NEW MEXICO ESTATE PLANNING AND TRANSFER TAXES

SOME BASIC CONSIDERATIONS

COMMUNITY LEGACY CONFERENCE

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After working several years in a large and a mid-size law firm, Alan D. Gluth opened Gluth Law, LLC on January 1, 2010. Mr. Gluth received his law degree from The University of Texas at Austin in 1998. His practice principally involves estate planning, gift and estate taxation, probate and trust matters, and tax-exempt organization matters in Southern New Mexico and West Texas.

Professional Data

Mr. Gluth was designated as a certified specialist in estate planning, trusts, and probate law by the New Mexico Board of Legal Specialization of the State Bar of New Mexico for several years until the board certification program ended at the end of 2019. Mr. Gluth is also board certified in estate planning and probate law by the Texas Board of Legal Specialization of the State Bar of Texas. Mr. Gluth was selected to the 2012, 2013, 2014, 2015, 2016, 2017, 2022 and 2023 "Super Lawyers" list for the State of New Mexico and Texas. Mr. Gluth has also been selected by his peers for inclusion in *Best Lawyers in America* every year since 2012 in the area of Trusts and Estates.

Civic and Personal Data

Mr. Gluth is married to JoAnn and they have four sons: Collin, Braden, Preston, and Peyton. Mr. Gluth and his family reside in La Union, New Mexico and volunteer for various youth charitable organizations in the El Paso/Las Cruces area. In his spare time, Mr. Gluth enjoys hiking and camping in the Gila wilderness and coaching youth baseball.

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1. Property Ownership in New Mexico

New Mexico is a community property state. In New Mexico, most lifelong residents of the state own most of their property as "community property". Community property consists of all property acquired during marriage that is not "separate property". Community property is owned equally by husband and wife.

Separate property consists of:

A. Property owned or claimed by the spouse before marriage and the proceeds of such property. Further, the income, profits and rents from separate property are classified as separate property.

B. Property acquired during the marriage by gift, will or inheritance.

C. Amounts recovered for personal injuries (disfigurement, pain and suffering) suffered by a spouse (but not tort recovery for medical expenses or loss of earning capacity, which is community property).

Because the origin of property determines its character as either "separate" or "community", it is most important to keep a record from the beginning of when and where property is acquired during marriage. Generally, the law of the state where one resides at the time title is acquired will control the nature of the ownership of each asset. The character of property follows people as they move from state to state. Forty-one of the fifty states do not follow the "community property" system in effect in New Mexico.

In New Mexico, a husband's will may dispose of only his one-half of the community property and any separate property that he might own. The same is true of the wife. Neither can dispose of the other's community property or separate property.

Income derived from separate property is separate property and income from community property is community property, unless the spouses have agreed otherwise in writing. Spouses in New Mexico may by written agreement change the classification of their property interests, which is referred to as a transmutation.

In New Mexico there is a presumption that all assets on hand whenever the issue is raised (i.e. upon divorce, upon the death of one of the spouses, etc.) are community property. The community presumption is especially strong in cases where there has been commingling of separate and community property, as in a bank account. It is thus possible that if adequate records are not kept, separate property may lose its identity as such.

Under certain circumstances, New Mexicans can avoid probate by owning their property as joint tenants with right of survivorship, which under the law means that 100% ownership in the property vests automatically in the survivor, regardless of any will, upon the death of the first joint tenant. Unfortunately, even in very small estates, this may "backfire" on both the decedent and the survivor, because the survivor's interest in the property may not receive the automatic "step up" in income tax basis upon the death of the first joint tenant,

thereby increasing the income tax that may be payable if the survivor sells former joint tenancy property.

2. **Importance of Having a Will.** It is important to have a will even if you do not have a substantial estate. Here's why:

A. So that your assets will pass to those you wish to have them. When a resident of New Mexico dies intestate (without a will), New Mexico law determines how his or her estate will pass; for example, if one dying intestate is survived by a spouse and children, his or her assets will pass as follows:

(1) The decedent's share of the community property passes to the surviving spouse.

(2) One-fourth of all of the decedent's separate property passes to the surviving spouse.

(3) Three-fourths of the decedent's separate property passes to the children.

New Mexico law also provides how the assets will pass if there are no surviving children and/or surviving spouse. It is complicated, and different than most people expect.

B. To avoid Court supervision of the administration of the estate. New Mexico has simplified the procedure involved in administering estates. Using the appropriate language in a will can result in what is known in New Mexico as "unsupervised administration", which means that the chosen personal representative can handle all of the affairs of the estate after death essentially free of court interference. Absent such a provision in a valid will, third parties can more easily cause a court to supervise the administration of the estate, which causes the expenditure of additional time and money.

C. To appoint a personal representative of your estate. Without a will that specifies who is to serve as the personal representative in the administration of the estate, the court will appoint an administrator for the estate from the following persons in the following order:

(1) The surviving spouse.

(2) The heirs of the decedent.

(3) Any other person who is "qualified."

D. To appoint the guardian of each of your surviving minor children in the event that there is no surviving spouse. If a guardian is not named in a will, the court will appoint a guardian.

E. **To avoid costly court-supervised formal conservatorship proceedings in the event minor children are to receive a part of your estate.** Appropriate simple trust provisions in a will are all that is necessary to avoid this problem.

F. **For estate planning purposes.**

3. **The Transfer Tax Structure and Rates.** When an individual dies, all of the property he or she owns at death, such as bank deposits, stock, bonds, real estate (including the house) and personal property such as the car, furniture, clothing and jewelry, and the proceeds of insurance policies on the decedent's life which he or she owned at death, must be valued at their fair market value on the date of death in order to determine if the estate is subject to the Federal Estate Tax (there currently is not a New Mexico Estate Tax). All of the decedent's separate property as well as his or her share of the community property is subject to the tax.

A. **The Federal Estate Tax.** The Federal Estate Tax is presently a tax based on the ownership of property at death. The examples in the chart included on Page 10 of these materials illustrate the currently effective tax rates. Refer to the chart to understand the following discussion:

The Federal Estate Tax Gross Estate is comprised of all property owned at death (Column a). Deductions are allowed for funeral expenses, expenses of administering the estate, including attorney's fees and probate court costs, and debts of the decedent including mortgages and liens; the marital deduction discussed below is also an allowable deduction. Although $50,000 is used as the allowable deduction throughout the examples on the attached chart, the actual amount of deductions will, of course, vary from estate to estate (Column b). The Gross Estate less Allowable Deductions equals the Taxable Estate (Column c). The Federal Estate Tax Rate (40%) is then applied to the Taxable Estate to obtain the "Tentative" Estate Tax (Column d). The Unified Credit Against the Estate Tax ($5,113,800 in 2023) (Column e) and the Deduction for State Death Taxes (Column f) are each then subtracted from the Tentative Tax to obtain the Federal Estate Tax due (Column g). The total amount of death taxes owed (both state and federal) are also shown (Column h). Although there are exceptions, the Federal Estate Tax is generally due and payable nine months after the date of death.

For decedents dying in 2023, approximately $12,920,000 worth of property may pass free of the Federal Estate Tax.

B. **The New Mexico Estate Tax.** The New Mexico Estate Tax is currently no longer in effect, but it may be reinstated in the future.

4. **Transfer Tax Savings Techniques.** Several techniques are available to persons fortunate enough to have taxable estates in order to help them reduce their transfer taxes. Some of the most common techniques are as follows:

A. <u>Unlimited Marital Deduction Bequest</u>. Prior to 1982, a spouse could make a "qualifying" gift or bequest to the other spouse which would qualify for the marital deduction, but the marital deduction allowed to estates in community property states like New Mexico was very limited. The 1981 Economic Recovery Tax Act removed this limitation. Since 1981, whatever property a person transfers to his or her spouse in a qualifying manner by lifetime gift or bequest at death is not subject to gift or estate taxes. Consequently, now there is no estate tax in the estate of the first spouse to die on property that passes to a surviving spouse in a manner qualifying for the unlimited marital deduction.

Qualifying marital deduction bequests include: (i) simple outright gifts; (ii) qualified terminable interest property ("QTIP") trust gifts; and (iii) various other types of gifts in trust for the surviving spouse. QTIP and other trust form marital deduction gifts allow the first spouse to die to specify where his or her trust assets will go after the death of the surviving spouse, and, if properly drafted, can provide protection for the surviving spouse against claims made by creditors against the trust assets.

Note that in many cases it is not advisable from a transfer tax standpoint to leave <u>everything</u> outright to the surviving spouse. For example, the amount (presently $12,920,000) that would pass tax-free anyway because of the Unified Credit against the estate tax (the "credit-shelter amount" or "exemption equivalent"), if bequeathed outright to the surviving spouse, might be taxed unnecessarily in the estate of the second-to-die, or surviving spouse if a certain spousal election is not made on an estate tax return for the deceased spouse (discussed below).

B. <u>Credit Shelter Bypass Trust</u>. An individual may leave part or all of his or her estate in trust so that his or her surviving spouse receives all of the income of the trust and so much of the principal as is needed for the care, maintenance and support of the surviving spouse. A common technique is to fund such a trust with the "applicable exclusion amount" or "exemption equivalent", currently $12,920,000, from the estate of the first spouse to die. Upon the death of the surviving spouse, the trust assets may then be divided among the children, or otherwise. The surviving spouse may serve as the trustee of the trust. Although the surviving spouse may have, in effect, the full use of the trust assets during his or her lifetime, these assets are <u>not</u> included in the gross estate of the surviving spouse upon his or her subsequent death. These assets thus "bypass" transfer taxes in the estate of the surviving spouse. If the credit shelter bypass trust can be <u>fully</u> funded with $12,920,000, approximately $5,113,800 of transfer taxes can be lawfully avoided in the estate of the surviving spouse. Moreover, any appreciation of the assets placed in the credit shelter bypass trust which occurs between the first and second deaths also escapes transfer taxes in both estates. There are other provisions that may be included in a credit shelter bypass trust which make it an extremely flexible technique that takes into account the needs of the surviving spouse and the problem of not having all of the facts regarding the needs of various children and other beneficiaries at the time a will is made.

C. <u>Portability of Applicable Exclusion Amount</u>. On December 17, 2010, the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 was signed into law. Under this Act, any or all of the $12.92 million applicable exclusion amount not

used by the estate of a deceased spouse may now be transferred to a surviving spouse by making an election on a timely filed estate tax return. This rule only applies for decedents dying after December 31, 2010. This carryover is referred to as the "deceased spousal unused exclusion amount" and is more commonly referred to as "portability." When the first spouse dies, the surviving spouse will be required to weigh the benefit of filing an estate tax return for his or her deceased spouse's estate in order to transfer his or her unused applicable exclusion amount to himself or herself versus the cost to prepare and file such a return. If it is unlikely that the total combined net value of all marital assets will exceed $12.92 million, then making the "portability" election on an estate tax return will likely not be worth the cost. These "portability" rules were made permanent by the American Taxpayer Relief Act of 2012.

D. **Lifetime Gift Giving.** One of the best techniques for reducing transfer taxes and for accomplishing personal and charitable goals is to begin a regular program of lifetime gifts to family members and/or favorite charities.

Individuals can give away up to $17,000 per donee per year free of any gift tax consequences (more to qualified charities). The Federal Gift Tax is imposed at the same rates as the Federal Estate Tax, subject to the same exemption equivalent, plus the $17,000 per year per donee Gift Tax "annual exclusion." Spouses together can give up to $34,000 per donee per year. Moreover, you can pay college tuition and pay the medical expenses of anyone in any amount without incurring gift tax liability. Note that assets to be given away during one's lifetime should be carefully selected. Note also that in making gifts of money, securities, life insurance policies, etc., to minors, one should consider the use of trusts, custodial gifts under the New Mexico Uniform Transfers to Minors Act, and, in some cases, other, more aggressive estate reduction techniques.

E. **Irrevocable Life Insurance Trusts.** If properly drafted, these trusts can remove life insurance proceeds (which are usually taxed in the estate of the insured) from the gross estate of the insured, thereby avoiding transfer taxation. The insured usually makes annual gifts of cash to the trustee for payment of the insurance premiums. These trusts can be (and usually are) drafted to include "Crummey" withdrawal powers. These powers qualify the annual cash premium gifts for the $17,000 Gift Tax annual exclusion. For many younger taxpayers with young children, life insurance proceeds constitute the bulk of their taxable estate, and actually may be the very asset that makes their estate taxable. The insured must generally live for three years after creating the irrevocable life insurance trust in order to avoid having the life insurance proceeds brought back into his/her taxable estate at death, although this "three-year rule" may be avoided if the trustee applies for and purchases the insurance policy.

5. **Ancillary Considerations.** There are several other considerations that are basic to any estate plan, aside from transfer tax savings, including the following:

A. **Liquidity.** Liquidity provides the funds to pay any transfer taxes, debts, funeral expenses, administration expenses, and support for the family during the period of the administration of the estate. The most common sources of liquidity are life insurance

proceeds, marketable securities, and cash savings. Individuals whose livelihood is derived from closely-held business interests are often on the short end when it comes to estate liquidity. If transfer taxes are owed, and if certain conditions are met, the payment of transfer taxes can be deferred or spread out over a term of years. However, it is possible that the deferral rules may be eliminated in future tax reform proposals.

B. Valuation and Inflation. Because all estate taxes are payable on the estate as valued at the date of death, many people assume erroneously during inflationary times that their financial statements reflect their net worth for estate planning purposes. This is generally not true because most balance sheets disregard appreciation or inflation in the value of assets, do not reflect life insurance at face amounts and do not account for the assumed historical growth of the estate itself. In essence, even though a current financial statement may show that one is "worth" well under the applicable limitations for estate taxation, one may nevertheless need estate planning in the face of continued inflationary increases in the value of assets.

C. Expectancy of Inheritance. All estate plans should take into account the amounts of assets that might be inherited from predeceased relatives. Sudden and unexpected and unplanned-for inheritances could result in the overloading of assets in an estate in such a way that an estate plan might be inadequate to handle them.

D. Spousal Replacement. While most people probably feel that their spouse would be "irreplaceable", every estate plan should consider the cost of replacing the deceased spouse in terms of earning capacity, skills and services in child care, and the like. While most estate plans assume, on actuarial grounds, that a husband will be the first to die, this is not always the case. A well conceived estate plan should consider "replacement" of a deceased spouse.

E. Retirement Benefits. Most people probably participate in retirement, pension, profit sharing, employee stock options, Keogh, IRA, or other deferred compensation plans. President Trump signed the SECURE Act in December of 2019 as part of the government's spending bill and it will inevitably affect more retirement savers, for better or worse. The SECURE legislation – which stands for "Setting Every Community Up for Retirement Enhancement" – puts into place numerous provisions intended to strengthen retirement security across the country. The following are a few of the key changes in the law.

Previously, qualified account holders such as those with a 401(k) or IRA had to withdraw required minimum distributions (RMD) in the year they turned age 70.5. The SECURE Act 2.0 increases that age to 73, which may have tax implications, depending on where the account holders fall in their tax bracket in the year they withdraw. The bill also eliminates the maximum age for traditional IRA contributions, which was previously capped at 70.5 years old. The SECURE Act also requires beneficiaries withdraw all assets of an inherited account within 10 years. There are no required minimum distributions within those 10 years, but the entire balance must be distributed after the 10th year. This change can be problematic for some beneficiaries, especially if they are in their 40s and 50s and at the peak of their earning years. Limiting the time frame in which someone can distribute

money from an inherited account means potentially boosting the tax burden those distributions will cause. Tax advisors should review in detail all deferred compensation plans to be sure that the designated beneficiary, payout options, and other elective matters do not conflict with the overall estate plan.

F. <u>Choice of Personal Representative, Trustee and Guardian</u>. Most people tend to name their surviving spouse or best qualified child to act as their personal representative in the event of death. Often times this choice is perfectly natural and correct. However, the decision is an important one and, especially in the case of large estates, a loved one may not be qualified to handle the estate properly. The following factors should be considered in choosing an executor, trustee, or guardian:

(1) Whether or not the person chosen has expertise in managing money and handling assets.

(2) Whether or not the person chosen has time available to administer your estate.

(3) Ability of the person chosen to handle possible conflicts within the family.

(4) Whether or not the person chosen is likely to die shortly or become disabled.

We often recommend that a bank financial services division or other professional fiduciary be named as either a primary personal representative or at least as a contingent personal representative.

G. <u>Business Activities of Professionals</u>: Many professional and business people are associated with others like them in partnerships, professional corporations, and the like. In addition to their primary employment in their professions, many professionals tend to invest in other "side" business ventures during their lifetimes. Often, such side business ventures are conducted under written partnership or joint venture agreements or in the corporate form. The value and liquidity of such investments depend on how the partnership, joint venture, or corporation is structured. Upon death, it is most important that there be a workable and fair plan in effect that will permit both the estate of the deceased party and the surviving partners, joint venturers, etc., to arrive at a value for the deceased party's interest, to determine how it will be purchased, who has the right to compel a purchase or sale of the interest, and how the purchase or sale will be funded. In short, it is vital that these arrangements be thought out at the time the venture is commenced and placed in writing. Absent such prior agreement, often called a "Shareholders Agreement" or a "Buy-Sell Agreement", significant investment values may possibly be lost in the process of settling the estate of a deceased partner or joint venturer.

H. <u>Durable Powers of Attorney</u>. If an individual suffers an injury or a diminution of mental ability, he/she may be unable to manage his/her own affairs, may need medical or health care, and may need someone to manage his/her affairs and consent to such care. One way to get legal authority to so act for another is to obtain court appointment as guardian of the estate (assets) and/or physical person of the loved one who needs assistance.

Unfortunately, conservatorships are time consuming and expensive to create, and require continual court approval of all actions taken, resulting in lawyer involvement and more attorney fees. The initial cost can be as much as $2,000 to $5,000, plus $300 to $500 each year for preparation of the conservator's annual accounting. The annual conservator's bond premium must also be paid. Fortunately, there is a much more inexpensive and efficient alternative known as the Durable Power of Attorney. Many persons now execute such an instrument at the same time they execute their wills. With the right language, these Durable Powers of Attorney will survive (endure beyond, hence "durable") even the onset of a disability caused by injury, gradual senility, or even a disease like Alzheimers. The Attorney-in-Fact appointed by the Durable Power of Attorney can take all actions that a court-appointed guardian can take, and, in fact, may be given much broader powers. Husbands and wives usually name each other as Attorney-in-Fact. Such powers should not be executed if there are marital problems. The powers can be escrowed with someone other than the Attorney-in-Fact if the grantor fears abuse by the Attorney-in-Fact prior to the onset of a disability. The usual attorney fees for a Durable Power of Attorney run between $100 to $150 and New Mexico has a statutory form that may be used.

I. Living Wills—Advance Health Care Directives. New Mexicans are able to execute a document, which instructs doctors, nurses, hospital administrators, and family members to "pull the plug" if the person is suffering from a terminal illness or a life threatening condition and is being kept alive by artificial life-sustaining procedures. This document can be drafted to indicate your preference regarding making an anatomical gift. You can also designate a person who will make medical treatment decisions for you if you become incapacitated while suffering from a terminal illness or life threatening condition. The cost is usually $150-$200. Many people now sign this document at the same time they execute their Wills and Durable Powers of Attorney.

J. Pre-Designation of Guardian. New Mexicans with mental capacity have been able to sign a document designating a guardian and/or conservator if they become incapacitated. Even more attractive, at least to some clients, is the ability to designate who may not serve in such capacity. Such a designation is included in the Statutory Durable Power of Attorney form.

K. Revocable Living Management Trust. An increasing number of our clients, especially as they get on in years, are now considering the Revocable Living Management Trust, sometimes called simply a "living trust". It is an especially attractive device for single people. With this device, a person can transfer all or part of his or her assets into trust, naming himself or herself as trustee, then naming a friend, family member or perhaps ultimately a bank as alternate trustee. Such a trust will not alter its creator's lifestyle in any significant way, except that there will be additional bookkeeping. The trust can remain in existence until it is needed. While the creator is has capacity, all income can be distributed currently. The alternate trustee can take over when the creator becomes incapacitated. **Note**: This type of trust will not avoid gross estate inclusion of the trust assets to reduce or eliminate estate, inheritance and other death taxes.

This device has the advantage of being somewhat more acceptable to some stock and security transfer agents, etc., who may be reluctant to accept even a well drafted Durable Power of Attorney. The Revocable Living Management Trust is an ideal vehicle for persons who want to manage their own affairs now, but are concerned about and receptive to management by another in the event of incapacity. This device can also be used to avoid probate if 100% of a person's assets are transferred to the trust and if it contains testamentary or dispositive provisions. Such a trust will not, however, substitute or serve in place of a well drafted Will, which everyone should have even if most or all of their assets have been placed in a living trust.

L. Disclaimers. There are statutory provisions that permit one to disclaim the ownership of property that one would otherwise receive by gift, bequest or inheritance. Such a "disclaimer", if made in accordance with all the rules, is not considered a gift by the party making the disclaimer. Wills may be drafted in which devisees are given the right to disclaim in favor of someone else specified in the will. A disclaimer by the surviving spouse might be appropriate where the surviving spouse has sufficient assets of his or her own to get along without the need of the bequest from the decedent. Furthermore, it is advantageous to disclaim property when one already has a large estate, or when that property would be taxed at a higher rate in the disclaimant's estate than in someone else's, or when that property would go to persons whom one wishes to benefit and who would also be beneficiaries of one's own estate. The disclaimer device gives added flexibility in any estate plan.

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CHART ILLUSTRATING CURRENTLY EFFECTIVE
FEDERAL ESTATE TAX RATES

(a) Gross Estate	(b) Allowable Deductions	(c) Taxable Estate	(d) Tentative Tax	(e) Unified Credit Against Estate Tax	(f) Deduction for State Taxes (Texas Estate Tax Due)	(g) Federal Estate Tax Due	(h) Total Death Tax Due
10,050,000	50,000	10,000,000	3,945,800	5,113,800	0	0	0
15,050,000	50,000	15,000,000	5,945,800	5,113,800	0	832,000	832,000
20,050,000	50,000	20,000,000	7,945,800	5,113,800	0	2,832,000	2,832,000