From Income Tax to IRAs:

Tax Optimization Strategies for Non-Taxable Estates

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① Introduction

Traditional estate planning advice revolves around moving as many assets as possible out of the estate to minimize estate tax liability. However, most people's estates will never approach taxability, meaning they need a different approach to estate planning.

At the most foundational level, planning for non-taxable estates—those valued at less than $13.61 million—means ensuring clients have appropriate documents like wills, trusts, and powers of attorney in place.

This guide will explore how to take planning for non-taxable estates even further, with strategies that focus on *including* assets in the estate rather than transferring them elsewhere to minimize income taxes. After all, tax optimization doesn't only apply to federal estate tax—many non-taxable clients can still benefit from strategic income tax planning.

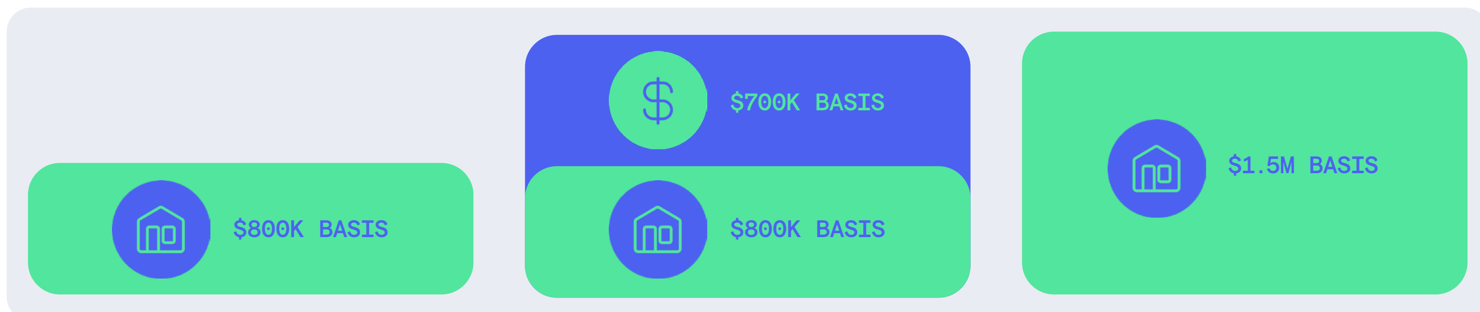
In this guide, we'll cover some principles of planning for non-taxable estates including:

- How to approach basis
- Basics of capital gains
- Income tax considerations
- State estate taxes
- Illustrative sample scenarios for key ideas

In addition to foundational estate planning concepts, we'll identify flags to look for when examining an existing estate plan or helping craft estate plan strategies that are relevant for clients without estate tax worries.

② Basis: General Principles and How it Works

How it works



Cost Basis

Bob buys a house for $800k.

He has an $800k basis in the house.

Transferred Basis

Bob gives the house to his daughter 10 years after buying it. The house has increased to $1.5m in value.

Bob's daughter has an $800k basis in the house. So, if she sells right away, she'd have $700k of gain ($1.5m less 800k basis.)

Step-Up Basis

What if Bob had instead died and left the house to his daughter 10 years after buying it?

Bob's daughter would have a $1.5m basis in the house. So, if she sells right away, she'd have $0 gain.

A QUICK REFRESHER ON BASIS...

Basis is the fair market value of a property, and is used to calculate any gain or loss on a sale or transfer of that asset. Basis can also be used for landlords or business owners to calculate depreciation. Why does basis matter in the context of estate planning? Capital gains.

③ Capital Gains: General Principles and How it Works

Capital gains are taxed at different rates depending on the person's taxable income, and are bracketed at 0%, 15%, and 20%. It's worth noting that irrevocable trusts are generally separate from their beneficiaries and settlors and thus have their own taxes and capital gains to consider.

State income taxes can also apply to capital gains, and some people are subject to the net investment income tax (NIIT) or alternative minimum tax (AMT) that can increase the tax rate.

CAPITAL GAINS TAX RATE 2024

Filing Status	0%
Single	$0 to $47,025
Married filing jointly	$0 to $94,050
Married filing separately	$0 to $45,025
Head of household	$0 to $63,000

A QUICK REFRESHER ON CAPITAL GAINS...

The majority of a person's belongings—their home, their furniture, their vehicle—are capital assets. When a person sells an asset, the difference between the asset's basis and the amount earned from the sale is either a capital gain or a capital loss. A person has a capital gain if they sell an asset for more than its basis, and vice versa. Anyone with taxable investments can be affected by capital gains.

③ Capital Gains: General Principles and How it Works

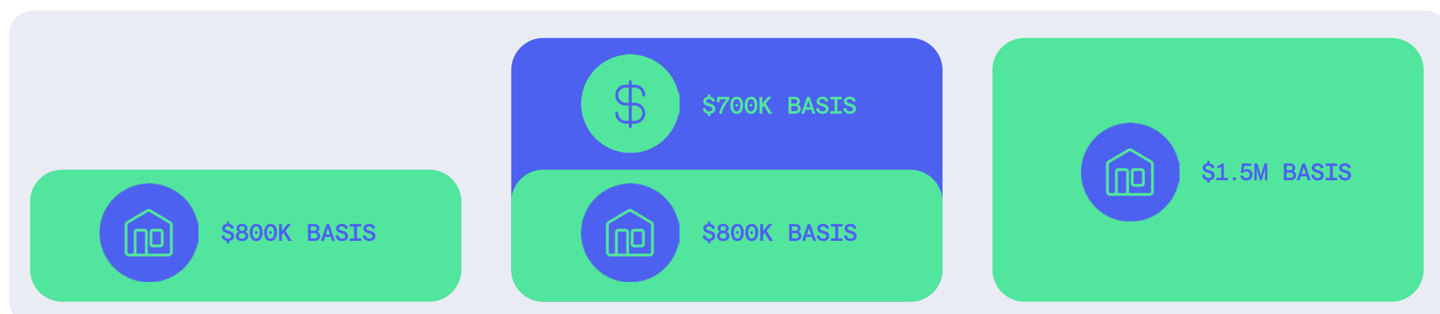
Net Investment Income Tax (NIIT)

The net investment income tax (NIIT) is a federal surtax levied on certain types of investment income for individuals, estates, and trusts that fall above a certain income threshold. The NIIT is a 3.8% tax taken from either the net investment income or the amount by which the modified adjusted gross income (MAGI) exceeds the set threshold amount (whichever is less).

Alternative Minimum Tax (AMT)

Under tax law, certain tax benefits are designed to dramatically reduce a person's regular tax burden. To ensure that high income taxpayers pay at least some amount of tax, the alternative minimum tax (AMT) sets a limit on those tax benefits. AMT only applies if the tentative minimum tax for a given year is greater than the regular tax for that year. AMT may apply to capital gains, though the 2017 tax reform significantly reduced its impact.

How it works



Cost Basis

Bob buys a house for $800k.

He has an $800k basis in the house.

→ If Bob sells the house, he'll use $800k as his basis for determining gains taxes.

Transferred Basis

Bob gives the house to his daughter 10 years after buying it. The house has increased to $1.5m in value.

Bob's daughter has an $800k basis in the house. So, if she sells right away, she'd have $700k of gain ($1.5m less 800k basis.)

→ This could be up to $260k in capital gains taxes if minimum rates applied.

Step-Up Basis

What if Bob had instead died and left the house to his daughter 10 years after buying it?

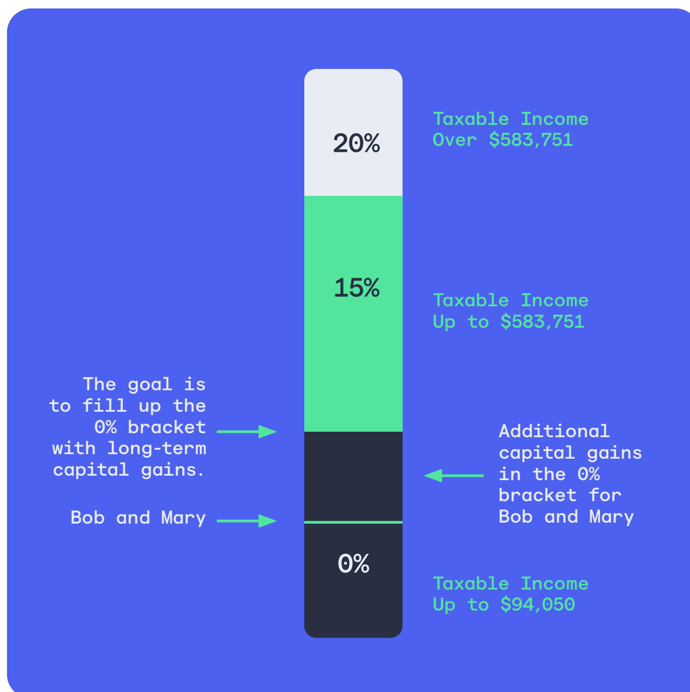
Bob's daughter would have a $1.5m basis in the house. So, if she sells right away, she'd have $0 gain.

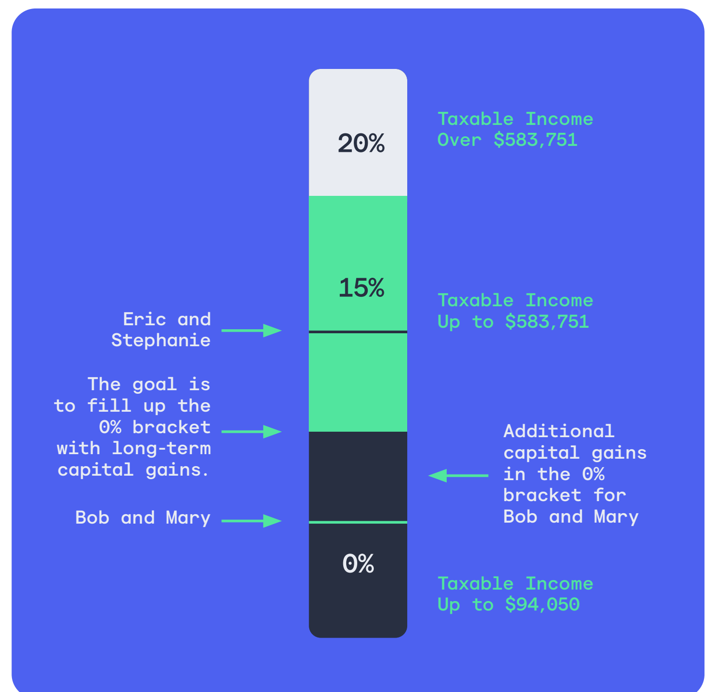
→ And thus, no capital gains taxes.

④ Strategies

0% bracket strategy

Harvest gains to top up the 0% capital gains bracket





Bob and Mary think they'll have taxable income of $54,050, putting them in the 0% capital gains tax bracket. Because the 0% bracket is up to $94,050 in taxable income, Bob and Mary could have up to $40,000 additional long-term capital gains and still remain in the bracket. The goal of this strategy is to fill up the 0% bracket with long-term capital gains.

Very wealthy and/or high income people may not be candidates for this strategy since the top of the 0% bracket is relatively low at approximately $45,000 taxable income for singles/married filing separately and approximately $90k for married filing jointly.

For example, Eric and Stephanie think they'll have taxable income of $250,000, so they are in the 15% capital gains tax bracket already. Since there's no room left in the 0% bracket, they are unable to use the 0% bracket strategy while their taxable income is at that level.

Additionally, there's no "wash gain" rule. A person can sell an asset, take a gain that's taxed at 0%, and then rebuy the same security to maintain their investment strategy.

④ Strategies

Basis strategies

For non-taxable estates, focus on inclusion in the estate

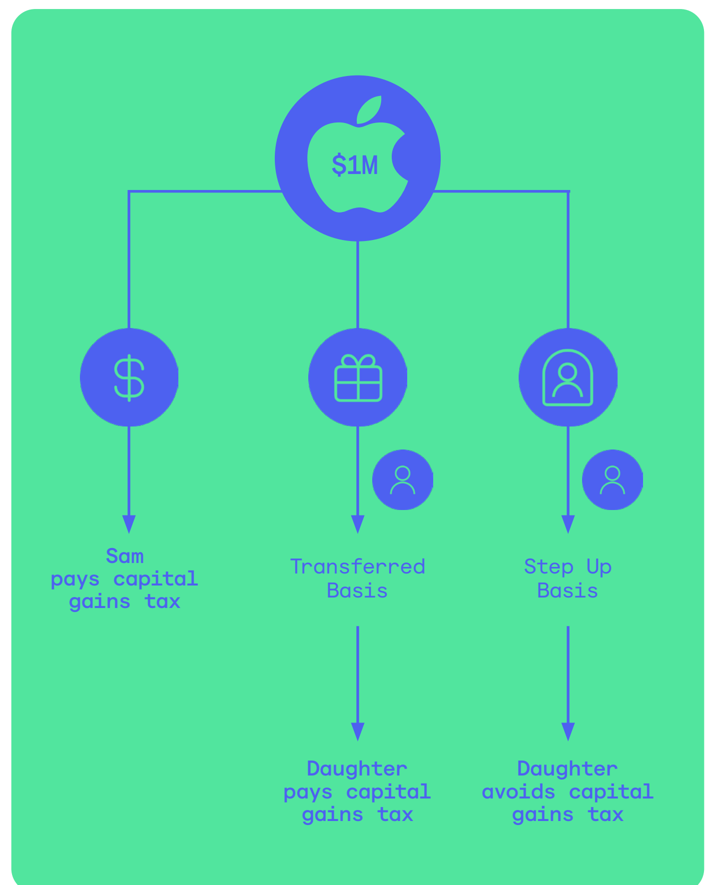
"Traditional" estate planning advice typically focuses on minimizing the size of the taxable estate. But the high exemption threshold of $13.61 million per person means most estates don't need to follow this type of advice to reduce estate taxes.

When an estate isn't taxable, there's a free basis step up on assets. This works best with low basis assets where there is strong hold conviction.

How it works

Sam owns $1 million of Apple stock he acquired in 1997 when it was trading at $0.12 per share. Here's how different scenarios could play out for Sam:

- If Sam sold the shares, he'd essentially have a million dollars in capital gains. This could result in approximately $370k in taxes if Sam was a California resident paying the highest possible tax rates.
- If Sam gives the shares to his daughter, she'd have transferred basis and would have capital gains taxes when she sells the shares.
- If Sam dies owning the shares and his daughter inherits them, she'd have a $1 million basis in the shares and could sell them without any capital gains. Or, if she continued to hold the shares (based on an informed investment decision), she'd have more basis now, reducing potential future capital gains.



④ Strategies

Alternative strategies

Overhaul the estate plan

In some situations, it may make sense to rethink the types of trusts used in a nontaxable estate plan if they were set up when exemption rates were much lower. For example, marital and bypass trusts are great estate tax-driven planning strategies, but may not work well for non-taxable estates. In this scenario, a bypass trust is solving for an estate tax problem that the client doesn't have, and is creating an income tax problem because the client won't get a basis adjustment upon the survivor's death for the assets in the bypass trust.

Similarly, you might consider unwinding unnecessary irrevocable trusts or family limited partnerships (FLPs) that were set up in the expectation of an investment outcome that never materialized or if the couple's asset level is below today's estate tax exemption. In other words, a client thought they would eventually have a taxable estate but they actually don't. Irrevocable trusts or FLPs can create an income tax problem and heavy compliance burden with many additional state and federal filings without any corresponding estate tax benefit, so unwinding them could be a way to save on income tax.

Keep in mind that it's important to consider ease of administration, asset protection, Medicaid concerns, and preservation of the first-to-die's wishes in making any changes to estate documents.

⑤ Income Tax

Planning for IRA-heavy estates

Beneficiaries who inherit Individual Retirement Accounts (IRAs) have a compressed timeline in which they must pay income taxes on those accounts. For example, most non-spousal beneficiaries have only 10 years to fully withdraw an inherited IRA, due to the SECURE Act which became effective in 2020.

Often, beneficiaries inherit IRAs when they're in their highest earning years, potentially increasing their tax rates. For example, let's say 80-year-old Robert dies and leaves his $1 million IRA to his 50-year-old daughter, Jenn. Forties and fifties are often a person's peak earning years and the inherited IRA layers income taxes on top of what may be the highest income tax rates Jenn pays in her life.

Let's look at income tax planning for a few specific types of IRAs.

⑤ Income Tax

Roth IRA

While a Roth IRA is still subjected to the 10-year rule, they don't have income taxes for withdrawals. Clients using Roth IRAs might consider the targeted amount achieved through regular or ongoing bracket top-up or deduction soak-up strategies. Additionally, they may need to adjust their investment strategy to account for the initial tax hurdle and align use of Roth funds with their preferred timelines.

The primary benefit of these strategies is that the converted funds remain completely available until death, so prepaying the income taxes through a Roth conversion might be lower risk than a gift from a financial planning standpoint.

Add Life Insurance

In some cases, a single life insurance policy could create liquidity for the surviving spouse. Life insurance death benefit usually isn't subject to income taxes, and as long as it doesn't tip the estate into becoming taxable, estate tax is irrelevant. This strategy could make the survivor more comfortable with doing a split IRA at first death strategy if they are concerned about not having enough money. Or, the survivor can use the life insurance death benefit to cover the income taxes from a Roth conversion. Either way, the survivor now has some flexibility for strategic income tax planning.

For charitably minded clients, this could make it possible to leave their IRA to charity and let the life insurance payout become the surviving spouse's income.

Split IRA at First Death

A traditional approach is to leave the entire IRA balance to the surviving spouse, and then the surviving spouse will leave everything to the kids upon their death. However, the SECURE Act means this doesn't always create the best outcome for the family's overall wealth. Here's an example of how a split IRA can be beneficial:

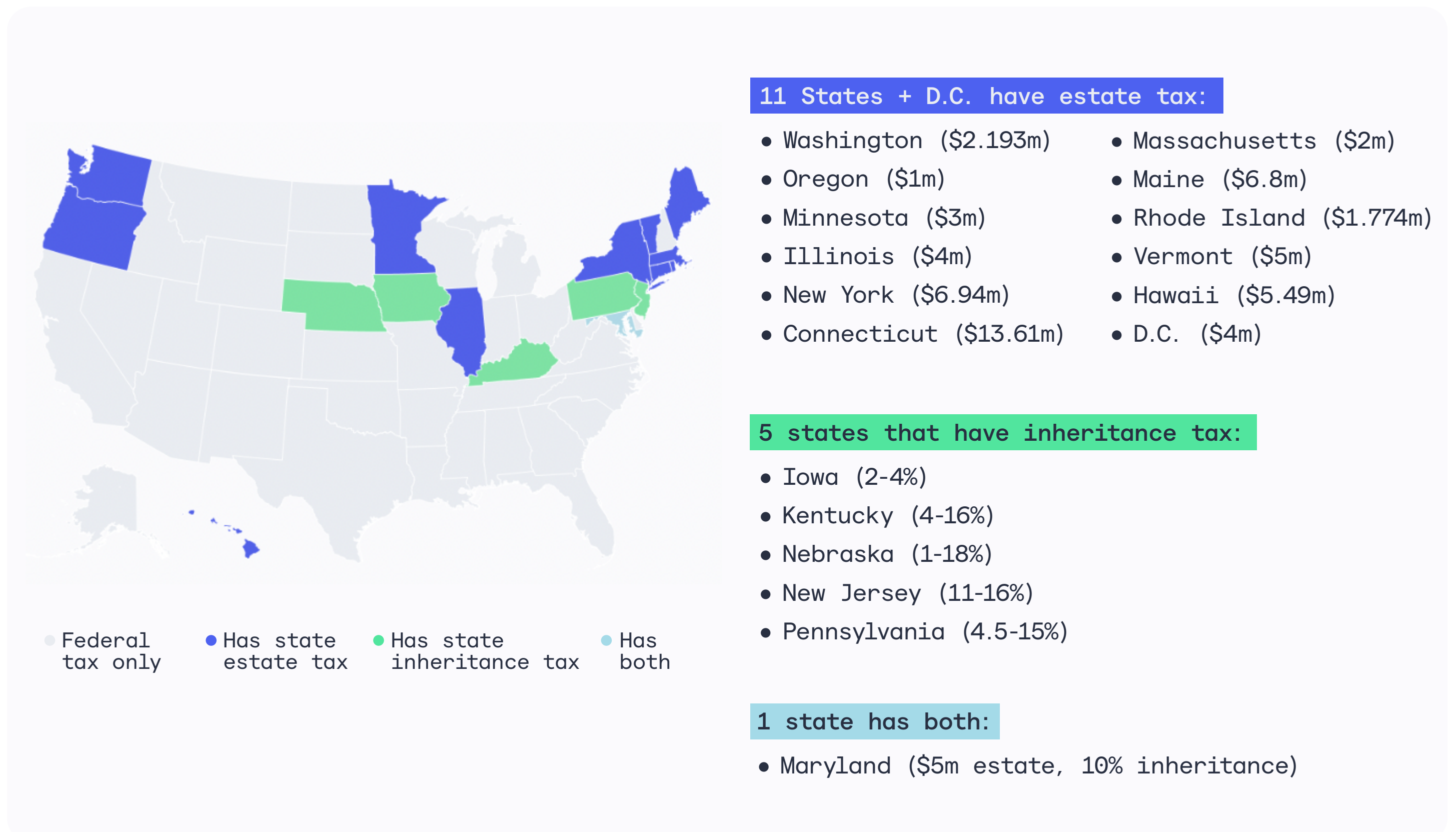
The first spouse dies and leaves half of the IRA to the surviving spouse and half to the children. The children have 10 years to withdraw their portions of that first half. When the second spouse dies and leaves the remainder of the estate to the children, they get a new 10-year period to withdraw anything left by the surviving spouse. This strategy gives the children more time to draw out the income tax exposure and could meaningfully reduce their tax burden.

⑥ State Estate Taxes

Considerations and Exemptions

While the federal estate tax exemption threshold is $13.61 million in 2024, twelve states and Washington D.C. have lower thresholds. This means that estates that are non-taxable federally may still be taxable at the state level.

Some clients in these states need to balance optimization for state estate tax savings or income tax savings.



⑦ 3 Key Takeaways When Planning for Non-Taxable Estates

① IRA-heavy estates need proactive planning

The classic advice of using spousal rollover as long as possible can actually have a negative impact because of the SECURE Act.

② Plan for the right tax

Non-taxable estates need to balance between state estate taxes, inheritance taxes, income taxes, etc. It's important for an advisor to understand the client's goals and plans, run the numbers, and optimize which taxes to plan for.

③ Know your basis rules

Transferred basis versus date of death basis can make a huge difference. Make sure to take advantage of free basis step ups to get those adjustments as often as possible, maximizing basis and reducing capital gains taxes for beneficiaries.