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ESTATE PLANNING

“What happens to my money and assets after I die?” No matter what your age or income, you need to think about estate planning. If you don’t make plans, other people will after you die. Not only could your wishes be ignored or changed; the tax bill could be needlessly large.

Minimizing your tax bill takes planning, and recognition that as the tax law changes your plans need to as well. Do you want your assets to go to your loved ones and friends, or to the IRS or your state treasurer?

Understanding all of the estate tax consequences is not a do-it-yourself project. There are many exceptions, exceptions to exceptions, elections, allocation rules, etc. This guide will help you understand some of the complex rules. When you talk to a tax professional, he or she will help you plan a strategy to minimize your estate tax liability.

WHAT’S “EGTRRA” AND WHY IS IT IMPORTANT?

Estate planning was turned upside down in 2001 when Congress passed the *Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)*. Instead of permanently repealing the federal estate tax, Congress repealed it for just one year, 2010. It did this because permanent

repeal would cost the federal government billions of dollars.

FEDERAL ESTATE TAX

Technically, the federal estate tax is abolished for decedents dying after December 31, 2009 and before January 1, 2011. However, Congress is expected to revive the federal estate tax sometime in 2010 (patterned after the 2009 estate tax) and make the estate tax retroactive to January 1, 2010. In this booklet, we will examine the federal estate tax as it existed in 2009 and the new carryover basis at death rules for decedents dying after December 31, 2009 and before January 1, 2011. Just as the expectation is that the estate tax will be revived to 2009 levels, the expectation is that the new carryover basis rules will be retroactively repealed. Nevertheless, the carryover basis rules are discussed since, at this point in these uncertain times, estate planning requires consideration of all contingencies.

Caution. Many people think the federal estate tax is for the wealthy, and don't realize the full value of their estate, or home. They may have purchased their home 20 or 30 years ago and don't know how much it has appreciated in value. Your home, combined with your investments, savings, and life insurance could easily push your estate over the federal estate tax threshold. That's why planning today is so important. You have to minimize the big federal tax bite.

2009 DEATHS

For decedents dying before January 1, 2010, their estate is entitled to an exclusion that exempts a portion of the property from the federal estate tax. In 2009, the amount excluded was \$3.5 million. That means that an estate of \$3.5 million or less isn't taxed.

2010 DEATHS

For decedents dying on or after January 1, 2010 and on or before December 31, 2010, the federal estate tax is technically abolished (at least until Congress may act to revive it). In its place are carryover basis at death rules. The income tax basis of property acquired from a decedent's estate generally must be carried over from the decedent.

BASIS

Stepped-up basis. The traditional federal estate tax uses "stepped-up basis" to value property. If your children or heirs

sell the property you leave them, their basis in the property is stepped-up to the value of the property as of the date of your death. Stepped-up basis is very valuable because your heirs escape tax on the appreciated value of the property.

Example. In 1992, you bought stock worth \$10,000. In your will, you leave the stock to your daughter. At the time of your death, the stock is worth \$30,000. Under the stepped-up basis rules, your daughter can immediately sell the stock and not recognize any taxable gain because her basis in the stock "steps-up" to \$30,000 from your \$10,000 basis.

Carryover basis. For decedents dying after December 31, 2009 and before January 1, 2011, stepped-up basis is replaced with carryover basis.

Example. In 1995, you buy stock worth \$50,000. You die in 2010 and leave the stock to your daughter. Its value on the day you die is \$125,000. Under the carryover basis rules, if your daughter sells the stock, she might pay tax on all the gain since 1995. That's \$75,000 in capital gains.

Executors are allowed to partially increase the basis of property by up to \$1.3 million (\$3 million in the case of property passing to a surviving spouse); further appreciation will be subject to tax when the asset is sold.

Caution. Under the stepped-up basis rules, an owner's poor recordkeeping and/or general ignorance of an asset's basis could be "cured" at the owner's death since the asset's basis would be stepped up to its date of death value. This treatment is not available under the carryover basis rules. One of the most important things you can do today is to keep accurate records of the value of your property. If you don't, the IRS will make its own determination of value and your heirs could end up paying more in taxes.

SPOUSAL DEDUCTION

Under the traditional stepped-up basis at death rules, the spousal deduction for federal estate taxes was one of the most generous in the tax law. It was unlimited. Everything you left to your spouse was tax-free.

Under the current law, the spousal deduction is no longer available. Because of the change to carryover basis, the marital deduction is \$3 million plus the \$1.3 million exclusion available to everyone.

Caution. Many wills have standard language that children and other beneficiaries will receive an amount equal to the estate tax exclusion. The rest of the estate passes to the surviving spouse and isn't taxed because the marital deduction is unlimited. If you have one of these standard clauses, you should take another look at it because of the increase in the estate tax exclusion. Your automatic exclusion could give your heirs more than you intended and give your spouse less.



GIFTS

Gifts are often overlooked as estate planning tools but they have some important tax advantages. You can significantly reduce your taxable estate by making gifts. Moreover, many gifts can be made tax-free.

Comment. Repeal of the federal estate tax for 2010 did not affect the federal gift tax. The gift tax is retained for 2010. For gifts made after December 31, 2009, the gift tax will be computed using a rate schedule having a top marginal rate of 35 percent and a maximum applicable exclusion amount of \$1 million. An annual per-donee gift tax exclusion also continues to apply.

Here are some advantages of gift-giving:

- Shift income to a child or relative in a lower tax bracket;
- Shift future appreciation permanently out of your income and estate tax situation;
- Help family and friends financially;

- Encourage children to take over a family business by giving them interests in the business; and
- Help a church, school, or charity before you die.

When you make a gift, the recipient takes your tax basis in the property. For non-business property, this generally means what you paid for it.

If the recipient sells the property, any gain on the sale will be measured using what you paid for the property, not what the property was worth when he or she received it.

Annual gift tax exclusion. For 2010, you can make tax-free gifts of up to \$13,000. This exclusion is available every year (although the amount generally changes). The IRS doesn't care how many people you make gifts to but if your gift is more than \$13,000 to one person, the IRS wants to know.

Gift splitting. You and your spouse can make separate gifts totaling \$26,000 in 2010 to the same person. That's \$13,000 from you and \$13,000 from your spouse.

Example. You and your husband have four children. You can make a total of \$102,000 in tax-free gifts this year by each of you giving \$13,000 to each of your children.

If you or your spouse makes a gift to a third party, the gift can be considered as

made one-half by you and one-half by your spouse. This is known as gift splitting. Both spouses must agree to split the gift.

Example. Anne Marie and her husband Andrew agree to split the gifts that they made during 2010. Anne Marie gives her nephew, Justin \$21,000 and Andrew gives her niece Rose, \$18,000. Although each gift is more than the annual exclusion (\$13,000 for 2010), by gift splitting they can make these gifts without making a taxable gift. Anne Marie's gift to Justin is treated as one-half (\$10,500) from Anne Marie and one-half (\$10,500) from Andrew. Andrew's gift to Rose is also treated as one-half (\$9,000) from Andrew and one-half (\$9,000) from Anne Marie. In each case, because one-half of the split gift is not more than the annual exclusion, it is not a taxable gift.

Educational and medical expenses. Gifts used for tuition and medical expenses are tax-free regardless of the amount. They are separate from the annual gift tax exclusion of \$13,000 for 2010. The payments must be made directly to the provider of the medical services or the educational institution to be tax-free.

Federal gift tax. What happens if your gift is more than \$13,000? That's when the federal gift tax can kick-in. You will need to file Form 709 with the IRS and report your gift(s).

Lifetime gift tax exclusion. In addition to the annual gift tax exclusion of \$13,000, you get a lifetime gift tax exclusion of \$1 million. Under current law, the \$1 million exclusion is permanent. Additionally, lifetime transfers between spouses are free from gift tax.

If used properly, gifts can benefit everyone involved. To do so, you must take the time to structure your gifts to minimize the tax consequences.

STATE DEATH TAXES

Many states impose an estate tax that is equal to the maximum state tax credit that your estate can claim under federal tax law. These are called “soak-up” or “pick-up” taxes.

EGTRRA abolished the state death tax credit. In its place, you get a deduction for state death taxes paid. The difference is very important to your estate planning and your heirs.

The change from a credit to a deduction isn't very taxpayer-friendly. A credit is subtracted from the tax itself, resulting in a dollar-for-dollar reduction in your tax liability. A deduction is subtracted from your gross estate, resulting in a reduction in the amount of property subject to tax.

ESTATE PLANNING TECHNIQUES

Let's take a look at some popular estate planning techniques that could lower your estate tax bill.

GRATs. A grantor retained annuity trust (GRAT) is a trust that pays you an annuity for a fixed number of years and the remaining assets go to your beneficiaries. The remainder is considered a gift that is made when the trust is created and consists of the amount you contribute to the trust less the value of the annuity payments. Assuming your investments are profitable, the remainder will grow. Because the gift was made when the trust was set up, no gift tax is imposed when the remainder passes to your beneficiaries. The rules for GRATs are very complex and the IRS monitors for abuses.

Defective grantor trusts. You may want to set up a trust while at the same time taking advantage of individual tax rates, which generally are lower than the tax rates for trusts. One way to do this is to deliberately create a trust that is valid under state law but fails the federal tax test for trusts. This causes the income from the trust to be taxed to you. Again, these arrangements are complex. The IRS will deny the claimed tax benefits if it discovers abuses.

Personal residence trusts. One type of grantor retained annuity trust is a qualified personal residence trust (QPRT). Setting up a QPRT is complex and must be done correctly if you are to maximize the tax benefits. While you are alive, you continue to reside in your home, but your residence is placed in a trust. Many people make their children the beneficiaries of the trust.

Family limited partnerships. People use family limited partnerships to maximize a person's annual and lifetime exemptions and because special discount rules can be very valuable. Many times they are used to pass a family business or farm to children.

Caution. The IRS is very concerned about abuse of family limited partnerships and the IRS looks at them very carefully. Some courts also take a tough line. A poorly constructed family limited partnership can be worse than none at all.

Qualified terminal interest property trusts. This type of trust, called QTIP for short, is used when you want to transfer annuities or life estates to a spouse and still get the unlimited spousal deduction. It may be used in conjunction with some of the other types of trusts already discussed.

Gift-loans. To avoid the federal gift tax, you can make a gift up to the annual exclusion amount (\$13,000 for 2010) and

give more in the form of a loan. This strategy relies on the assumption that the estate tax will be permanently repealed. The loan would presumably be forgiven on your death.

Caution. One danger is that the IRS could determine that the entire transfer was a gift and the loan was a sham. You have to carefully follow all of the rules to show it is a legitimate loan.

Crummey trusts. People set up Crummey trusts to transfer assets to their children. A Crummey trust – named for the person who first used one – gives the child the minimum access to the assets required by law for the IRS to treat the transfer as a completed gift. Your goal is to keep the assets in the trust until you want your son or daughter to have them.

LIFE INSURANCE

Life insurance is one of the most common estate planning tools. If your beneficiary is your spouse, the proceeds generally go to him or her tax-free.

Another important purpose of life insurance is to provide liquidity to your estate. Your executor can use the proceeds to pay for burial and other costs as well as the estate tax on assets that your family won't want to sell.

The tax consequences get more complicated when the proceeds go to your estate. One way to avoid taxation is to use a life insurance trust.

Life insurance proceeds are subject to estate tax unless they go to your spouse. Proceeds may be taxed if the insured owned the policy at death or had transferred it within three years of death. Even if the policy was transferred to another, the insured is still considered to own the policy if he or she can:

- Change the policy;
- Borrow against the policy;
- Surrender the policy for its cash value; or
- Pledge the policy for a loan.

Many people use life insurance to pay estate taxes. This way, the bulk of the estate stays intact and isn't lost to taxes. Life insurance can also take some of the pain out of carryover basis.

Life insurance trusts. If a life insurance policy and all policy rights are transferred to a trust and the former owner survives three years, the proceeds can escape estate

tax. You can have the trust managed professionally, protecting beneficiaries.

Life insurance trusts can be funded or unfunded. If the trust is funded, you have to transfer cash or other property to pay the premiums on the policy. If it is unfunded, you or someone else has to make periodic contributions to it so the premiums are paid.

Caution. Life insurance trusts have been abused and some lawmakers in Congress have proposed legislation banning or severely restricting them.

GENERATION SKIPPING TRANSFER TAX

The generation skipping transfer tax (GSTT) is a tax on the transfer of property to a person who is more than one generation younger than you (for example, your grandson). It was created to close a loophole that allowed very wealthy families to avoid estate tax.

Some terminology. The GSTT applies to three types of transfers:

- Direct skips;
- Taxable terminations of GSTT property; and
- Taxable distributions of GSTT property.

If your assets are large enough that GSTT could be a problem, your professional tax advisor can walk you through each of these types of transfers. The GSTT is very complicated and requires careful long-range planning to minimize tax consequences.

CHARITABLE GIVING

Charitable giving is an important part of estate planning. The tax breaks and the various methods of charitable giving combine to give you a variety of options. More recently, deferred charitable gifts have developed as an estate planning tool. They allow you to keep an economic benefit from the gift and get special tax treatment.

Qualified gifts. Your donations must be given to “qualified” charitable organizations. You can deduct your gifts to religious, charitable, scientific, educational and other groups that are incorporated as 501(c)(3) organizations. Gifts to the federal government, state government, and some local governmental bodies also are deductible. If you have any questions about the deductibility of your gift, ask your tax advisor.

Types of gifts. Charitable gifts can be outright gifts of cash or they can take other forms, such as:

- **Bequests:** In your will, you bequeath a gift to your favorite charity and your estate gets a charitable deduction.
- **Life insurance:** You name a charity as the beneficiary of your life insurance and when you die, the proceeds go to the charity. You can also make a charity the owner of a life insurance policy on you.
- **Stocks and other investments:** You can transfer ownership of stocks, bonds, mutual funds, and other investments to your favorite charity. You can make a contribution of appreciated stock to a qualified charity and deduct the fair market value of stock without recognizing income on the appreciation, provided that any gain would have been long-term capital gain.
- **Annuities:** Many charities have gift-annuity programs you can invest in. You get the investment income from your gift during your lifetime.



- **Trusts:** Charitable remainder trusts are one type of trust you can set-up during your lifetime. You get the investment income and after you die, the charity gets the assets of the trust.
- **Private foundations:** People who want to make very large gifts often create their own private foundations.
- **Cars, trucks, boats:** Some charities welcome donations of cars, trucks and boats. The IRS has very strict rules for donations of cars and trucks. Your deduction, if \$500 or more, is limited to the price that the charity ends up selling your car, truck or boat for (generally, a low wholesale value). If the charity uses the vehicle, however, you're entitled to deduct full market value. It is crucial to obtain written confirmation from the charity for the vehicle to claim the deduction.

IRA charitable rollover. In 2009, individuals age 70 1/2 and older were able to distribute up to \$100,000 from their IRAs tax-free to charitable organizations. The distribution is not reported as income to the taxpayer. Distributions may be from a traditional or a Roth IRA. This special treatment tax treatment for IRA distributions to charitable

organizations may be extended by Congress for 2010.

These are just a few of the many methods you can use to make gifts. Before you make a gift to your favorite charity, ask your tax advisor how you can maximize the tax savings from your gift. If the gift is taxable, you and not the recipient are liable for the tax.

Caution. Charitable giving scams are very prevalent, especially on the Internet. Many scams use names similar to legitimate charities or say they are working on behalf of a genuine charity. One of the most common scams involves vehicle donation.

CONCLUSION

The federal estate tax rules, as you've learned, are very complex and almost always interact with each other. Estate tax planning is made more complicated in 2010 because of the repeal of stepped-up basis and its replacement with carryover basis. It is likely that Congress will, in turn, repeal carryover basis and revise the federal estate tax with stepped-up basis. But, as of the date of posting of this booklet, Congress has not acted. Please contact our office if you have any questions. We'll be glad to start mapping out an estate plan.