Morgan Stanley

PRIVATE WEALTH MANAGEMENT

ESTATE PLANNING

The Three Phases of Estate Planning:

A Simple Approach to Complex Estate Planning

For many individuals, wading into the process of estate planning can feel daunting—the U.S. tax code is complex and there are a myriad of strategies to choose from; how do you determine which is the right fit? The process may be simplified by breaking estate planning into three phases and creating a roadmap through each phase with well tested estate planning tools and techniques.

Federal Gift and Estate Tax

To understand why and how to implement estate planning strategies, it's important to understand the Federal gift and estate tax regime.

Each U.S. person[1] is entitled to transfer via gifts during life or bequests at death a certain amount of assets free of Federal gift or estate tax. In 2024, the Federal gift and estate tax exemption is $13,610,000 per individual and $27,220,000 for married couples. This amount is based on $10,000,000, indexed for inflation, so it adjusts annually.

The current Federal estate and gift tax exemption (the "Lifetime Exemption") is set to automatically sunset on December 31, 2025, causing the Lifetime Exemption to revert to $5,000,000, adjusted for inflation from 2010, unless there is a change in the law before that time.

The Federal gift and estate tax exemptions are unified, meaning that any use of the gift tax exemption during life reduces the amount of estate tax exemption available at death. If transfers made during life or at death exceed the donor's Lifetime Exemption, the excess may be subject to tax at a rate as high as 40%.

In addition to the Lifetime Exemption, each person may make a gift of up to $18,000 per year (as of 2024) (the "Annual Exclusion") to as many individuals as they like, either outright or in trust, without tapping into their Lifetime Exemption. This means that a married couple who elects to split

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[1] For purposes of this article, U.S. person means a U.S. citizen or person domiciled in the U.S. For Federal transfer tax purposes, a person is domiciled in the U.S. if the person is living in the U.S. with no present definite intention of living elsewhere. Determining whether a person is domiciled in the U.S. is a facts and circumstances test.

gifts may gift up to $36,000 per year (as of 2024) to as many individuals as they like[2].
Lastly, an individual may pay tuition directly to an educational institution and medical expenses directly to the provider without using Lifetime Exemption or the Annual Exclusion.

Phase I: "What If I'm Incapacitated or Die?" Planning

Ensuring loved ones will be provided for and a deceased person's wishes for distribution of their estate are carried out after their death are two priorities in estate planning. To accomplish these goals, it's important to execute and implement estate planning documents, which most typically include, at a minimum, a Will, Durable Power of Attorney for Financial Management, and Advance Health Care Directive. Additionally, a revocable trust may be part of the estate plan for privacy protection, to avoid cumbersome state probate procedures, and when the decedent has assets in multiple states. After executing these documents, it's also important to regularly revisit and review such foundational documents, particularly after major life changes occur. This is to ensure each document is in good working order, meets your current needs and contains current generally recommended language and tax planning features.

Whether your main estate planning document is a Will or revocable trust, if you are married, consideration should be given to including language establishing a Credit Shelter Trust and Marital Trust in the document. Further, if you have children, you may want language in the document establishing lifetime trusts for bequests made to them.

Credit Shelter Trust

One estate planning consideration for minimizing Federal estate taxes is full utilization of the Lifetime Exemption. If the Lifetime Exemption is not fully used through lifetime gifts, a strategy for married couples who are both U.S. citizens is to fund a Credit Shelter Trust (sometimes referred to as a Family Trust or Bypass Trust) at the time of the first spouse's death.

A Credit Shelter Trust is established and funded with the assets of the first spouse to die (the "Deceased Spouse") under their Will, separate revocable trust, or a couple's joint revocable trust. The Trust is funded with an amount of assets equal to the Deceased Spouse's remaining unused Lifetime Exemption. The provisions of the Credit Shelter Trust can provide income and principal distributions to the Surviving Spouse and other family members, but, if the Surviving Spouse is serving as trustee, the distributions of principal should be limited to an ascertainable standard like "health, education, maintenance, and support." On the death of the Surviving Spouse, the Credit Shelter Trust will terminate and any assets remaining in the trust (including any appreciation from the Deceased Spouse's death) will not be included in the estate of the Surviving Spouse and will pass to the remainder beneficiaries free of Federal estate tax. One downside to the Credit Shelter Trust is that, unlike a Marital Trust, the assets in the Credit Shelter Trust will not receive a tax basis adjustment to fair market value at the death of the Surviving Spouse.

Marital Trust

In addition to a Credit Shelter Trust, married couples should also consider including a Marital Trust (sometimes referred to as a Qualified Terminable Interest Property Trust or QTIP Trust). Like a Credit Shelter Trust, a Marital Trust is established with the assets of the Deceased Spouse under their Will, separate revocable trust, or a couple's joint revocable trust and is generally funded with all the assets of the Deceased Spouse above the amount allocated to the Credit Shelter Trust. If structured appropriately, a Marital Trust will allow deferral of Federal estate tax until the Surviving Spouse's death.

To qualify for the Federal estate tax marital deduction, the trust must be for the exclusive benefit of the Surviving Spouse during their lifetime, all income must be distributed to the surviving spouse at least annually, and, generally, an appropriate election must be made on the Deceased Spouse's Federal estate tax return. The trust can authorize principal distributions to the Surviving Spouse in addition to the mandatory income distributions, but neither income nor principal may be distributed to anyone other than the Surviving Spouse.

The assets distributed to the Marital Trust will not be subject to Federal estate tax at the death of the Deceased Spouse. However, the assets (including any appreciation) will be included in the Surviving Spouse's estate, thereby deferring, but not avoiding, estate tax until the death of the Surviving Spouse. As the assets

[2] For 2024, a U.S. person may give up to $185,000 to a non-U.S. citizen spouse.

will be included in the Surviving Spouse's estate, the income tax basis of the assets remaining in the Marital Trust will be adjusted to fair market value upon the Survivor's death. That means that any unrealized gains or losses will be eliminated and the new income tax basis in those assets will be the fair market value as of the Deceased Spouse's date of death. In addition to estate tax deferral, the Marital Trust can preserve the Deceased Spouse's wishes for who receives the remaining trust assets after the death of the Surviving Spouse and provide creditor protection for the Surviving Spouse during their remaining life.

Lifetime Trusts for Descendants

Finally, those who have one or more children should consider utilizing lifetime trusts for the benefit of their children and further descendants.

Lifetime trusts hold assets for the beneficiary's lifetime, not terminating until their death, and do not require any mandatory lump-sum distributions of principal (for example, a distribution of one-half of the principal of the trust upon the beneficiary attaining age 30 or all of the trust principal upon the beneficiary attaining age 40, as is common in many simple estate plans). Instead, distributions of income and principal are within the discretion of the trustee. Upon the beneficiary's death, the trust terminates, and any remaining trust assets can be distributed in further trusts to the beneficiary's descendants. Lifetime trusts may provide three significant benefits: (1) creditor protection for each trust beneficiary, (2) the ability to reduce or eliminate the Federal estate tax on the trust assets that could arise at a beneficiary's death, and (3) the ability to control the method and amount of beneficiary access to the trust assets.

As long as there is either a third-party trustee of the trust or, if the beneficiary is serving as trustee, an ascertainable standard for distributions to the beneficiary (e.g., distributions may only be made for health, education, maintenance, and support), then the assets may be protected from the beneficiary's creditors, including possibly a divorcing spouse. This may not be the case if the assets are in the name of the child as a result of a mandatory distribution of principal or outright distributions.

Additionally, the assets can be excluded from a child's Federal taxable estate by applying one or both parents' Generation Skipping Transfer ("GST") Tax Exemption, which, similar to a Credit Shelter Trust for a surviving spouse, allows for the original value plus appreciation to be exempt from the application of the GST Tax and potentially avoid inclusion in the child's estate. This tax advantage is not possible if the assets are in the name of the child as a result of a mandatory distribution of principal or outright distributions.

Finally, for parents and grandparents who are concerned about creating "trust fund" kids, who, due to easy access to funds, may lose the incentive to be productive citizens with goals and purpose such concerns can be addressed in the trust terms. The trust's terms could limit the beneficiary's access to trust funds unless the beneficiary conforms to certain behaviors required in the trust. For example, in order to receive distributions, the beneficiary must be in school full time on a reasonable degree trajectory or be employed full time. Alternatively, a beneficiary could receive a distribution to start a business if they have a complete business plan approved by the trustee.

Phase II: Gifting

After executing foundational estate planning documents containing the relevant elements discussed above, it's time to move on to Phase II, which involves determining whether to make lifetime gifts to reduce the taxable estate.

The strategies in this section focus on utilizing the Annual Exclusion and the Lifetime Exemption through lifetime gifting. Gifting can be an important part of the estate planning process used to reduce one's current taxable estate and potentially reducing a future estate tax bill by removing both the current value of the gift and the future appreciation on the gifted assets. Gross estates that exceed the decedent's Lifetime Exemption may be subject to Federal estate tax calculated at a rate as high as 40 percent (in addition to potential applicable state estate taxes), so it's helpful to gift appreciating assets early to ensure the growth is outside of the taxable estate.

Annual Exclusion Gifting

As noted above, each person can give up to their Annual Exclusion amount each year ($18,000 in 2024) without incurring a gift tax and without the need of tapping into their Lifetime Exemption. By utilizing the Annual Exclusion each year, a donor can remove a significant amount of assets from their estate while also providing a source of funds for loved ones. These gifts can be made outright to

the recipient or in trust for the benefit of the recipient. If trusts are the preferred method, specific provisions must be included in the trust and the trustee must provide notice of the gift to the intended beneficiary to ensure each gift to the trust qualifies for the Annual Exclusion, as the exclusion requires the gift be made available to the beneficiary in the year it was given to apply that year's Annual Exclusion amount.

The Annual Exclusion could also be used to fund an Irrevocable Life Insurance Trust ("ILIT"). Depending on the age and health of the donor and the amount of the death benefit desired, the donor's Annual Exclusion could be used to fund the premiums of the policy. If annual premiums are due, the donor may make contributions to the ILIT and the trustee will pay the insurance premium. A properly drafted ILIT may keep the policy it holds outside of the donor's taxable estate and could provide almost immediate cash to the beneficiaries for payment of estate expenses, including taxes.

Another potential use of the Annual Exclusion is to fund 529 Plan Accounts for the benefit of young children or grandchildren. 529 Accounts are income tax-advantaged education savings accounts for post-secondary education expenses (or in some states, K-12 education expenses), including college, university, or vocational school. While post-tax cash is gifted to the 529 Account, the growth in the account and withdrawals are income tax-free as long as the distributions from the account are for qualified education expenses. Additionally, it's possible to "superfund" a 529 Account by contributing five years of Annual Exclusion in one tax year and making a timely election on a Federal gift tax return. This method can kickstart compounding growth early.

Lifetime Exemption Gifting

Once a donor has decided if and how to best use their Annual Exclusion, the next consideration is whether they want to utilize their Lifetime Exemption through lifetime gifts. As noted above, the Lifetime Exemption is set to automatically reduce to $5,000,000, indexed for inflation, on December 31, 2025, unless further legislation is passed. Individuals with a potential taxable estate larger than their Lifetime Exemption may want to consider whether to make gifts up to their Lifetime Exemption before the potential sunset date, essentially locking in the higher exemption amount by removing the value of the gifted assets and any future appreciation on the assets from their taxable estate. Individuals can work with their advisors to determine how much they can comfortably remove from their estate without negatively impacting their asset needs for lifestyle support.

Once someone has decided they want to use their Lifetime Exemption, it's then time to determine which gifting strategy or strategies best fit their goals. Though gifts can be made outright to beneficiaries, making gifts to trusts are another option and can provide, if structured appropriately, additional benefits such as creditor protection and GST Tax planning.

Which type of trust to use will depend on the donor's overall goals. As examples, donors may choose to use one irrevocable trust vehicle for planning like a Spousal Lifetime Access Trust ("SLAT"), a Dynasty Trust, or use a combination of both. A SLAT is a trust created by one spouse primarily for the benefit of the other spouse but may also benefit children or others, while a Dynasty Trust is a trust created for non-spouse beneficiaries, most typically the donor's children and further descendants.

Donors may also seek estate tax savings through the establishment and funding of grantor trusts. A grantor trust is an irrevocable trust that is not considered owned by the donor for Federal estate tax purposes but is considered owned by the donor for income tax purposes (meaning, the donor will be responsible for paying the income tax generated by the trust and will report the income on his or her individual tax return). By transferring the assets to the grantor trust, the donor can remove their value from their taxable estate; by maintaining liability for the trust's income tax obligation, the donor also reduces their taxable estate by making such tax payments and prevents the trust assets from being diminished by that expense. Effectively, the income tax payments are additional indirect gifts to the trust that are not subject to gift tax. In contrast, a non-grantor trust is treated as its own taxpayer and the trust must pay its own income taxes.

Phase III: Planning for Individuals without Using the Lifetime Exemption

Phase III planning would involve techniques that are less reliant on the use of Lifetime Exemption. These options are helpful for those who have already exhausted their Lifetime Exemption and want to continue to reduce the value of their taxable estate. Phase III techniques are also

useful for those who are still building their estates and have estate tax exposure, but don't desire to or can't afford to move a significant amount of principal off their balance sheet.

The techniques discussed in this section—Sales to Grantor Trusts and Grantor Retained Annuity Trusts—are generally referred to as "estate freeze" techniques and function similarly, with advantages and disadvantages to each. The "estate freeze" aspect moves the appreciation of an asset out of the donor's estate, as long as the asset growth is greater than the interest rate required for the technique. While these techniques generally work better in lower interest rate environments, they are still effective with higher interest rates if the asset growth exceeds the interest rate.

Sales to Grantor Trusts

A sale to an irrevocable grantor trust[3] takes advantage of the income tax treatment of grantor trusts, discussed above. As the grantor trust and the donor are treated as the same taxpayer for income tax purposes, a donor can sell an asset to the grantor trust without incurring capital gains. The Internal Revenue Code essentially treats the "sale" as an asset moving from the donor's left hand to their right hand, rather than to a separate taxpayer.

After establishing a grantor trust and funding it with a small gift (generally, at least 10% of the overall sale amount), the donor sells other assets to the trust in exchange for a promissory note from the trust. Typically, the promissory note will require interest-only annual payments with a balloon payment of the outstanding principal balance at the end of a specified term of years. The interest rate must be at least equal to the applicable government prescribed interest rate at the time of sale (referred to as the Applicable Federal Rate, or AFR).

As discussed, the donor's sale of assets to the trust will not generate any capital gains, though the donor must survive the term of the promissory note. Further, the trust's interest payments on the promissory note to the donor will not generate interest income during the donor's life. The donor can achieve a tax-free transfer of wealth to trust beneficiaries to the extent the trust's combined rate of income and growth on the purchased assets exceeds the promissory note interest rate.

This technique can be further leveraged by selling illiquid assets like income producing real estate or a non-managing membership interest of a Family Limited Partnership (FLP) or Limited Liability Company (LLC) to the trust, as these types of assets can be subject to discounts on the value of the sale for lack of control and lack of marketability.

Grantor Retained Annuity Trust

A GRAT is an irrevocable trust to which a donor transfers assets for a specific term of years (for example, two years or four years) and retains a fixed annual annuity payment. The annuity payment is a portion of the original transferred amount plus interest at the Internal Revenue Code section 7520 rate (a higher rate than the AFR). A common type of GRAT is a "zeroed out" GRAT, which is designed so that the donor receives back the entire amount contributed to the trust plus interest, leaving an assumed "zero" gift that uses none of the donor's Lifetime Exemption. If the assets inside the GRAT grow at a rate higher than the 7520 rate during the GRAT term, the excess appreciation is transferred to the donor's chosen beneficiaries when the term ends.

If the donor does not survive the annuity term or if the assets do not appreciate above the 7520 rate, the assets all return back to the donor. If the donor survives the annuity term and the assets appreciate sufficiently, the donor can achieve a tax-free transfer of wealth to remainder beneficiaries.

Sale to Grantor Trust vs. GRAT

The two techniques discussed function similarly and achieve similar goals but have important differences that may make one a better fit than the other, depending on the assets to be transferred and the donor's overall goals.

As an example, someone may choose to use a GRAT with a short term of two to four years in order to capture the appreciation of a fast-growing asset (e.g., stock in a company that is soon to go public). On the other hand, it may be more advantageous to use a sale to a grantor trust when the relevant asset is a slower growth asset (e.g., real estate or a diversified portfolio) as the longer note term at a

[3] This technique is sometimes referred to as a sale to an Intentionally Defective Grantor Trust ("IDGT").

lower interest rate may allow more appreciation to build before the note must be repaid.

An advantage of a GRAT is that it can be used without utilizing any Lifetime Exemption versus a sale to a grantor trust involves some use of Lifetime Exemption to make an initial gift to the trust.

Finally, a GRAT is generally not an appropriate technique to use the donor's GST Tax Exemption, as the GST Tax Exemption is applied at the end of the GRAT term, at a presumably much higher post-appreciation value. In contrast, a sale to a grantor trust can apply GST Tax Exemption at the initially contributed value, allowing better leverage of the GST Tax Exemption.