SMART INSIGHTS FROM FINANCIAL PROFESSIONALS

How Much of Your Estate Will Be Lost to Taxes?

If you're worried that a sizable chunk of your legacy may go to Uncle Sam, there are steps you can take to reduce the effects of the SECURE Act and the possibility that other changes could be on the way.

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This year, legacy planning will be more important than ever because of changes to inheritance rules and tax laws that went into effect last year and other changes that could be coming.

The good news is that many people are not likely to see their income taxes raised for the foreseeable future. But the bad news is that many more people are likely to see higher taxes on their estate after they have passed away.

2 POTENTIAL TAX PROBLEMS FOR BENEFICIARIES

Here's a look at two tax law changes (one that's current, and one that has been proposed) that aren't favorable for beneficiaries, along with adjustments people can make in their estate planning:

• **Elimination of the stretch IRA.** This was an estate planning strategy that extended the tax-deferred benefits of an IRA that was inherited by a non-spouse.

These inherited IRAs allowed the beneficiary to continue to get the advantages of tax-deferral spread out over their lifetime. And that meant younger beneficiaries could receive larger benefits from inheriting an IRA by stretching the withdrawals over their lifetime.

But the SECURE Act ended the stretch IRA. The big difference under the law — which was passed in 2019 and went into effect on Jan. 1, 2020 — is that in most instances, non-spouse beneficiaries have to withdraw all of the funds in the inherited IRA within 10 years from the death of the original account owner. So now, no matter how old the adult beneficiary is, they must withdraw all of the money (and pay taxes on it) within 10 years.

This law could potentially lead to the government getting more of your IRA assets by the way of taxes and your family getting less. It also means that when building your estate plan, you need to consider the tax rates your family could be paying during those 10 years. If your inheritors are still likely to be working when you pass away, then the tax rate they pay could be substantially higher.

• **Possible elimination of the step-up in basis provision.** Here's how the law currently works: Someone inherits an asset that has appreciated in value since its purchase, and when they sell the asset they only have to pay taxes based on the gains in value from the day they inherited it. They don't have to pay based on how much it has appreciated since it was initially purchased.

But President Biden has proposed tax changes that eliminate the step-up in basis. Here's what eliminating it would mean: Say you leave shares of a stock that you purchased at $60,000 to your child. When you passed, the stock was worth $100,000 and your child sold it six months later for $105,000. If step-up basis is eliminated, your heir would no longer get to take a tax basis at the $100,000 the stock was valued at on the date of your death. Instead, his or her basis in the inherited stock is the $60,000 you paid for it.

So, under current rules, your kid would pay capital gains taxes on $5,000 ($105,000 sales price less $100,000), but if step-up basis is eliminated, he or she would have to pay capital gains taxes on $45,000 ($105,000 sales price less $60,000).

If Biden's proposal is enacted, then you could see a lot of seniors selling their homes and their after-tax investments, because as many retirees are in lower tax brackets, they are likely to pay a lot less taxes while they're alive than their families will pay after they're gone.

THREE WAYS TO HELP LIMIT THE TAX BILL FOR YOUR HEIRS

So, what can you do to try to protect yourself and your heirs? Here are some estate planning options to compensate for these potentially looming tax hikes on beneficiaries:

• **Universal indexed life insurance.** You could use money from your taxable accounts to buy a universal indexed life insurance policy that pays out to your family tax-free upon your death. This could help cover the tax burden.

Meanwhile, the policy could help you while you're alive because you can attach a rider on the policy that allows you to use the death benefit to make tax-free withdrawals to help pay for long-term care.

• **Roth IRA conversions.** A popular idea these days is to convert money from tax-deferred traditional IRAs into Roth IRAs. Qualified Roth withdrawals are tax-free, both for you and your beneficiaries. Keep in mind that you do pay taxes when you make the conversion, so you don't want to convert too much money at once and bump yourself into a higher tax bracket. It could be advisable to stretch the conversion out over a few years. This will also help your surviving spouse, who is much likelier to pay higher taxes as an individual.

• **Take advantage of the gift tax exclusion.** You can give up to $15,000 per year to an individual without incurring a gift tax. When Biden was running for election, he proposed lowering the exemption threshold on estate taxes from $11.58 million by half, but there have been calls to lower it even more. With that in mind, it makes sense for people with estates valued over $3 million to develop gifting strategies to avoid paying up to a 40% tax rate on their assets above the estate tax exemption threshold.

With possible estate tax changes on the horizon, planning is taking on added importance. If you're keeping score, then existing rules make it so your family will potentially keep less of your IRA and 401(k) assets and, if new proposals are passed, they are likely to keep less from some inherited assets. Those changes could affect everyone, no matter their income level.

While leaving a large inheritance isn't a high priority for most people, you also have to ask yourself: How much of the assets that you leave behind do you want going to the government? If you want your family to keep more of what you leave behind, then you should review your plans with your tax, legal and financial advisers and see how they can help reduce your exposure and lighten the burden on your heirs.

Dan Dunkin contributed to this article.