was able to launch the business by using seed money from his wealthy father-in-law. Such assets can play an important role in helping the next generation succeed.

Transferring Family Capital to the Next Generation

Too often, consultants like myself only pay attention to the third component of family capital, that of money and tangible assets. However, I've found that transferring the other two types of family capital is equally, if not more, important. Transferring family capital requires the family to answer the following questions:

1. What kinds of family capital (human, social, financial) will be helpful to future generations of family members (those both in and outside the business)?
2. What family capital do we currently have that needs to be transferred to the next generation or other family members?
3. Who has access to this family capital, or, if we don't have the family capital that is needed, how do we develop it so it can benefit future generations?

Family leaders need to think about these questions as they begin the process of transferring family capital. If not, younger family members may need to bring these issues to the attention of their elders to encourage the process to start, since it may take months or years to accomplish. Raising these issues is not easy since they may feel that they will be seen unfavorably by their elders if they ask questions about a possible inheritance. However, if the family has developed high levels of trust, that may open the door to have a discussion between generations on this topic, or family advisors may need to broach the subject with the family.

To facilitate the process of transferring all three types of family capital, I have found that it is useful to do the following:

1. Create a genogram of one's nuclear and extended family. A genogram is essentially a pedigree chart that shows each generation of family members and describes the relationships between family members (e.g., close, conflicted, cut-off, etc.). While the chart can be complex, I generally suggest that the family put together a genogram that includes three generations of family members. Deceased family members should be included in the chart since their social contacts and other resources might be available to help the next generation.
2. Create a "family capital genogram" that identifies who in the family has access to family capital. This genogram adds information about each person regarding:
    - The family capital that each person has at his or her disposal, and
    - The family capital that each family member may need in the future.
3. Develop a plan to improve relationships between those who have family capital and those who need it. In some cases, this may require the help of a skilled counselor or consultant.
4. Develop specific plans to transfer family capital from one person to another by using the "learning by doing" approach. This may also require getting outside advisors (e.g., lawyers, accountants, etc.) to help in the process.

To help families transfer family capital to the next generation, I've learned one important lesson: make them earn it! Family human and social capital generally cannot be transferred unless family members are willing to put in the time and effort to obtain them.

I have found the "learning by doing" approach to be the most successful method to transfer family capital. This approach requires:

- Identifying what type of family capital needs to be transferred, and
- Identifying potential learning experiences that will help the person acquire the family capital.

This approach assumes that the person transferring the family capital will serve as a mentor (or find a mentor) for the persons receiving the family capital to help them and answer any questions they may have.

An example of someone who exemplifies this type of learning is J. Willard Marriott, founder of the Marriott Corporation, along with his father, Will. At age 14, Bill was asked by his father to take a herd of sheep from Ogden, Utah, to San Francisco by train, sell them, see the world's fair that was being held there, and then return safely.

This experience helped Bill gain new knowledge, develop confidence, and build relationships that would help him not only as a rancher, but as a future business leader. In today's world many parents wouldn't trust their 14-year-old son to pick up a gallon of milk at the local grocery store and bring it home, let alone have him take several thousand sheep by train hundreds of miles from home — and with no cell phone to check in!

There are a variety of approaches used by families to help transfer family capital using this learning-by-doing approach. For instance, I've seen some family leaders identify formal training (e.g., apprenticeships, degree programs) that will help the next generation develop the skills and experience they will need. Family leaders also may work with the next generation on projects or in a business to mentor them and teach them what they need to know.

For example, before transferring money to the next generation, a family leader might require the next generation to find a job, earn their own money, and make and keep a budget to demonstrate responsible use of finances. The family leader could provide support for the younger family members by helping them in their job search and teaching them how to manage money and live on a budget.

As an example of transferring social capital, Jon Huntsman, the founder of the Huntsman Corporation, took his son Peter (now the current CEO) on business trips to help Peter understand how the business worked and to build relationships with key company employees.

More importantly, when Peter started working in the family business, he started near the bottom of the organization as an oil truck driver.

This allowed Peter to understand the business from the bottom up, to demonstrate his competence at various levels in the company, and most importantly, begin to develop a social network which, when coupled with his father's social network, would help him in his future role as CEO.

To ensure the effective transfer of financial capital, family members may need to gain knowledge of the basics of finance and investing.

They might also be included in family projects that help them understand how financial and other assets can be used to grow a business or to help the family in some way. It's important for future leaders to have some hands-on experience related to managing money effectively.

Conclusion

In summary, transferring family capital is often the key to a successful transition between generations.

Families need to be aware of what family capital currently resides in the family and what family capital is needed by the next generation, and then create a plan to transfer that family capital, generally by using a "learning by doing" approach.

W. Gibb Dyer (Ph.D. MIT) is the O. Leslie and Dorothy Stone Professor in the Marriott School of Business at Brigham Young University. He is ranked as one of the top ten scholars in the world in the field of family business and has published nine books and more than 50 articles. Dyer's research has been featured in *Fortune, The Wall Street Journal* and *Fast Company,* and in 2008 he was given the outstanding faculty award from the Marriott School.

Charitable Planning

Creative charitable giving ideas for donors who want to give more.

By Eva Stark, JD, LL.M.

Americans are generous. In fact, the United States is consistently ranked at or near the top of lists of the most charitable countries. When giving to charity, most Americans write a check or provide credit card information, try to remember to retain necessary records, and hope for the best come tax time.

However, by utilizing more creative charitable giving strategies, some of which are described below, donors could not only enjoy greater tax savings but also could make even more impactful gifts.

General tax treatment of cash contributions to public charities

The most basic form of charitable contribution is the gifting of cash. From an income tax perspective, cash contributions to qualifying charities are generally deductible as an itemized deduction up to a certain percentage of the donor's adjusted gross income (AGI). Prior to the enactment of temporary, pandemic-related changes, cash gifts to public charities could be deducted in an amount up to 60% of AGI (limitations are more stringent for gifts to charities that are not public charities and for non-cash donations). Qualifying gifts in excess of the AGI limitation could be carried over for up to five years. For 2020 and 2021 only, pandemic-related legislation suspended the AGI limitation on cash gifts to certain public charities. As a result, for 2020 and 2021, cash gifts to certain public charities may be deductible up to 100% of the donor's AGI.[1] In addition, pandemic-related legislation created an above-the-line deduction for cash gifts to qualifying charities of up to $300 (or $600 for married taxpayers who file jointly) for tax years 2020 and 2021.[2]

Donating long-term appreciated publicly traded securities

While many cash donors also own highly appreciated, publicly traded securities (e.g., stocks, bonds, mutual funds) that are held for over a year, few think about donating such long-term appreciated securities instead of cash. The potential benefit of donating appreciated securities is twofold:

- There is generally no income recognition to the donor when the appreciated security is transferred to the charity, and
- Generally, the donor is entitled to a charitable deduction equal to the full fair market value of the security.

As shown in example 1, below, by gifting long-term appreciated stock instead of selling the stock and gifting cash, Michael and Roberta have lowered their tax bill and could choose to utilize the savings for additional charitable gifting.

As a bonus, they have reduced their concentrated position in the

1 For cash gifts to donor advised funds, a 60% limitation generally applies and the 100% AGI limitation does not apply. A 30% AGI limitation generally applies to cash gifts to private foundations.

2 As a result, individuals who do not itemize deductions may still be able to realize a small tax benefit from charitable gifts.

EXAMPLE 1. Michael and Roberta own various securities in their brokerage account. Their holding in a high-growth technology stock appreciated substantially over the past few years and has become an outsized portion of the portfolio. Michael and Roberta wish to make a $10,000 gift to charity.

	Security is sold and net proceeds donated	Security is donated
Value of securities needed for contribution:	$12,811	$10,000
Basis:	$1,000	$1,000
Income tax rate:	23.8%	0%
Tax due:	$2,811	$0
Net gift to charity:	**$10,000**	**$10,000**

technology stock without realizing any capital gains and can now reinvest in other securities or even the same stock at a higher cost basis. Avoidance of the additional $12,811 of income might additionally help them qualify for other deductions and credits, depending on their specific circumstances.

Note that the AGI limitation for long-term appreciated securities is 30% if donated to a public charity.

Funding a Donor Advised Fund (DAF)

A DAF may be thought of as a charitable checking account and/or brokerage account. Contributions to the account are generally deductible for the donor in the year of the contribution (subject to AGI limitations and itemization), the account may be invested and generally grows tax free, and the donor may make nonbinding recommendations for gifts from the account to qualifying charities for years. Many community foundations, financial institutions and public charities offer donor advised funds. Account minimums, fees, grant size minimums, assets accepted, etc., vary widely.

The key benefits of this tool are that a DAF may:

- Allow donors to time charitable contributions in a more tax-efficient manner, and
- Contributions grow tax-free for greater future giving.

A large donation to a DAF might be advantageous in a year where the donor has unusually high income or if "bunching" or "accelerating" multiple years' donations into a single year's contribution creates tax advantages in the client's particular circumstances.

Utilizing the Qualified Charitable Distribution (QCD)

Unlike the gifting of appreciated securities or funding of a donor advised fund, the QCD is only available to taxpayers over the age of 70½, but it can be a useful tool for those who qualify.

A QCD is a direct transfer of pre-tax IRA funds from the custodian to a qualifying charity (funds distributed to the IRA owner generally do not qualify for QCD treatment). Qualifying charities for QCD purposes generally do not include private foundations, supporting organizations, or donor advised funds. The strategy's main benefits are that the qualifying distribution:

- Generally does not count as taxable income, and
- Generally will count towards the account owner's required minimum distribution for the year.

The maximum distribution that can qualify is $100,000 per year, and married couples may each make a QCD from their own IRA of up to $100,000 per year.

As shown in example 2, below, by donating IRA funds directly to

EXAMPLE 2. Angela is 76 years old, single, and RMDs from her IRAs total $20,000 in 2021. She can live comfortably without the RMDs and she would like to donate the full amount of her RMD to her favorite charity. She is in the 22% income tax bracket and lives in a state with no state income tax.

Impact of cash donation vs. QCD	RMD withdrawal and subsequent donation of net proceeds	QCD
Distribution from IRA:	$20,000	$20,000
RMD satisfied:	Yes	Yes
Income tax rate:	22%	0%
Tax due:	$4,400	$0
Net gift to charity:	**$15,600**	**$20,000**

charity, Angela was able to avoid realizing $20,000 of additional income, which may in turn impact the extent to which Social Security retirement benefits are taxed and/or her eligibility for other credits and deductions that are income based, including Medicare premiums, etc.

In addition, while Angela is likely to itemize deductions which may offset some of the additional tax due, a QCD may produce additional tax savings or allow for larger charitable gifts in many cases, especially for those who do not itemize deductions.

Creating a Charitable Remainder Trust (CRT)

A CRT entails the transfer of cash or other property to an irrevocable trust that provides an income stream back to the donor (or other beneficiaries). The income stream may be for a term of up to 20 years or for the life of the donor and may begin immediately or at some future time. Assets remaining at the termination of the CRT pass to the charity designated in the trust instrument. The donor can generally receive an immediate income tax deduction for the present value of the charitable gift, subject to certain limitations. Taxes on the income stream produced by the CRT are generally payable as payments are made from the CRT, under a tiered system (first ordinary income, then capital gains, then other income, and finally, principal). Real estate or low-basis securities may be attractive assets for funding a CRT as these may produce little income but might trigger substantial taxes upon liquidation. A CRT can generally liquidate assets income-tax free as a tax-exempt entity and reinvest the proceeds in more desirable, income-producing assets to fund the income stream to the donor. Note that it is important that assets are transferred to a CRT in advance of any agreement to sell such assets to a third party.

Funding a Wealth Replacement Trust

In addition to the strategies briefly touched on above, charitable giving ability may be leveraged even further by utilizing life insurance. Some donors may be hesitant to give to charity for fear that the legacy they desire to leave to their heirs will be diminished. In such situations, a "wealth replacement trust" may be considered. The technique involves the purchase of a life insurance policy on the donor, in an amount sufficient to replace or exceed the value of property gifted to charity. The policy is generally held in an irrevocable trust designed for creditor protection and to avoid inclusion of the death benefit in the donor's taxable estate. The donor might utilize, in part, the income stream from a charitable remainder trust or potential tax savings to make gifts to the irrevocable life insurance trust to fund policy premiums. At the donor's death, policy death benefits are collected by the trustee, generally income-tax free, and can remain protected from potential creditors or beneficiaries' mismanagement for generations.

Conclusion

Charitably inclined individuals may wish to further explore these and other charitable giving tools with their professional advisors.

Tax consequences for charitable giving strategies vary widely depending on particular circumstances, so clients should thoroughly assess their objectives and chosen strategies with their CPAs or other tax advisors.

Eva Stark, JD, LL.M., joined The Nautilus Group in 2014 to assist with the development of estate and business plans. She also performs advanced tax research. Eva graduated summa cum laude with a BS in economics and finance from The University of Texas at Dallas. She earned her JD, with honors, from Southern Methodist University, where she served as a student attorney and chief counsel at the SMU Federal Taxpayers Clinic. She received her LL.M. in taxation from Georgetown University Law Center. Prior to joining Nautilus, Eva worked in private practice in tax controversy, business law, and litigation.