# For Trusted Advisors

# Six things you may not know about state estate taxes.

By Eva Stark, JD, LL.M.

## 1 You may live in a state with a state estate tax and/or inheritance tax regime.

Seventeen states and the District of Columbia currently impose some type of state-level estate tax or inheritance tax.[1] To many individuals, the terms "estate tax" and "inheritance tax" may seem interchangeable as they both imply a death-related tax. However, a true estate tax is a tax on the right to pass property onto others and is usually payable by the decedent's estate. A true inheritance tax, in contrast, is a tax on a beneficiary's right to receive property and is usually imposed on the beneficiary.

Another key distinction between the two taxes is that the estate tax rate is generally the same regardless of who the recipient of the property may be. An inheritance tax rate tends to vary depending on the relation of the beneficiary to the decedent. Generally, transfers to "close relatives" such as children may escape inheritance taxes or are taxed at a preferential rate, while transfers to more "distant" relatives such as nieces and nephews or cousins may be subject to higher rates.

## 2 You may be subject to state estate taxes even if you do not live in a state with a state estate tax regime.

In addition to imposing an estate tax on decedents domiciled[2] in the state, states with an estate tax regime may impose an estate tax on the real property or tangible property of "nonresidents" that is physically in the state. Other property with a connection to the state may be subject to state death taxes as well. For example, a state's estate tax laws may tax certain interests in entities which own realty in the state, interests in certain entities taxed as partnerships or S corporations that own closely held businesses or farms in the state, etc.—specific state law provisions regarding what may be taxable vary widely.

In addition to the surprise tax-hit, nonresidents may only qualify for a reduced estate tax exemption amount as compared to residents of the state.

## 3 Your state estate tax exemption may be lower than the federal exemption.

While federal estate taxes affect only a small group of taxpayers, state estate taxes have significantly lower exemptions and are a concern for a much wider range of individuals. The Tax Cuts and Jobs Act of 2017 doubled the federal estate tax exemption amount to $10 million. Adjusted for inflation, the exemption amount for 2022 will be $12,060,000 per spouse.[3] In contrast, state estate tax exemption amounts can be as low as $1 million in Massachusetts or Oregon, $2,193,000 in Washington, $3 million in Minnesota or $4 million in Illinois. While some states have indexed their estate tax exemption for inflation, others have not.

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1 CT, HI, IL, ME, MD, MA, MN, NY, OR, RI, VT, WA and the District of Columbia impose an estate tax. IA, KY, MD and PA impose an inheritance tax, and NE imposes a county inheritance tax. MD imposes both an estate tax and an inheritance tax.

2 An individual's domicile, not residency, generally determines whether the individual will be taxed as a "resident" or "nonresident" for state estate tax purposes. Domicile generally refers to the place an individual views as his or her permanent home.

3 Certain provisions of the Tax Cuts and Jobs Act of 2017 are scheduled to sunset at the end of 2025 and the federal estate tax exemption amount will be reduced to $5 million, adjusted for inflation, barring any further action by Congress.

## 4 Your state estate tax rate may be lower than the federal rate.

The highest marginal federal estate tax rate is 40%, applicable to taxable amounts in excess of $1 million. State estate tax rates are typically much lower. The highest marginal state estate tax rate may be in the 16% to 20% range, or lower, depending on the state. While not all states offer graduated rates, the highest tax bracket is often not reached until taxable amounts exceed $9-$10 million.

## 5 Your state estate tax exemption may not be portable, which may necessitate additional planning.

The federal estate tax exemption is "portable"—i.e., a decedent's unused federal estate tax exemption may be utilized by the surviving spouse in certain circumstances. If the decedent passes $1 million to his children upon death and all other assets pass to the surviving spouse, the surviving spouse might be able to utilize the decedent's remaining $10.48 million exemption in addition to his or her own exemption. Portability may allow a surviving spouse to take advantage of his/her deceased spouse's unused exemption without traditional "A-B" trust planning.

A-B trust planning involves the creation and funding of a "bypass trust" at the first death to utilize the decedent's exemption and channeling remaining assets to the survivor to defer estate taxes until the second death.

Many states that impose a state estate tax do not currently allow for portability of an individual's state estate tax exemption amount. As a result, a bypass trust may be required to utilize the predeceased spouse's state exemption amount, or it may be wasted and the family's state estate taxes will unnecessarily increase at the survivor's death. In some states, it may also be permissible to create a separate "state QTIP trust" which may defer state estate taxes until the surviving spouse's death and also utilize the decedent's exemption for federal estate tax purposes. (Note that some states do not permit a separate state-QTIP election).

## 6 Your state may not have a gift tax—even if it has an estate tax.

For federal tax purposes, the gift and estate tax exemptions have been unified—with a combined lifetime exemption of $11.7 million (in 2021). Lifetime gifts that utilize the exemption reduce the amount of exemption that remains available at death. This may not be the case with state estate taxes.[4] In several—but not all—states with a state estate or inheritance tax regime, it may be possible to reduce or avoid state estate or inheritance tax by making lifetime gifts. Those contemplating lifetime gifts should be mindful that rules may be in place that penalize the use of "deathbed" gifts to avoid the estate or inheritance tax and a look-back period may apply. Additionally, certain states may take into account lifetime gifts for filing thresholds for estate taxes.

State estate, inheritance and gift tax laws vary greatly from state to state and change frequently. As such, clients should always consult with a CPA, tax attorney or estate planning attorney regarding specific state death taxes that may be applicable to them and state estate, gift or inheritance tax planning.

4 CT has a unified gift and estate tax regime.

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As a result of the Tax Cuts and Jobs Act of 2017 (TCJA) the estate, gift and generation skipping transfer (GST) tax exemption amounts increased to approximately $11.18 million per person (approximately $22.36 million for a married couple). For assets transfers in excess of the applicable exemption amount and otherwise subject to such taxes, the highest applicable federal tax rate remains at 40 percent. While the exemption amounts are indexed for inflation, current law provides for an automatic sunset of these increased exemption amounts after 2025. As a result, the exemption amounts available in 2026 and beyond could be reduced to a level provided under prior law ($5.49 million/single and $10.98 million/couple in 2017, indexed for inflation) absent further action by Congress. In addition, under different rates, rules and exemption amounts (if any), there may be state and local estate, inheritance or gift taxes that apply in your circumstances. Please consult your own tax or legal advisor for advice pertaining to your specific situation. This material includes a discussion of one or more tax related topics. This tax related discussion was prepared to assist in the promotion or marketing of the transactions or matters addressed in this material. It is not intended (and cannot be used by any taxpayer) for the purposes of avoiding any IRS penalties that may be imposed upon the taxpayer. The Nautilus Group® is a service of New York Life Insurance Company. Nautilus, New York Life Insurance Company, its employees or agents are not in the business of providing tax, legal or accounting advice. Individuals should consult with their own tax, legal or accounting advisors before implementing any planning strategies. SMRU 1924687-A Exp 4/13/2022

Special Needs Planning

# Often overlooked deductions for medical capital improvements and their financing.

By Thomas M. Brinker, Jr., LL.M., CPA

As the number of children diagnosed with autism and other intellectual disorders continues to skyrocket, the lives of all those concerned are impacted. In March 2020, the Centers for Disease Control and Prevention reported that as many as one in 54 children born today have an autism spectrum disorder (an increase from the CDC's 2018 report that found a one in 59 prevalence), with boys more than four times as likely to be identified with autism than girls. In addition, the CDC says that about one in six children ages 3–17 have been diagnosed with a developmental disability (such as autism, ADHD, blindness, and cerebral palsy among others), with one in four U.S. adults nationwide having a disability.

Parents caring for those with special needs are often unaware of the substantial tax benefits available to them and often forego hundreds, if not thousands, of dollars in potential tax deductions and reductions in their tax liability. Medical care expenditures alone for a child with special needs can prove astronomical. As a result, parents and their advisors need to become familiar with some unusual Internal Revenue Code provisions that may assist and/or hinder in this process.

The following focuses on the medical expense and home equity interest expense deductions pertaining to home-related capital expenditures incurred to accommodate an individual having special needs.

## The medical expense deduction

Only individuals itemizing their deductions on their federal individual income tax returns can claim a medical expense deduction. Un-reimbursed medical expenses are deductible only to the extent they exceed 7.5% of a taxpayer's "adjusted gross income" or AGI. This 7.5% AGI threshold for the medical expense deduction was made permanent under the Taxpayer Certainty and Disaster Tax Relief Act of 2020.

Alternatively, parents who are eligible to participate in tax-advantaged plans through work for funding medical expenses, such as flexible spending accounts or health savings accounts, can set aside limited amounts of money to finance medical care expenses on a pre-tax basis while bypassing the AGI limitation.

Although these amounts are indexed annually for inflation, pre-tax contributions to flexible spending accounts are currently limited to $2,750 for 2021, with health savings accounts capped at $3,600 for singles and $7,200 for families

with an additional $1,000 catch-up contribution (for 2021) for those over age 55.

## The missed opportunity: capital expenditures as a medical expense

Under most circumstances, capital expenditures are not permitted as a medical expense deduction. However, a medical expense deduction is available when the capital expenditure is made primarily for the medical care of the taxpayer, the taxpayer's spouse, and/or the taxpayer's dependents. To secure a current medical expense deduction for a capital expenditure, the cost must be reasonable in amount and incurred out of medical necessity for primary use by the individual requiring medical care.

Qualifying capital expenditures for medical expense deductions fall into two categories:

1. Expenditures improving the taxpayer's home while also providing medical care (e.g., a central air conditioning system for an individual suffering from a chronic respiratory illness).
2. Expenditures removing structural barriers in the home of an individual with physical limitations (e.g., construction costs incurred for an entrance ramp, widening doorways and halls, customizing bathing facilities, lowering kitchen cabinets, adding railings).

Under Treas. Reg. 1.213-1 (e)(1)(iii), capital expenditures in the first category are deductible only to the extent that the cost of the improvement exceeds the increase in the property's fair market value as a result of the capital expenditure. For example, after a physician recommends daily swimming for an individual suffering from arthritis, the family installs a therapeutic swimming pool costing $30,000. As a result of the expenditure, the home increases in value by $5,000. Therefore, $25,000 may be deducted as a medical expense (plus the ongoing pool maintenance). Expenditures incurred in the second category are fully deductible under the presumption that there is no increase in the property's value as a result of removing a physical barrier.

As illustrated in the examples above, under either category, costs incurred to operate or maintain the capital expenditure (such as increased utility and maintenance costs to operate the elevator or air conditioning system) are deductible currently as medical expenses as long as the medical reason for the expenditures continues to exist.

**EXAMPLE 1:** In 2020, Johnny was injured in an extreme sport accident. Johnny sustained a chronic disabling leg injury, which requires him to spend most of his time in a wheelchair. His physician recommends that he install an elevator in his home to alleviate the pressure on his lower body from walking up and down stairs. During the year, Johnny made the following expenditures: wheelchair: $3,500; elevator: $19,500; operational and maintenance costs incurred with the elevator: $2,800; and entrance ramp and door modifications: $7,500. According to appraisers, the home increased in value as a result of the elevator by $5,000. As a result of the appraisal, Johnny's medical expense deduction associated with his capital expenditures is $28,300 ($33,300 less the home's increase in value of $5,000). If Johnny's AGI was $75,000 in 2020, his medical expense deduction would be $22,675 after subtracting 7.5% of his AGI.

**EXAMPLE 2:** In 2020, Amy, a single mother with AGI of $80,000, fully supported her 20-year-old daughter living with her. Her daughter has no income for the year, and was properly claimed as Amy's dependent. During the year, Amy installed a central air conditioner at a cost of $17,500, which her physician said was required in caring for the daughter's asthma. After installation, Amy's home increased in value by $6,000. In addition, Amy incurred the following medical expenses in 2020: over-the-counter medications: $550; prescribed drugs: $350; physician expenses: $1,250; and un-reimbursed health insurance premiums: $4,250. For 2020, Amy's current medical expense deduction is $11,350 after subtracting 7.5% of her AGI ($17,350 less $6,000). If the air conditioning system increases the monthly utility bill by $125, Amy's deduction would increase by $1,500, resulting in an $12,850 medical expense deduction for the year 2020. (Note: Over-the-counter medications are not a deductible medical expense.)

## Can a home equity loan provide a deduction when financing the improvement?

Families caring for those with special needs frequently borrow against their homes in financing their family medical expenses. Although interest expense incurred on a home equity

loan is no longer deductible as an itemized deduction under 2017's Tax Cuts and Jobs Act (TCJA), there are notable exceptions.

In general, home equity loans represent borrowings other than the indebtedness incurred in acquiring, constructing, or substantially improving a principal residence and/or a second home. Under Sec. 163(h)(3)(F): "Special Rules for taxable years 2018 through 2025," the home mortgage interest deduction is currently limited to acquisition indebtedness of $750,000 (from prior law's $1,000,000) for homes acquired after 2017. Further, the home equity loan interest deduction has been suspended through 2025.

As of 2018, parents seeking an interest expense deduction for home equity indebtedness will only be permitted a deduction if the loan is to purchase, construct, or substantially improve a residence.

Therefore, a home equity loan interest deduction will only be permitted if the parents secure the loan for medical capital expenditures (i.e., substantially improving the home) made to the home in accommodating the individual with special needs (with total indebtedness limited to $750,000). However, utilizing a home equity loan to finance ongoing medical care will not result in an interest expense deduction.

**EXAMPLE 3:** Bill and Jane Johnson made a $200,000 down payment and borrowed $700,000 to purchase a residence worth $900,000 in 2013. Their home is currently valued at $1,150,000 with an acquisition debt remaining of $500,000. In 2020, they borrow $200,000 to provide for the ongoing medical care of their 15-year-old son with special needs and use their residence to secure this note. They may deduct interest on the $500,000 of remaining acquisition debt only... unless the $200,000 home equity loan was utilized to improve the home, such as a medical capital expenditure (e.g., installing an elevator or therapeutic swimming pool, constructing entrance ramps, widening doorways and halls, lowering kitchen cabinets, adding railings). It should be noted that both the medical capital expenditure and the home equity loan's interest are deductible as an itemized deduction if the Johnsons itemize their deductions.

## Where to seek answers?

In addition to national organizations devoted to special needs planning, talk to a locally recommended Chartered Special Needs Consultant or a CPA and/or financial services provider specializing in planning for those with special needs to see how a medically related capital expenditure may reduce your tax bill.

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Business Planning

# Four critical areas of planning that can improve small business longevity, success.

By Joshua Dietz, JD, LL.M.

Small businesses have an essential role in the U.S. economic landscape. They are credited for approximately 47% of private sector employment, 40% of private sector payroll, and 32% of U.S. export trade value.[1] However, despite the substantial statistics, small businesses still appear fragile.

The likelihood of having a successful start-up may be roughly equivalent to flipping a coin. About 70% of small businesses survive 2 years, 49% survive 5 years, and only about 33% make it 10 years.[2]

This raises two important questions: (1) What differentiates the successful businesses from the unsuccessful? (2) Can small business owners increase the potential for their business's longevity and success?

There is good news. Small business owners can increase their odds by planning, which has been credited as a primary factor resulting in significant improvements to overall business success rates. The following provides a general overview of four specific areas where business planning can be critical to longevity and success.

## Entrance planning

Entrance planning is an important first step for developing a stable foundation. The National Federation for Independent Business, which has been researching business start-up success rates since the 1970s, says the entrepreneur's approach toward pre-planning and evaluation for a new business has resulted in a 30% improvement in those success rates over the past half century.[3] While business owners may be knowledgeable in their specific industry, more are recognizing that running a business requires experience and knowledge in multiple industries (e.g., tax, insurance, accounting, legal, banking, etc.).

1 https://cdn.advocacy.sba.gov/wp-content/uploads/2020/11/05122043/Small-Business-FAQ-2020.pdf

2 https://cdn.advocacy.sba.gov/wp-content/uploads/2020/11/05122043/Small-Business-FAQ-2020.pdf

3 https://www.nfib.com/content/resources/start-a-business/why-do-small-businesses-fail/

Practicality dictates that a single business owner, or a small team of co-owners, cannot master every aspect necessary to operate a successful business. New entrepreneurs are increasingly utilizing a network of advisors and mentors.

While evaluating advisors and mentors, it is wise to recognize that experience matters. A study by MIT's Sloan School of Management compared U.S. Census data with Internal Revenue Service tax data and found that the most successful business start-ups were founded by owners in their forties.[4] Researchers identified that entrepreneurs are also 125% more successful if they were previously employed in their respective industries prior to starting their own business.[5] However, entrepreneurs, especially younger entrepreneurs, should not be dissuaded. Instead, this information lends credibility to the positive impact a team of knowledgeable and experienced advisors and mentors may provide.

## Business finances

Financial miscalculations are the most cited reasons for small business closings, and one of the top reasons businesses fail is because they simply run out of money.

All industries have a basic cost threshold and some businesses have higher operational expenses than others. Many businesses close because they either fail to obtain sufficient funding or that funding is not spent wisely. A common business mistake is to obtain loan financing for operational expenses that do not produce or increase revenue. Budgeting practices of successful businesses include having access to liquidity and targeting such funds for optimal use.

Another common oversight is not managing accounts receivable (AR)

— the money owed to a business for services and goods that have already been provided. Essentially, companies with AR are financing their customers' purchases. Small businesses need to understand delays in payment receipts standard for their respective area or industry and have a plan to mitigate this area of financial risk.

## Taxation

Taxes are another critical area that catches many business owners by surprise. Most owners are familiar with federal individual income tax rates and they may even be aware of the federal self-employment tax. The reality is there are several applicable tax regimes that apply to every business (federal income tax, state income tax, state and local tax, payroll taxes, excise taxes, etc.), all of which vary depending on location, the particular industry, and other circumstances of the business.

Mistakes may result in missed tax savings opportunities and trigger severe penalties, not only for the business but also for the owners personally. Knowledgeable attorneys and tax professionals can help verify businesses are operating under the proper entity structure, using accurate accounting methods, meeting all tax reporting requirements, and paying the correct amounts to the correct tax agencies.

## Exit planning

Exit planning, or succession planning, may cause owners to immediately think of retirement. But exit or succession planning also includes selling the business, passing the business to heirs, and exiting due to unforeseen circumstances such as disability or death. After investing significant resources into their businesses, it is important for owners to have a plan in place to collect the return on that investment and increase the success of ownership transition.

Numerous family businesses do not have an exit or succession plan and a significant portion of owners who plan to retire within five years have not identified a successor. A CNBC

4 https://mitsloan.mit.edu/ideas-made-to-matter/20-year-old-entrepreneur-a-lie
5 Id.

survey found that in the Baby Boomer generation, 78% plan to sell in order to fund their retirement yet only 30% have actually documented their plan.[6] A successful business transition—especially one on which the business owner's retirement security might depend—takes time and a plan should be put in place well in advance.

In addition to planning for a successful exit at retirement, there is always a risk of an owner's death or illness. In such a scenario, having a manager or team of key employees in place who can independently operate the business is critical. With proper planning, such key players can be incentivized to remain with the business for extended periods.

Disability insurance or life insurance benefits can provide necessary liquidity to keep the business operating, avoid a fire-sale liquidation, or allow the business to be smoothly transitioned to a co-owner. Proper planning can ensure the financial security of the family of a disabled or deceased owner, without over dependence on the future success of the business.

Of course, business exit or business succession planning is neither quick nor easy, but its potential payoff may be the difference between a smooth transition with financial security, or business and family disputes and an increased likelihood of business failure.

## Conclusion

Small businesses are an important aspect of the U.S. economic structure. Owning a small business can be a very rewarding endeavor, but it also requires consistent planning and investment.

The right team of advisors can help identify areas of concern in any existing business plan. They also can help design and implement financial, tax, and exit or succession strategies that address a business owner's individual goals while helping to increase the odds for the longevity and success of the business itself.

6 https://www.cnbc.com/2015/04/13/ew-small-biz-have-an-exit-plan.html

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