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Your Potential Federal Estate Tax Liability

The purpose of the accompanying analysis is give you an idea of your potential federal estate tax liability based on your current "net worth." The effects of any state succession or inheritance taxes will not be taken into account.

The federal estate tax is based on the net difference between your various taxable assets and your allowable debts/liabilities at date of death. In effect, this is a form of "net worth" calculation. Under the current rates, this graduated tax can reach as high as 55% for certain size estates! Thus, calculating your potential estate tax–and planning how to reduce it–shouldn't be taken lightly.

Under the present laws, married individuals can leave an unlimited estate to their surviving spouse, assuming that spouse is a US citizen. No tax problem here. But it is at other levels where the tax liability can come into play. That is, when the surviving spouse dies, or if there is no qualified spouse, or if the estate exceeds a value of $675,000(higher if the estate involves a family-owned business.) At this point, federal estate taxes–like a shark–can come charging into the picture to take huge bites out of your assets.

A brief rundown on some basic techniques that people use to do estate tax planning is enclosed. When it comes to estate tax planning it's always a good idea to know two things. One, where you stand tax-wise; that is, how much you have potentially to lose. Two, what tax-saving avenues are open to you to cut down on these taxes. That's because: Three, if you don't take advantage of these tax-saving techniques before certain events occur, you lose the opportunity. So please review the accompanying text in addition to the estimated estate tax calculation, based on your situation.

Basics Of Estate Planning

Most people assume that only the wealthy need estate tax planning. This is not so, because it doesn't take a great deal to reach the taxable levels; not when you start adding up all the components the IRS uses to determine what's taxable. Keep in mind that such items as life insurance proceeds, annuities, value of your company retirement plan, and real estate are only some of the taxable components. Also, when the estate tax does kick in, it starts furiously, with an opening 2000 marginal tax bracket of 37% after your unified credit exemption.

But an estate plan also fulfills other important functions. Properly done, it can also insure that your remaining assets at death go exactly as you wish, to exactly whom you want, in as little time as possible, and at the smallest cost. Failure on your part to do the proper–and legal–estate planning will mean that the courts will decide what to do with your assets, and who will handle it.

So, basically good estate planning will do all of the following: Cut federal and state taxes, minimize red tape for the transition, allow you to enjoy your money while you are still alive, and make it easy for your survivors to handle your estate after you pass on.

Normally, most people do not do their own estate planning. They use lawyers, tax accountants, financial advisors and planners. But, the biggest mistake made by a majority of people is that they don't even know enough to decide if they need help, what kind of help to get, when to get it, and what the trade-offs will be for all this planning. In fact, to most people, all this estate planning is a confusing, scary area(no one likes to even think about dying, much less plan for it). So how do they respond? They do nothing!

Big mistake. Especially since, once you understand some basic tax-savings possibilities in this area, you will quickly realize how easy it is to implement. You see, basic estate planning is not complicated so much as it is a timing consideration and a decision as to trade-offs. All you have to do is decide on which trade-offs make sense for you. The rest is done by the lawyers, financial advisors, and so forth.

Consequently, what follows is a brief outline of certain basic estate tax planning techniques that may come into play some time in your financial history. These techniques can be divided into five main areas as follows.

1 - Outright Gifts to Charities

There are two ways this can be done: before or after death. If you give to qualified religious, educational, scientific, charitable, or literary organizations before death, you achieve dual functions. First, you may qualify for an itemized deduction on your income tax return to save on taxes; second, it reduces the size of your taxable estate.

After death, the taxable estate is reduced by the fair market value of any gifts bequeathed. Thus, if it is property or stocks, bonds, etc., the fair market value at date of death is used as the deductible amount.

Remainder Interests

In this scenario, the donor retains life use of the property, and agrees to have the property pass to a charity upon death. An income tax deduction based on the fair market value of the property less the so-called "lifetime-use" value is received by the donor, and the estate is reduced upon death.

Easement donations also fall into this category. You may have a piece of property in which you grant an "easement"–or a right to use the property for a specified period of time. This has a value to it under current IRS rules. As an example, you may allow a charity to use part of the woods on your property for a bird sanctuary. This easement can create a deduction from your taxable estate, as well as a current income tax deduction.

Charitable Trusts

There are two main types of trusts most people use for charities:Charitable Remainder Trusts, and Charitable Lead Trusts.

CHARITABLE REMAINDER TRUST**:** In this type, the donor gives property over to an irrevocable trust. However, the income generated by this property is still retained by the donor and/or the donor's beneficiaries. Upon death of donor and/or beneficiaries, the charity gets the property in full, income and all.

This creates a current income tax deduction based on the value of the remainder interest donated, reduces the taxable estate, and can shift taxable income to lower-bracket beneficiaries.

It's also a great way to convert a non-income producing asset into an income producing one, tax-free. If you have a property that has highly appreciated value compared to your cost basis(like a stock, or building), you can set up this trust such that the charity will sell the property, invest the proceeds in income-producing assets, and you get this income. If you had done this yourself, you would have had to pay capital gains tax on the sale of the property first, so you would have had less principal to re-invest on your own, and, therefore, possibly less income being generated.

CHARITABLE LEAD TRUST: This is the opposite of the above. The income from the investment is gifted to the charity, and the property itself is kept in the estate. The donor gets a deduction for the "present value" of the income stream gifted to the charity. The charity gets this income until the donor's death when the property is passed to the beneficiaries.

2 - Use Of Gifts To Individuals

You can reduce the size of your taxable estate by making gifts to individuals while you are still alive. While this will not give you a current income tax deduction, it obviously lowers your taxable estate.

However, you are limited to how much you can give per year per person to take advantage of this. You are allowed to give up to $10,000(adjusted annually for inflation) per year per person. A couple can jointly give $10,000 each per person; thus, a husband and wife could give their child up to $20,000 per year. Beyond this amount, you can be held liable for gift taxes as the donor. There are a few exceptions to this dollar value limitation. Any payments made directly to a qualified secondary level educational institution, or any qualified medical payments made directly to the source are not subject to the $10,000 limitation.

A caveat: Any gifts that parents make to minors to reduce their estate must usually be made under the Uniform Gifts To Minors Act, or to the Uniform Transfer To Minors Act, or to qualified trusts to preserve this estate tax planning technique.

3 - Use Of Marital Deduction

Although a spouse can leave an unlimited size estate to the surviving spouse who is a US citizen, it is different if it is being left to anyone else. For other-than-a spouse who is a US citizen, the maximum size estate currently exempt from federal taxes is $675,000 per individual(higher if the estate involves a family-owned business). This refers to the "unified credit" allowance.

Thus, if your total taxable estate is under $675,000 you may need little federal estate tax planning. But if your estate is higher than $675,000 and you are concerned with estate taxes even after your surviving spouse passes on, then you can use this Per Individual unified credit exemption in your favor and save taxes on a combined estate of up to $1,350,000.

To do this, you would leave $675,000 to your spouse(since the law allows you to leave any amount to a qualified spouse with no immediate federal estate tax consequences) and set up a "credit-shelter" trust to hold the remaining $675,000 which you have designated as your allowable unified credit exemption. According to a loophole in the laws, your spouse is still allowed to receive the income from this trust, but the principal would pass on to the next level of beneficiaries upon the spouse's death.

What you have done here is to make use of both your $675,000 unified credit, and your spouse's, so you can shield up to $1,350,000 using this relatively simple estate tax planning technique. For this to work effectively however, the title to your assets must be allocated properly before the death of either spouse. Any jointly held property may not work properly in this maneuver. So some "asset shifting" may be needed in order to set this up.

US CITIZEN VS NON US CITIZEN: Under certain tax provisions enacted, only spouses who are US citizens can receive an unlimited estate. All others–including Resident Aliens–can only receive a maximum of $675,000. Thus, if your estate is over this amount, your non-US citizen spouse can get hit with a heavy estate tax under certain scenarios.

There are a couple of loopholes to consider in this regard to beat the system a bit. First, you can shift assets so each spouse owns less than $675,000. This can cut down on the potential tax problem, all other variables being equal. Under this tax act, you can shift assets by making a gift of up to $100,000 per year to a non US citizen spouse without running afoul of gift tax laws by filing a gift tax return citing certain code sections associated with non US citizen-spouses. Second, you can set up a Qualified Domestic Trust to preserve tax-exempt status on up to $1,350,000. This can be a very complicated part of estate tax planning, but it is a possible option.

4 - Using Life Insurance

Using life insurance may be a valuable estate tax planning tool. It is divided into two areas: Using life insurance to pay estate taxes and using life insurance trusts to avoid paying estate taxes.

Using Life Insurance To Pay Estate Taxes

In its simplest form life insurance can be a cheap way to do estate tax planning. If your estate tax bracket is high, and if you do not outlive your statistical lifespan, the cost of having life insurance can be a great deal cheaper than the estate tax you will owe. Thus, life insurance may be a good investment in this context.

So, life insurance can provide the liquidity needed to pay the estate taxes. This can be valuable especially if you have little cash in the estate, but a lot of property that you don't want to be sold at death. The life insurance proceeds can be used to pay the taxes, thus preserving the character of the estate.

A cheaper way to go for a married couple doing estate planning is to buy a "second to die" policy. This is especially true if one of the spouses is considerably older than the other and/or has health problems. The policy is cheaper because the insurance companies are spreading the statistical "mortality rate" calculation over two combined life spans instead of separate ones.

For some people, a decent life insurance policy may be the easiest form of estate tax planning. While you are not saving estate taxes, you are planning for their payment without reducing your other taxable assets. So, this is still a form of estate tax planning.

Using A Life Insurance Trust

Normally, life insurance proceeds paid to anyone other than a spouse who is a US citizen are included in one's taxable estate. While these proceeds are not subject to income tax chargeable to the beneficiaries, the proceeds do get added to the rest of the taxable estate. Thus, once the total value of the estate exceeds $675,000 including the value of the life insurance, estate tax headaches can occur down the road.

There is a loophole to this, however. The present 2000 law states that life insurance proceeds are taxable in one's estate only if the insured OWNED the contract. Legally, owning a policy means paying for it, and having the power to exercise various rights such as the right to change beneficiaries, change the policy terms, or cancel the contract. So, if you legally disavow ownership by having some other individual or a trust own the policy, these proceeds will not be included in your taxable estate even though you are still the one insured. In short, you are making an irrevocable election to give up control over the policy. You can do this by having another person own the policy. Example: Your beneficiary for the policy could take over ownership, and make the premium payments.

Or, you can set up an Irrevocable Life Insurance Trust to own the policy. This works great in the situation where you want your spouse to benefit from the policy without it going into your estate, and still have some control over the principal amount while the spouse is alive. This trust can also be allowed to pay your spouse the income from investing the life insurance proceeds. The life insurance proceeds themselves go to another beneficiary(such as a child) upon the death of your spouse.

This technique may be applied even to life insurance policies from your job by transferring the incidence of ownership of this policy and naming your heirs as beneficiaries.

Some Caveats: If you transfer any insurance policies that have "cash surrender value" this amount may be considered as a gift, so the gift tax rules may come into play if this value exceeds $10,000. There is also a three year rule which applies. If you die within three years of transferring over any existing policies, this estate tax planning technique may be disqualified. To beat this problem, however, you can consider canceling an existing policy and starting fresh with a new one, everything else being equal.

5 - Use Of Trusts

As previously mentioned, some trusts can be valuable estate planning tools. The Charitable Trusts to allocate property and/or income, the Credit Shelter Trust for taking advantage of the $675,000 unified credit, and the Irrevocable Life Insurance Trust we just discussed are good examples. But there are a few more to outline as well.

Note that trusts can fulfill other purposes besides estate tax planning. Proper use of a trust can greatly reduce the costs and time associated with the probate process; they can save or at least stabilize income taxes; and they can provide for control, continuity, and clarity of management even after death. In fact, trusts have so many uses, that entire books and careers are based solely on the use of these interesting "creatures of the tax codes."

However, the purpose of this text is to concentrate only on the estate tax planning benefits of certain trusts that may apply to the majority of taxpayers like you. Again, this is to give you a basic overview so that you know what's out there.

First, what is a trust? From a legal and tax standpoint, a trust is a separate entity to which a grantor has transferred legal ownership of property of some type(including cash) for the benefit of one or more beneficiaries. This trust has a legal life of its own.

For estate tax planning purposes, the other trusts to review besides the ones already discussed in the other sections are the Minor's Trust, the Generation Skipping Trust, and the Grantor Retained Income Trust.

Minor's Trust

This trust is used in conjunction with estate tax and income tax planning for the situation in which someone wants to make a gift to a minor but still wants some control over the property. Most of these trusts are the so-called "2503(b)" trusts. The property can be managed by a trustee for the benefit of the beneficiary. By making this an irrevocable trust, the donor effectively removes the principal from the taxable estate, and the trust can continue indefinitely.

Variations on this theme can be done in which the trust can have a scheduled termination date. A 2503(c) trust does this. In this one, it ends when the minor reaches age 21. If done properly, it also effectively removes assets from the donor's taxable estate.

Generation Skipping Trust

Under current federal estate tax rules for 2000 this trust permits the donor to avoid estate taxes on up to $1,030,000 of assets if the property in question passes to another generation besides the second generation. An example: A trust is set up which gives your child the income from the trust but not the principal. Instead, your child is given the right to distribute this property to the child's offspring down the road. Thus, the principal has "skipped a generation" and, under current legal interpretations, this avoids taxability to the donor's estate up to the $1,030,000 figure. Also, any potential appreciation in the property along the way may escape the estate tax as well.

Grantor Retained Income Trust

Commonly referred to as a GRIT, this is a form of trust which may allow you to remove a substantial portion of the value of your residence from your taxable estate without losing the right to live in it for a designated period.

Basically, you turn your residence over to an irrevocable trust and your beneficiaries will receive the residence after a certain period. But you retain the right to live in the house for this specified period of years before the title goes over to the heirs.

This saves estate taxes because the restriction you place to retain your right to live in the house has a value for tax purposes. The longer you extend this right, the greater the value. Thus, this value gets subtracted from the actual fair market value of the residence for estate tax purposes. As an approximation, a $350,000 residence that is transferred into a GRIT with a 10 year life may end up with a value of only $140,000 or so for estate tax savings. That could mean a savings of up to $115,000 in estate taxes for some people.

In addition, any potential property appreciation after the house goes into the trust is effectively removed from estate taxes under current law.

One big catch, however. If you do not outlive the original term of the trust you set up for your right to retain occupancy, the full value of the property–including any appreciation–goes back into your estate.

Conclusion

Estate tax planning requires two components. First, the knowledge of your specific situation to execute the trade-offs. In effect, how much estate tax are you up for, and is this potential tax-savings worth it to you to make the necessary changes. The second component is the timing factor. You must do these things at certain times to qualify for the tax-saving features.

As you can see, effective estate tax planning is not a one-time thing. It needs a periodic review of your financial situation and your marital status, as well as that of your potential beneficiaries. This must be coupled with the ever-changing federal and state tax laws as they apply to estate tax planning. Finally, you must coordinate all of this with your own cash flow situation.

However, with the right advisors, and with time on your hands, this can be some of the most effective planning you can do on a dollar-for-dollar tax-saving basis.