Estate Planning

Tax Guide

Pass your estate with MAXIMUM TAX EFFICIENCY

You've worked hard to create a sizable estate, and you deserve to pass it on. To maximize your tax efficiency, understanding transfer laws is important. This is because you transfer – not sell – assets to another individual or organization. These laws may change depending on the revenue needs of the government or other factors.

There are two main types of taxes that threaten every estate plan:

1) **Income taxes** – ordinary income and capital gains.

2) **Transfer taxes** – estate, gift and generational skipping transfer taxes.

In order to minimize the tax threat to your estate plan, you should have a basic understanding of the two tax systems and how they will affect your financial assets.

GLOSSARY

Realization
The sale or exchange of an asset, which produces a taxable event.

Recognition
Debt forgiveness. Under certain circumstances, it amounts to a taxable event.

WHAT'S INSIDE

Income taxes

In the United States, individuals and corporations pay U.S. federal income tax on their income, which includes both ordinary income and capital gains.

What are ordinary income taxes?

Earned and unearned incomes are subject to ordinary income taxes:

- **Earned income** is income from employment or an active trade or business.
- **Unearned income** generally comes from investment income.

What are capital gains taxes?

Capital gains are taxed when there is either a **realization** or **recognition** event. Once an asset is sold or exchanged, a gain or loss is realized and determined. The amount of taxes due depends on your tax bracket and the amount of time the asset was held prior to the sale.

How are capital gains taxes calculated?

Cash received
- From sale of capital asset

Fair market value
- Current market value of capital asset

Liabilities shed
- Liabilities associated with capital asset

Cash received
\+ Fair market value
\+ Liabilities shed
Amount realized

Cost of property
\+ Capital additions
− Cost recovery
Adjusted basis

Cost of property
- Original cost of attaining property

Capital additions
- Additional improvements made to an asset

Cost recovery
- Previous depreciation deductions

Timing
- Long-term capital gain on assets held longer than one year
- Short-term capital gains on assets held less than one year

Amount realized
− Adjusted basis
Realized gain/loss

Determining net capital gain or loss
1. Net long-term capital gains and losses
2. Net short-term capital gains and losses
3. Net long-term against short term

How is taxable income calculated?

Form 1040, or the U.S. Individual Income Tax Return, contains the basic tax formula and is the method taxpayers use to report their taxable income. The calculations from form 1040 can be found below:

Exclusions from income
- Gifts and inheritances
- Most life insurance proceeds from non-MEC policy
- Qualified distributions from Roth IRAs
- Gain on sale of residences (up to $250,000 single or $500,000 married)
- Tax-exempt bonds
- Compensation for injuries
- Scholarships

Earned income
- Salary and wages
- Income from active business

Unearned income
- Interest, dividends, capital gains, annuities, lifetime distributions from Modified Endowment Contracts (MECs), rents, royalties, passive activity income

Income (all income)
− Exclusions from income
= Gross income
− Deductions for Modified Adjusted Gross Income
= Modified Adjusted Gross Income (MAGI)
− Greater of itemized or standard deductions
− Personal and dependency exemption
= Taxable income

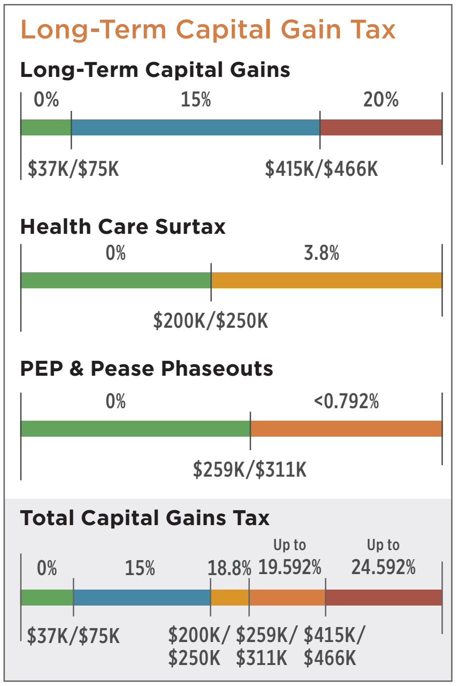
Personal exemption phaseout (PEP)
- Reduces personal exemption by 2% for:
  - Every $2,500 of income above threshold for single taxpayers
  - Every $1,250 of income above threshold for joint taxpayers

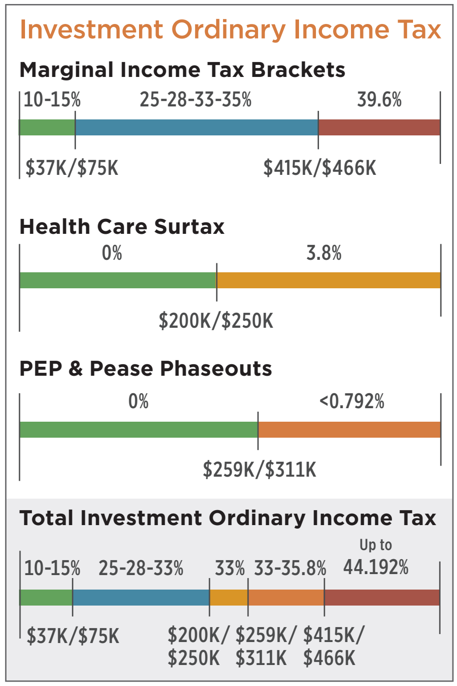
Pease limitation
- Cuts itemized deduction by 3% of Adjusted Gross Income above threshold amounts up to a maximum amount of 80%
- Deductions not included:
  - Investment interest
  - Medical expenses
  - Casualty, theft and wagering losses

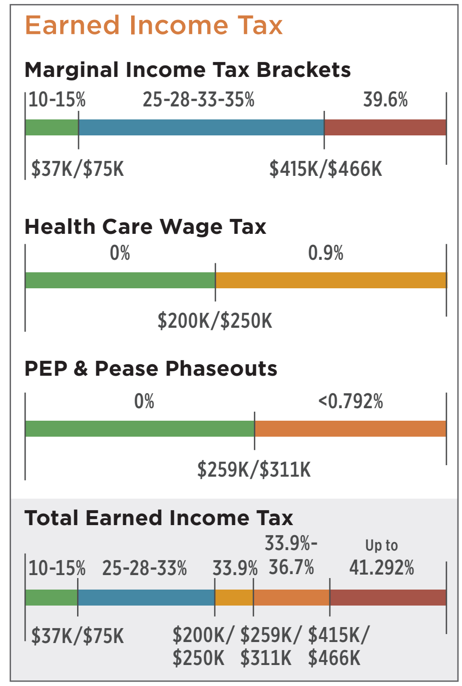
Deductions for MAGI
- Ordinary, necessary and reasonable business expenses (Section 162)
- Alimony
- Moving expenses
- Educational expenses

Tax rates according to type of income

The charts below show the tax rates for capital gains, investment income and earned income. Tax brackets are distinguished by color, and the numbers below each bracket (i.e., $37K/$75K) represent the single/joint taxpayer income cutoff for that bracket. "K" denotes income is in thousands of dollars.







How is trust income tax calculated?

Like an individual, a trust is a separate, taxpaying entity. Who is liable for taxes on income earned by a trust depends on who receives or retains benefits from the trust: the trust entity, the beneficiaries or the grantor. If trust income is retained by the trust it is taxed to the trust, while distributed income is taxed to the beneficiary who receives it.

Please note: The tax brackets for income taxable to a trust are much more compressed and can result in higher taxes than for individuals. Please see the table below for tax rates.

Trust income tax rates (for 2016 tax year)

If taxable income is	The tax is
Not over $2,550	15% of the taxable income
Over $2,550 but not over $5,950	$382.50 plus 25% of the excess over $2,550
Over $5,950 but not over $9,050	$1,232.50 plus 28% of the excess over $5,950
Over $9,050 but not over $12,400	$2,100.50 plus 28% of the excess over $9,050
Over $12,400	$3,140.50 plus 39.6% of the excess over $12,400
	Plus 3.8% healthcare surtax on net investment income over $12,400

Transfer taxes

The government also taxes assets that are gratuitously transferred from one person to another. A gratuitous transfer occurs when one individual gives an asset to another person and does not receive anything in return. In this transaction, the donor is the individual who is taxed.

How the transfer tax works

Let's compare transfer taxation to a trip to the grocery store:

The maximum estate tax rate is 40 percent, but each individual has a $5.45 million exemption (2016, indexed for inflation) on all transfer taxes, including estate and gift taxes. This exemption amount can be used in any combination during life or at death, as long as the total amount does not exceed $5.45 million.

The shopping cart represents your estate.

During your lifetime, you place assets in your cart (or estate) such as real estate, investments, life insurance, qualified plans and others.

The transfer tax comes when you 'check out' with the cashier. This 'checkout' occurs when you gratuitously transfer assets from your estate to another person – either during your lifetime (gift taxes) or at your death (estate taxes).

The federal government gives you a "basic exclusion amount" (or coupon) with the transfer tax. This coupon allows you to transfer $5.45 million (2016, indexed for inflation) without taxation. However, if you transfer more than the basic exclusion amount, a transfer tax is triggered.

Federal estate, gift and generation-skipping transfer tax

Year	Exclusion	Top tax rate
2013	$5.25 million	40%
2014	$5.34 million	40%
2015	$5.43 million	40%
2016	$5.45 million	40%

Forecast for future estate taxes

Recent legislation set the federal estate, gift and generation-skipping transfer tax exclusion at $5 million, indexed for inflation. Depending on inflation rates, tax experts predict the exclusion to grow to the following levels:

Basis
The value of an asset with respect to capital gains taxation and transfer ownership.

	Federal estate, gift and generation-skipping transfer tax exclusion	
Inflation rate	**Tax year 2023**	**Tax year 2033**
Low inflation	$5.66 million	$6.37 million
Median inflation	$6.58 million	$8.95 million
High inflation	$8.18 million	$14.6 million

Source: Bernstein Global, 2014 Heckerling Institute on Estate Planning, *Venn Diagrams I: Meet me at the intersection of Estate and Income Tax.*

Federal gift taxes

There is a $5.45 million gift tax exclusion (2016, indexed for inflation) for transferring assets during life. If a portion is used during your lifetime as a gift, the asset is put through the 'checkout' at the time of the transfer.

Exceptions

- You can give unlimited amounts to your spouse without gift tax consequences.
- The annual gift tax exclusion allows transferring up to a certain amount each year ($14,000 in 2016) without affecting the lifetime exemption amount. This gift must create a present interest in the gift in order to qualify for the annual exclusion.
- Payments made directly for qualified medical expenses or tuition are not considered taxable gifts.
- You can also give unlimited amounts to qualified charities without transfer tax consequences. In addition, the donor may receive an income tax deduction for these charitable gifts.

Basis: Carryover basis for gifts

- A donee receives an asset at the same basis as the donor. There is no step-up in basis for the donee.
- If the fair market value of the asset is less than the donor's basis, then the double basis rule applies:
  - For losses, basis is the fair market value at the date of the gift.
  - For gains, it is the donor's basis.

Example

During his lifetime, a father gives his daughter real estate he purchased for $15,000 but is now worth $20,000.

The federal government first allows the annual gift tax exemption ($14,000 for 2016), creating a $6,000 taxable gift to his daughter ($20,000 - $14,000).

There is no gift tax because the father uses $6,000 from his lifetime exemption ($5.45 million for 2016).

There are no tax ramifications to his daughter, and she receives the real estate at her father's **basis** of $15,000 instead of the fair market value of $20,000.

Federal estate tax

There is a $5.45 million estate tax exemption (2016, indexed for inflation) for transferring assets at death. Using the shopping cart analogy, everything in your cart is put through the 'checkout' at death.

Exceptions

- You can transfer unlimited amounts to your surviving spouse without estate tax consequences.
- Portability allows you to transfer any unused portion of the exemption to your surviving spouse. Please see the discussion on portability on page 8.
- In addition, you can transfer unlimited amounts to a qualified charity without transfer tax consequences. These transfers also qualify for the unlimited charitable estate tax exclusion.

Basis: Step-up in basis for capital assets

- When assets are transferred at death, a donee receives a step-up in basis at the fair market value at the donor's time of death.
- However, retirement income assets don't receive a step-up in basis. Examples of retirement income assets include qualified plans, IRAs and nonqualified annuities.

Example

Instead of the father passing the real estate to his daughter during his lifetime, he passes it to her at his death.

He purchased the asset for $15,000. It is now worth $20,000.

The $20,000 amount is used, and his transfer tax exemption ($5.45 million in 2016) is reduced by $20,000.

There are no tax ramifications to his daughter, and she receives the real estate at a step-up basis of $20,000.

Generation-skipping transfer tax

There is a $5.45 million (2016, indexed for inflation) generation-skipping transfer tax (GST) exemption for transferring property to a person two or more generations younger. For purposes of the GST tax, persons two or more generations younger than the transferor are called "skip persons". This tax is **in addition to** gift or estate taxes.

Example

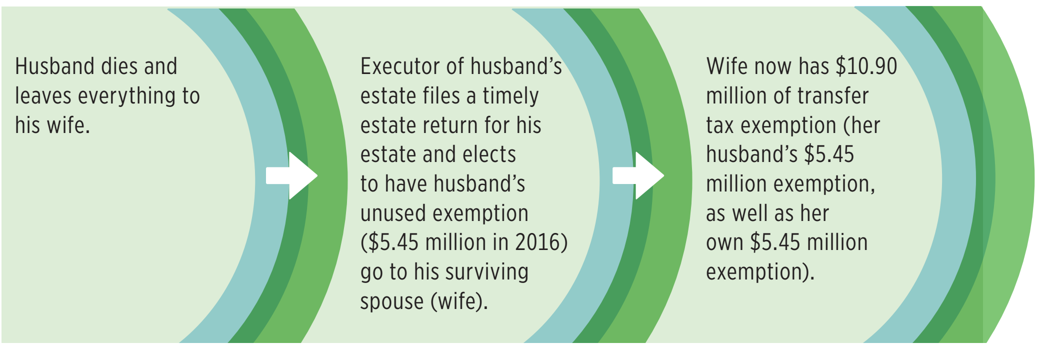
In addition to passing the real estate to his daughter at death, the father leaves $500,000 to his granddaughter in his will.

This is a direct generational skip and reduces his overall GST exemption ($5.45 million in 2016) by $500,000.

Portability

Portability is the ability for the deceased spouse to transfer any unused transfer tax exemption to the surviving spouse. This is the deceased spousal unused exclusion amount (DSUE). It applies only when the executor has timely filed an estate tax return and an irrevocable election has been made. Portability only applies to estate and gift taxes, not GST taxes.

Example:



Your **financial assets**

For estate planning purposes, there are three categories of financial assets. Each of these three types of assets has a different tax treatment:

1. Capital assets

2. Retirement income assets

3. Legacy assets

Capital assets

Capital assets have a tax basis. Some examples of capital assets are investments, real estate, a business and cash accounts.

Timing	Tax consequences
Purchase	After-tax dollars
Income generated	Ordinary income
Sale	Capital gains • Long term (held longer than one year) • Short term (held less than one year)
Disposition at death	Fair market value at date of death • Can get a step-up or step-down basis

Retirement income assets

Retirement income assets are designed to be used for retirement income. Some examples of retirement income assets are qualified plans, IRAs and annuities.

Timing	Tax consequences
Contributions	Qualified – Before tax Nonqualified – After tax
Growth	Tax deferred
Distributions	Ordinary income • Qualified – All ordinary income • Nonqualified – Exclusion ratio
Disposition at death	No step-up

Legacy assets

Legacy assets are designed to be used for legacy planning and have tax-preferential treatment. Life insurance and Roth IRAs are two examples of legacy assets.

Timing	Tax consequences
Purchase	After tax
Growth	Tax deferred
Distributions	Tax preferred
Disposition at death	Automatic step-up in basis

Take a fresh look at your estate plan

Your financial advisor can work with you and your estate planning professionals to navigate the many different tax laws that impact your income and your assets. Together, we'll take a fresh look at your estate plan and help you maximize your estate today, tomorrow and at death.

Keeping promises **since 1880**

With a long history in offering flexible life insurance, Securian Financial Group, the holding company parent of Minnesota Life and Securian Life, and its affiliates have been committed to protecting clients since 1880.

Minnesota Life Insurance Company and Securian Life Insurance Company, a New York authorized insurer, are highly rated by the major independent rating agencies that analyze the financial soundness and claims-paying ability of insurance companies. For more information about the rating agencies and to see where our ratings appear relative to other ratings, please see our website at **securian.com/ratings**.

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Whether you're purchasing a new policy or making changes to one you currently own, choose a policy backed by a company that shows how much it cares about you.

Life insurance products contain fees, such as mortality and expense charges, and may contain restrictions, such as surrender periods. Please keep in mind that the primary reason to purchase a life insurance product is the death benefit.

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