# Estate Planning SMARTS

Update 2

## How the New Tax Law Affects Your Estate Plan

*By Deborah L. Jacobs*

After nearly a year without an estate tax, Congress has restored it retroactively, preventing the tax from automatically springing back Jan. 1 at hugely unfavorable rates. Under prior law, the amount of each estate that is exempt from estate tax was scheduled to become $1 million in 2011 (down from $3.5 million in 2009, when the tax was last in effect). The tax on the balance would have risen to 55 percent in most cases (up from the 2009 rate of 45 percent).

The plan that Congress passed Dec. 16, part of a law that also extends Bush-era income tax cuts, is far more generous. Starting immediately, each of us can transfer up to $5 million at death tax-free. Beginning next year, widows and widowers get a special new break – the ability to add a spouse's unused exemption to their own. This dramatic development, enabling spouses together to transfer up to $10 million tax free, also eliminates the need in many cases for the tax-planning gyrations that lawyers routinely recommended to preserve each of their exemption amounts.

Under the new law, heirs of people who died in 2010 will have to make some tough strategic choices. After an initial shakeout period, the rest of us will probably find estate planning much simpler going forward.

One drawback of the legislation is that it only applies for the next two years, so in 2013 the tax-free amounts and rates will again be up for grabs. That is likely to be an issue mainly for people who are already very wealthy or might someday strike it rich.

For now, the most important first step for all of us is to revise our current documents if that's necessary to avoid unintended consequences. If you don't have a will, the new law provides a firmer foundation on which to build. But as always, estate planning is not just about taxes. Even if taxes are no longer a concern, you still need an estate plan to accomplish other key financial goals.

## The Basics

Here's what you need to know about the new law.

- The estate tax has been restored retroactively to Jan. 1, 2010.
- The amount that you can pass through your own estate plan without having to worry about taxes is $5 million in 2010, indexed for inflation after 2011. The tax on the rest is a maximum of 35 percent.
- Starting for deaths in 2011, widows and widowers can add any unused exemption amount of their most recently deceased spouse to their own exemption – a new strategy called portability. In figuring the total exemption (up to $10 million), the amount that's portable is not indexed for inflation, but the surviving spouse's own exemption amount is.
- There is still a gift tax (this tax did not lapse in 2010) if you give away more than a certain sum during life, but the tax-free amount for such gifts has been raised starting in 2011 – to $5 million from $1 million (it too, will be indexed for inflation and married couples can combine their amounts, bringing the total to $10 million). Meanwhile, the tax rate on the excess, which was scheduled to increase to 55 percent in 2011, will remain at its current 35 percent maximum. When you die, the estate tax exemption available to you is reduced by the amount of the gift tax exemption you have used.
- Generation-skipping transfer tax, also suspended in 2010, has been restored starting next year. It applies, on top of estate or gift tax, to assets given to grandchildren (or to trusts for their benefit). But here, too, the law offers a $5 million exemption starting this year. Oddly, there's no tax on the excess this year – a loophole – but the rate goes to 35 percent next year. There is no portability for this tax, but for transfers during life married couples can combine each of their exemptions to give away a total of $10 million without incurring the tax.
- For income tax purposes, the cost basis of inherited assets gets adjusted to the fair-market value on the date of the owner's death. This fresh start limits the capital-gains tax inheritors must pay if they sell the property.
- For assets inherited at any time in 2010, an executor – the person or institution that remains in charge until an estate is legally closed – has a choice: at the executor's election, an estate can be subject to the new estate tax plan and take a basis adjustment on inherited assets, or follow the system that was in effect for most of 2010 (no estate tax). If they choose the latter, they must use the original price paid for an asset when computing the income taxes heirs will owe if they sell it. 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.

## Gift and Estate Taxes

Compare new rates and exemptions with those from 2009.

| 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 | $5 million | $5 million | 35%*** |
| 2011 | $5 million** | $5 million** | $5 million** | 35% |

**The estate tax exemption amount is reduced for lifetime taxable gifts.*
***Indexed for inflation after 2011*
****The GST rate is 0 percent in 2010. A flat rate of 35 percent applies after that.*

## What's Next for Your Plan?

Your estate plan does not have to be complex, especially now that the amount exempt from taxes has reached $5 million ($10 million for married couples). If you haven't revised your estate plan in a number of years, the current tax-free amount is much higher than it was when you last met with your lawyer. A will that made sense in past years could result in your surviving spouse getting much less than you would like or even being shut out of your estate.

These are the key issues to consider:

***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 increasing. In 1999, it was $650,000; starting in 2010 it is $5 million.

Instead of naming a specific sum that will go into a trust, 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 was good standard practice, but now that the exemption is $5 million, make sure the document reflects your intent. It's possible that under your current arrangement, less money would go to your spouse than you would like (see What's A Bypass Trust?) or that too much would go to your grandchildren. Consult your lawyer about whether amendments may be necessary.

## What's a Bypass Trust?
## (And Why You May No Longer Need or Want One)

Formula clauses in wills and trusts, which express inheritances in terms of fractions or percentages, may lead to undesirable results with bypass or credit-shelter trusts. Before Congress passed the new law, introducing portability, these trusts were the most popular way of preserving the exemption for both spouses.

Here's how bypass trusts (often called family trusts) would work: assume your will includes a formula clause that would allocate up to the maximum tax-free amount to the trust if you die before your spouse. The trust distributes income and principal as you specify in the trust document – say to your spouse and family members while your spouse is alive, then paying what is left to family.

Since money in the bypass trust is covered by the exemption amount, it will not be taxed when you die. Putting the funds in trust, rather than leaving them to your spouse outright, ensures that neither the assets nor any appreciation on them will be considered part of your spouse's estate. Therefore, they are not subject to tax when he or she dies.

If the rest of your assets go to your spouse, the tax on this portion, called the marital share, is not eliminated but rather postponed until that person's death. Assuming the assets pass outright or through another special kind of trust, no tax will be assessed when you die, because assets inherited from a spouse are entitled to an unlimited marital deduction. If your spouse doesn't spend all that money, what remains of the marital share will be taxed when he or she dies. (Special rules apply to spouses who are not United States citizens.)

All this is still true. But what happens under the new tax law? Depending on how a formula clause is worded, it is possible that everything will go into a bypass trust. And that could lead to some awful scenarios. One possibility, if the trust isn't set up to make payments to your spouse (for example, if it only benefits your children from a previous marriage), is that your spouse will get nothing. Another possibility is that even if the trust does benefit your spouse, all the money will be locked up in the trust, and your spouse won't receive anything outright.

If your estate plan now suffers from this defect, the lawyer who initially wrote the document can fix the problem with a simple amendment. Assuming these are the only changes you are making, the charges should be nominal and billed at an hourly rate.

Another question to discuss with your lawyer is whether, with portability, you even need a bypass trust. The trust has the advantage of sheltering appreciation and could also be helpful in situations where you want to protect assets from creditors or benefit children from a previous marriage. But for most other cases, where couples have combined estates of $10 million or less, they might be better off just leaving everything outright to each in what is called an "I love you will."

When outright bequests to the surviving spouse make sense for estate tax reasons, there may also be income tax benefits down the line. When the second spouse dies, these assets, included in her estate, get an adjustment in basis to their date of death value, which minimizes the capital gains tax heirs must pay when they are sold. In contrast, the basis on assets that went into the bypass trust when the first spouse died will not have changed since then.

If you go the simpler route, keep in mind this important requirement: the executor handling the estate of the first spouse to die will need to transfer the unused exemption to the survivor. This requires filing an estate tax return, whether or not any tax is due; one would hope that the Internal Revenue Service will develop a short form for this purpose.

***Were you planning to make large taxable gifts in 2010?*** Such 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. Even people in a position to do this tend to be reluctant to make gifts so large that they will incur gift tax. Still, for much 2010, it seemed like a wise financial strategy for those who were comfortable with the idea: with both the gift tax and the estate tax scheduled to increase to 55 percent, the 35 percent gift-tax rate in 2010 looked like a bargain.

Under the new tax law, this argument no longer holds. Not only will the gift tax rate remain at 35 percent, but the amount that anyone can transfer before this tax even applies will go up next year to $5 million ($10 million for married couples). So if, for estate planning reasons, you were contemplating large yearend gifts, you might want to reconsider.

If you're feeling generous, you can still give as much as $13,000 a year each to as many people as you like without paying gift tax. Spouses can combine this annual exclusion to give $26,000 jointly to each of as many people as they would like.

## It's Not Just About Taxes

For all the talk right now about estate tax, it affects very few people. In 2009 less than 1 percent of the population needed to be concerned about estate taxes. With a tax-free amount of $5 million, that number will be even lower. But don't lose sight of the fact that estate planning goes far beyond taxes.

Whether or not taxes were a concern for you previously or aren't any more – 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. Although you have to pay income tax on the amount you shift, doing so can eliminate the requirement for you or your heirs to pay tax on future distributions. With a Roth you also avoid the requirement to take yearly minimum distributions starting at age 70 1/2, and that can leave more for beneficiaries if you don't use the money yourself. 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.

Finally, think 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). These goals are not dependent on tax rates.

## What's Next for 2010 Inheritors?

Uncertainty about the future of the estate tax has delayed estate administration. Congress recognized that and has extended key deadlines for estates of people who died in 2010 before it was enacted. The following deadlines, which are normally nine months after the date of death, have been shifted to nine months after the law was passed: filing the return, paying any estate tax that is due and disclaiming, or turning down, an inheritance. Likewise, the deadline for applying the generation-skipping transfer tax exemption is nine months after the law was passed, rather than nine months after the transfer.

Under the new law and only for estates of people who died in 2010, an executor must decide whether the estate will be subject to prior law (no estate tax or generation skipping transfer tax, but carryover basis) or the new law. Most estates worth $5 million or less will probably be better off under the estate-tax regime, while those worth more than that are likely to adopt the other approach. But executors should ask tax advisers to verify that by crunching the numbers.

With either approach, as in past years, unless the date of death value of a costly asset is obvious (as it is for marketable securities, for example), you will need to start by getting an appraisal.

If you go the estate-tax route, you will use this information to figure the total value of the estate, and then apply exemptions and deductions. For instance, you subtract charitable bequests from the total. There is also an unlimited marital deduction for assets passing to a citizen spouse, either outright or through certain kinds of trusts.

Under a modified carryover basis system, you use date of death values for a different purpose. Subject to certain limitations, if an asset is worth more when someone dies than she paid for it, her estate can apply the basis allowance to the difference. Once this allowance is used up, there might be income tax, but it's not triggered until the asset is sold (a common misconception). At that point the total amount subject to tax would consist of the difference between the date of death value and the basis allowance, plus any appreciation after the date of death.

For example, let's say you inherit publicly traded stock from your mother. If she bought it for $500,000 and it's worth $2 million when she dies, there's $1.5 million of appreciation, or what tax geeks call "built in" or "unrealized" gain. Without a basis adjustment, if you immediately sold the stock, carryover basis rules would require you to pay tax on all that gain. But instead the law allows you to bump the basis up by $1.3 million, so it's as if the stock cost $1.8 million ($1.3 million plus $500,000) instead. When you sell it, assuming the value hasn't changed since Mom died, you would pay capital gains tax on $200,000 ($2 million minus $1.8 million).

Tending to other details associated with carryover basis could be more cumbersome. Potential difficulties can arise with:

***Locating purchase records.*** If you can't prove what assets originally cost, the IRS assumes the cost is zero and could try to saddle you with capital gains tax on the total sales amount.

With investments like Mom's stock, tax returns and brokerage statements can lead you to what someone owned on the date of death. Going back through the years, they also show dividend payments, which may provide another clue about when an investment was purchased.

But if the assets have been moved between financial institutions, the original cost might not be on file with the current broker. You may even have to sort through papers that predate computerized records.

In other contexts when the initial cost was unclear, accountants have had clients estimate when something was bought, then obtained price information directly from public companies or by checking newspaper archives. The consensus is that this will work in this context, too.

Real estate can pose a much bigger problem. Consider a home that has been in the family for many years. Basis consists not only of the purchase price, but factors in capital improvements that add value to the home. To re-create those records, you might need to scour grandma's attic for canceled checks showing what she spent to renovate the kitchen or add dormers to the country house, for example.

***Selling appreciated assets.*** It is possible (though not entirely clear) that carryover basis applies only to assets sold in 2010. This interpretation stems from the sunset provision of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 – the law that provided for the one-year lapse in the estate tax. Section 901(b) of the law says that in 2011 old laws will apply as if EGTRRA "had never been enacted."

If that is true, inheritors may be able to escape the carryover rules by holding assets at least until next year. At that point, if an investment is sold, the capital gains tax would apply only to any increase in value after the date of death.

So what should executors do this year? As a practical matter it's still easiest to liquidate the assets unless, from an investment perspective, they have good reasons to hold them.

***Coping with a new set of paperwork.*** The deadline for reporting carryover basis is April 15 of the year following a person's death – the same day on which his or her final income tax return must be filed. (This due date is different from the one that applies for the estate tax return, which is normally due nine months after the date of death.) As with an income tax return, it will be possible to extend the deadline by six months, to October 15.

So far the IRS has not created the form that will be used for this purpose or the accompanying instructions. It might be a separate carryover basis return, using the Social Security number of the person who has died. Or there might be a form or schedule for reporting carryover basis that gets attached to the final income tax return.

Either way, the form is likely to ask executors to list each asset, along with its basis and date of death value. They will also need to indicate which assets the free basis will be applied to, and in each case how much the basis will get bumped up. There's no need to sell the asset before filing this form; what you're allocating is built-in gain between the original cost of the asset and the date of death value.

Certain limitations apply. For example, there is no basis adjustment on what is called income in respect of a decedent, or IRD. This is income that wasn't taxed before a person's death and would have been taxed if the individual had lived long enough to receive it. Examples include traditional individual retirement accounts, qualified retirement plans, a company bonus, income from an S corporation and money owed on a promissory note under an installment sale.

Also keep in mind that while the $1.3 million exemption can be applied to assets given to anyone, the $3 million exemption is limited to assets given exclusively to a spouse, either outright or in certain kinds of trusts. So you may not use this exemption if money is going into a trust that will benefit people in addition to the spouse.

***Applying the basis allowance fairly.*** If some assets may be kept in the family, it's most efficient to allocate the basis to those that are likely to be sold first. But this strategy could cause some inheritors to benefit from the free basis more than others. And that creates conflicts when an executor is also a beneficiary and allocating the basis a certain way would benefit herself.

This problem is analogous to one that has come up previously, when all assets were valued as of the date of death. Often several years pass before beneficiaries receive those assets. And meantime, values can fluctuate. When making in-kind distributions to beneficiaries (as opposed to handing out the proceeds of assets that have been liquidated), executors have always tried to give out assets that are not only roughly equal in value, but also have a roughly similar basis.

***Guarding against an executor's added risks.*** Legally, an executor is a fiduciary, who is expected to act prudently and be impartial. Under the best of circumstances, it can be a difficult job, with a risk of liability for missteps. Still, the complicated landscape this year, especially as it involves carryover basis, seems to leave an executor extra-vulnerable.

Executors can advise families that they are navigating uncharted waters, alert them to the investment risks of waiting to sell assets, give reasons for any strategies they recommend and ask beneficiaries what they want to do. Along the way, it's wise to document conversations with follow-up correspondence and notes to the file.

If you're an executor and a family disagrees with your recommendations, it's best to do what they ask but get them to sign a document releasing you from liability and indemnifying you for losses. Such precautions are unusual – executors are expected (and often paid) to handle difficult situations. But in the current environment, you will probably feel more comfortable with this document in your back pocket.

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**Deborah L. Jacobs,** a lawyer and award-winning journalist specializing in legal topics, is the author of the bestselling book *Estate Planning Smarts: A Practical, User-Friendly, Action-Oriented Guide*. This is the second update to that book. You can register at www.estateplanningsmarts.com to receive e-mail notifications of future ones and follow Jacobs on twitter at http://twitter.com/djworking.