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Estate Planning

GAINER DONNELLY & DESROCHES

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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. You could lose up to 50 percent of your estate to taxes if you don’t plan correctly.

Minimizing the tax bill takes planning and recognizing that you need to change your plans as the tax law changes. Uncle Sam has a lot of ways of taxing your assets after you die. There’s the federal estate tax, gift tax, generation skipping transfer tax, taxes on trusts, and so on. On top of that, many states have a death tax. 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, you will plan a strategy to minimize your estate tax liability.

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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). During the 2000 Presidential election campaign, repeal of the federal estate tax was a hot issue. Candidate George Bush promised to work for its repeal and one of the first things he did after his election was to call on Congress to get rid of the federal estate tax. Congress did...but not permanently and not immediately.

Instead of permanently repealing the federal estate tax, Congress repealed it for just one year, 2010.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.

Over its final five years before 2010, EGTRRA makes some very taxpayer-friendly changes. Fewer people will be hit by the federal estate tax, especially small businesses and family farms.

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The rules are confusing because they change every year between now and 2010. Then, after 2010, the old rules come back, which makes estate planning even more of a challenge. Of course, between now and 2011, Congress could change the law and permanently repeal the estate tax.

Prediction. Before September 11th, 2001, permanent repeal of the estate tax was very popular on Capitol Hill. Today, permanent repeal has fewer supporters and the reason is the war on terrorism. The war is costly and traditionally during times of war, Congress raises the federal estate tax. The ultimate fate of the estate tax may depend on how long the war on terrorism lasts.

Your estate planning strategies now, more than ever, depend on your age and health.

- If you are young and in good health, your strategy could be based on the expectation that Congress will permanently abolish the estate tax...but not losing sight of the possibility that you could die earlier.
- If you're older or your health is more precarious, you might expect that your estate will be subject to estate tax.

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Federal estate tax

Your taxable estate is the value of your gross estate minus deductions, exclusions, and credits. How much you owe depends on the size of your estate.

Because of the unified credit, taxable estates of no more than \$1 million before application of that credit generally owe no estate tax.

Caution. Many people think the federal estate tax is only for the wealthy. They don't realize the full value of their estate, especially the value of their home. They may have purchased their home 20 or 30 years ago and don't know how much it has appreciated in value. In some parts of the country, housing prices are at least double what they were 10 years ago. 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.

Before EGTRRA, federal estate tax rates ranged from 18 to 55 percent. The new law gradually reduces the top rate; it will continue to do so through 2009. In 2010, the estate tax is repealed, but remember, just for one year.

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Here's a look at how the top tax rate drops:

| Year | Rate |
|------|------|
| 2005 | 47% |
| 2006 | 46% |
| 2007 | 45% |
| 2008 | 45% |
| 2009 | 45% |
| 2010 | Zero |

Because EGTRRA is only temporary, the old rate of 55 percent comes back when EGTRRA expires on December 31, 2010.

Caution. Only the top rate drops. The lower rates of 18 to 43 percent don't change at all. If your estate isn't large enough for the drop in the top rate, you won't see *any* change.

Federal estate tax exclusion

Your estate is entitled to an exclusion that exempts a portion of your property from the federal estate tax. In 2005, for example, the amount excluded was \$1.5 million. That means that an estate of \$1.5 million or less wasn't taxed. In 2006, the exclusion is \$2 million. The exclusion grows to \$3.5 million by 2009. (In technical terms, this exclusion is referred to as the "unified credit.")

That's good news in the short-term. However, because estate tax reform is only temporary, the exclusion is scheduled to fall back to \$1 million in 2011. Inflation is going to erode the value of that \$1 million exclusion, so it will be worth a lot less. Of course, Congress may well tinker with these numbers before 2011 rolls around.

Here's a chart showing the exclusion amounts today through 2010:

| Year | Exclusion |
|------|---------------|
| 2005 | \$1.5 million |
| 2006 | \$2.0 million |
| 2007 | \$2.0 million |
| 2008 | \$2.0 million |
| 2009 | \$3.5 million |
| 2010 | Zero |
| 2011 | \$1.0 million |

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 don't pay 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. 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. In 2010, stepped-up basis won’t be as valuable if your estate is worth more than \$1.3 million. Anything over that amount will be taxed using “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. If your daughter sells the stock, she might pay tax on all the gain since 1995. That’s \$75,000 in capital gains.

Don’t let the IRS decide which of your beneficiaries uses stepped-up basis and who gets to carry over basis. You can specify in your will which of your assets will benefit from this valuable tax exception.

Caution. 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.

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Planning tip. Instead of leaving everything to your spouse, you might consider setting-up a marital deduction trust and a nonmarital trust. The nonmarital trust gives your spouse the income he or she needs during life but because your spouse lacks control over the trust, the assets are not included in his or her estate at death. The marital deduction trust gives your spouse the bulk of the funds he or she needs during life.

Spousal deduction

The spousal deduction for federal estate taxes is one of the most generous in the tax law. It’s unlimited. Everything you leave your spouse is tax-free...at least until 2010.

Like the estate tax exclusion, the spousal deduction disappears in 2010. That year, because of the change to carryover basis, the marital deduction is \$3 million plus the \$1.3 million exclusion available to everyone. The unlimited spousal deduction returns in 2011.

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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.

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. You can make tax-free gifts of up to \$12,000. This exclusion is available every year. The IRS doesn't care how many people you make gifts to but if your gift is more than \$12,000 to one person, the IRS wants to know.

Married couples get a double benefit. You and your spouse can make separate gifts totaling \$24,000 to the same person. That's \$12,000 from you and \$12,000 from your spouse.

Example. You and your husband have four children. You can make a total of \$96,000 in tax-free gifts this year by each of you giving \$12,000 to each of your children. Alternatively, one spouse may give \$24,000 to each child and then file a "split-gift" return with the other spouse.

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 \$12,000. 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 \$12,000. That's when the federal gift tax can kick-in. The federal gift tax rates track the federal estate tax rates.

In 2005, the top federal gift tax rate was 47 percent. In 2006, the top federal gift rate falls to 46 percent. EGTRRA gradually reduces the top rate between 2002 and 2009. By 2010, the top rate will drop to 35 percent. Because EGTRRA is temporary, the old top rate of 55 percent returns in 2011.

The top rate after 2009 will apply to gifts over \$500,000. Lower rates of between 18 and 34 percent will apply to gifts below \$500,000.

Lifetime gift tax exclusion. In addition to the annual gift tax exclusion of \$12,000, you get a lifetime gift tax exclusion of \$1 million. Unlike the other changes in EGTRRA, the \$1 million exclusion is permanent and doesn't expire after 2010.

Caution. The federal estate tax exclusion is reduced by the portion of the gift tax exclusion you use during your life. For example, if you die in 2005 and you had already taken full advantage of the \$1 million gift tax exclusion, your federal estate tax exclusion would be \$500,000 instead of \$1.5 million.

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 abolishes 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.

Repeal was gradual, but is now in full force. The credit was reduced 50 percent in 2003, and 75 percent in 2004 and it ended completely in 2005.

Prediction. Elimination of the state death tax credit shifts the cost of repeal of the federal estate tax to the states. Some states will be very hard hit (for example, New York, Pennsylvania, New Jersey, and Florida). If you live in a state that

imposed only a “pick-up” tax, pay attention to what your state legislature is doing. It could impose a new state death tax to make up for the loss of revenue from the old “pick-up” 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.

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.

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. Because your gift isn’t immediate, its value is calculated using a discount rate and that’s how you save on taxes.

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

Caution. There’s been considerable abuse of family limited partnerships lately 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. One benefit of a QTIP is that the executor of your estate has 15 months to decide how to divide the

assets in the trust. This window is especially important because of the gradual rise in the exclusion amount and decline in estate tax rates over the next eight years.

Gift-loans. To avoid the federal gift tax, you can make a gift up to the annual exclusion amount (\$12,000) 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 have 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. The loophole was a gap between the federal estate tax and the federal gift 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.

Exemption. You can give up to \$1.5 million to your grandchildren in 2005 without triggering GSTT. In 2006, this amount increases to \$2 million. The amount is total and not \$1 million to each grandchild.

Looking ahead, the exemption increases to:

- \$2 million in 2006, 2007 and 2008; and
- \$3.5 million in 2009.

Repeal. EGTRRA repeals the GSTT for one year, 2010. Between 2002 and 2009, the top GSTT rate gradually falls from 50 to 45 percent, but the lower GSTT rates do not change.

Prediction. Even if Congress permanently repeals the federal estate tax before 2010, it probably won't ditch the GSTT. If it did, it would re-open the old loophole that the GSTT was designed to close.

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.

Note: In the aftermath of Hurricane Katrina, Congress passed the *Katrina Emergency Tax Relief Act of 2005 (KETRA)*. Normally, you are only allowed to contribute 50 percent of your adjusted gross income to a charity. Under *KETRA*, however, Congress temporarily removed this limit. The unlimited giving provision was only in effect from August 25, 2005 and December 31, 2005, and is not extended to 2006. This means that if you donated more than 50 percent of your adjusted gross income to a charity – any charity, not just those affiliated with assisting hurricane victims—you may take a charitable deduction for the entire amount on your 2005 tax return.

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.
- **IRAs:** You name a charity as the beneficiary of your IRA. After you die the proceeds go to the charity.
- **Stocks and other investments:** You can transfer ownership of stocks, bonds, mutual funds, and other investments to your favorite charity.
- **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. Your deduction, if \$500 or more, is limited to the price that the charity ends up selling your car, truck or boat (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.

These are just a few of the many vehicles 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 and after Hurricane Katrina. 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.



Planning tip. Generally, you get the maximum tax savings from gifts of appreciated, long-term, capital gain assets, such as stocks and bonds. If you're in the 25 percent tax bracket and you give \$1,000 cash to your favorite charity, you'll cut your tax bill by \$250. If you give \$1,000 in stock that includes long-term gain, you'll not only cut your taxes by \$250, you'll also save in capital gains tax. That's two tax breaks instead of one.

Conclusion

Let's quickly review some of the most important points you need to remember about estate planning:

- Start planning today;
- 2001's big tax cut, EGTRRA, radically changed the federal estate tax rules;
- The federal estate tax gradually goes down until it disappears in 2010 but returns in 2011;
- In 2010, and only in 2010, stepped-up basis is replaced with carryover basis;

- The estate tax exclusion rises to \$3.5 million in 2009 but falls back to \$1 million in 2011;
- Marriage helps minimize your family's overall estate tax bill because the spousal deduction is unlimited;
- Gifts are important – and often overlooked – estate planning tools;
- You can combine gifts with trusts and get valuable tax savings; and
- Charitable gifts are tax deductible and can reduce your estate tax bill.

The federal estate tax rules, as you've learned, are very complex and almost always interact with each other. You have to aggressively strategize for the maximum tax savings or else you could lose up to 50 percent of your estate to taxes. Sit down with a tax professional and start mapping-out an estate plan.