

Estate Planning SMARTS

Update 1

The Bottom Line At the Dawn of 2010

By Deborah L. Jacobs

As we reach the new year, we're all living with the estate tax in limbo, as Congress ponders next steps. Keep this in mind if you read elsewhere about financial strategies. With the current uncertainty about the future of the tax, aggressive tax moves carry more than the usual risks. Steps designed to take advantage of new loopholes may become ineffective once Congress acts. Let's all hope that happens sooner, rather than later.

Here's where the situation stands:

- ✿ Both the estate tax and the generation-skipping transfer tax (on assets given to grandchildren) were repealed at the end of 2009
- ✿ Both taxes are scheduled to return in 2011 at the unfavorable rates that applied 10 years earlier. The amount that is exempt from each of these taxes will then be \$1 million, and the tax on the rest will be 55 percent
- ✿ There is still a gift tax if you give away more than \$1 million during life, but the tax rate has been reduced from 45 percent to 35 percent
- ✿ Heirs can no longer increase the cost basis of inherited assets to reflect their fair market on the date of death. Instead, the original cost basis of the property applies. This means, for example, that family members who inherit the Apple stock you gradually accumulated might be stuck hunting for all your transaction slips and adjusting for stock splits along the way (a potential nightmare). And when they sell any of the shares, there will be capital gains tax on the appreciation. Each estate can exempt \$1.3 million of gains from this carryover basis rule, as it's called. Another \$3 million exemption applies to assets inherited from a spouse.



What's Next?

Most estate planners expect Congress to restore the taxes retroactively, and to put back in place the system that applied in 2009, as this book went to press: a \$3.5 million exemption for estate tax and generation-skipping transfer tax, with a 45 percent rate for these two taxes as well as the gift tax (see Chapter 3).



Gift and Estate Taxes

The following table compares current rates and exemptions with those from 2009 and those scheduled to take effect next year unless Congress changes the law.

| Year | Lifetime Gift Tax Exemption | Total Gift and Estate Tax Exemption* | GST Tax Exemption | Gift, Estate, and GST Taxes/ Top Rates |
|---------|-----------------------------|--------------------------------------|-------------------|--|
| 2009 | \$1 million | \$3.5 million | \$3.5 million | 45% |
| 2010** | \$1 million | Unlimited | Unlimited | 35% |
| 2011*** | \$1 million | \$1 million | \$1 million | 55% |

*The estate tax exemption amount is reduced for lifetime taxable gifts.

**Estate tax and GST tax repealed. Top rate is for gift tax only.

***Estate tax is reinstated.

If Congress passes retroactive legislation, past court cases suggest that restoring the tax this way is perfectly legal. But people with enough at stake may bring lawsuits arguing that a retroactive tax is unconstitutional. Prompt Congressional action after the holiday recess would reduce the incentive to bring these cases.



Thinking Ahead

If the weeks drag into months without resolution on the tax front, these are some issues to consider (roughly in order of the number of people they affect):

How good are your records? You'll do your loved ones a favor by organizing your records to readily show the cost basis of assets they might ultimately inherit. Many people who did not previously

need to be concerned about estate taxes will be affected by the carryover basis rule. Chances are it's too onerous and impractical, from an administrative perspective, to stick, but you should prepare – just in case it does.

Are there formula clauses in your estate planning documents? Skim your will and living trust to see if either includes phrases like “that portion,” “that fraction” or “that amount” (without saying what it is). These are signs of lawyers trying to take maximum advantage of the estate tax exemption, which kept changing. Instead of naming a specific sum that will go into a trust, such as a bypass or credit-shelter trust (Chapter 3) or a generation-skipping trust (Chapter 14), many documents refer to an amount up to the exemption or express the sum as a percentage of whatever the limit happens to be when the person dies. This is good standard practice, but in a year without an estate tax, make certain the document reflects your intent. For example, it's possible that under your current arrangement, the designated fraction or percentage would mean that less money would go to your spouse than you would like (Chapter 4) or that too much would go to your grandchildren. Consult your lawyer about whether amendments may be necessary.

Do you have the resources to transfer large sums of money while you are alive? These gifts leave less for the government to tax, and if the assets increase in value after you have passed them along, the appreciation is tax-free. But even people in a position to do this quickly run up against the \$1 million lifetime gift tax exemption (\$2 million for married couples). Most people are reluctant to make gifts so large that they will incur gift tax. For those who are comfortable with the idea, the gift tax is now 35 percent, making this a good time to use various tools to get the maximum bang for each estate-planning buck (Chapter 15 and 16). The downside, of course, is that the previous tax rate, which was 10 percent higher, could be restored retroactively.

Would you like to provide a financial cushion for your grandchildren in the years ahead? Normally, when you give assets directly to grandchildren or set up or add assets to trusts that benefit this generation or future ones, you need to plan for the generation-skipping transfer or GST tax (Chapter 14). This tax applies on top of estate tax and gift tax. With the repeal of the GST tax for one year at the start of 2010, advisers are proposing a variety of techniques to maximize gifts to grandchildren. How they will be affected by a law that takes effect retroactively remains unclear. Proceed with caution.



It's Not Just About Taxes

For all the talk right now about estate tax repeal, this tax affects very few people. In 2009 less than 1 percent of the population needed to be concerned about estate taxes. And as noted throughout this book, estate planning goes far beyond taxes. Whether or not taxes were a concern for you in 2009 or might be again – either later this year or in 2011 – make a New Year's resolution to give your estate plan a check-up, and keep it! Be sure you have all the basic estate planning documents to provide for your own care if you can no longer handle your affairs (Chapter 1) and to leave your assets to the people (Chapter 2) or charities (Chapter 17) that you wish to benefit. If you have life insurance, make sure you have properly completed the beneficiary designation form

(Chapter 8). Beneficiary designation forms for your retirement accounts should also be filled out and coordinated with the rest of your estate plan (Chapter 7).

If you have a spouse or partner, make sure your mate is well provided for financially (Chapter 4). Name a guardian for children who are minors or have special needs and leave funds for them in good hands in case something happens to you (Chapter 5). Don't delay saving for the enormous education expenses that your children or grandchildren will face (Chapter 9).

Consider converting a traditional IRA to a Roth IRA. This estate-planning strategy frees heirs of the need to pay income tax as they withdraw funds from the account, and in effect passes more money to children and grandchildren tax-free. Starting in 2010, all taxpayers, regardless of their income or filing status, can do a Roth conversion. The decision tree on page 106 of *Estate Planning Smarts* can help you determine whether a Roth is right for you.

If you're thinking of moving to another state or dividing your time among various locations, factor in how that would affect your estate plan (Chapter 10). About half the states have a separate estate tax, which applies not only if you live in one of these states, but also if you own real estate there.

Trusts continue to be an important estate planning tool, but not necessarily for tax saving. For many people the focus is on other crucial purposes that trusts can serve: to hold money for minors (Chapter 5), forestall spendthrift family members (Chapter 6) or protect assets from former spouses or creditors (Chapter 18), for example.

There's no need to delay thinking about the legacy you would like to leave – for example, by providing everyone in your family with the best possible education (Chapter 9), developing a succession plan for the family business (Chapter 12), keeping a vacation home in the family (Chapter 10) or making meaningful gifts to charity (Chapter 17). Just because Congress is inefficient and disorganized doesn't mean that you must follow suit.

Deborah L. Jacobs is a lawyer and award-winning journalist specializing in legal topics. Her new book, *Estate Planning Smarts: A Practical, User-Friendly, Action-Oriented Guide*, is available through booksellers or at www.estateplanningsmarts.com. This is the first update to that book. You can register at www.estateplanningsmarts.com to receive e-mail notifications of future ones.