UTILIZING ESTATE PLANNING TO MINIMIZE FEDERAL ESTATE TAXES

What are the Federal Estate and Gift Tax Exclusion rates?

Year	Exclusion Amount	Max/Top tax rate
2001	$675,000	55%
2002	$1 million	50%
2003	$1 million	49%
2004	$1.5 million	48%
2005	$1.5 million	47%
2006	$2 million	46%
2007	$2 million	45%
2008	$2 million	45%
2009	$3.5 million	45%
2010	repealed	0%
2011	$1 million	55%

What does this mean to you?

The government imposes different kinds of tax on transfers of property. Some of the taxes are only incurred at a certain dollar amount or higher. Others are incurred at all levels.

For example, currently, in 2008, you can give a person up to $12,000.00 per year without having to file a gift tax return and report the gift (transfer). However, in Pennsylvania, any dollar amount that transfers from one person to another person as a result of death, such as inheritance, is subject to the state inheritance tax.

The Federal estate tax and the Federal gift tax have a unified credit available to offset the total taxes assessed against a person during his or her lifetime. That means that upon a person's death, the total amount he or she gave away during his or her lifetime

that was taxable PLUS the amount of property that transferred to someone as a result of his or her death, is offset by the unified credit and the remaining total is subject to the tax rate.

Let's take a look:

During his life, John gave away to family and friends a total of $400,000.00 in taxable gifts. He filed the proper gift tax returns, but did not pay any tax at the time he filed the returns.

John then died in 2008. The total value of the property he left to his family equaled $1.7 million dollars. When added together, the total gifts and inheritance equals $2.1 million dollars. In 2008, the unified credit is $2.0 million dollars. That means that $100,000.00 will be subject to the tax rate of 45%.

My spouse and I have more than the exclusion limit, but not much more. Is there anything we can do to help avoid or minimize this tax?

Keep in mind that this tax is PER PERSON, not per couple. Spreading out the way your property is owned, both during your lifetime and after your death can divide what you have together into two smaller estates and perhaps decrease your individual total assets below the taxable threshold.

Here's an example:

John and Marsha have been married for thirty-five years. Both worked jobs through their lives, but John's work was steadier and paid a higher salary. Marsha had lower income and took time off for a few years while they raised their children.

As a result, John's IRA has a significantly higher value than Marsha's. John's IRA has a value of $150,000.00, but Marsha's IRA only has a value of $45,000.00.

Additionally, John's mother left him a vacation home worth $250,000.00 when she died. This property is only in John's name.

John has 4 CD's in his name worth about $200,000.00 total and Marsha has 2 CD's in her name, worth about $50,000.00 total. Their home has a value of $500,000.00. They've had good luck with investments. Their joint money market has a value of about $345,000.00 and they have Microsoft stock worth about $250,000.00.

Asset	John	Marsha	Joint
IRA	$150,000.00	$45,000.00	
Vacation home	$250,000.00		
CD's	$200,000.00	$50,000.00	
Home			$500,000.00

Money Market			$345,000.00
Microsoft Stock			$250,000.00
Totals	$600,000.00	$95,000.00	$1,095,000.00

Collectively, John and Marsha have assets totaling $ 1,790,000.00. John has a life insurance policy with a death benefit of $1 million and Marsha has a life insurance policy with a death benefit of $500,000.00.

Life insurance proceeds are one of the few transfers that pass as a result of a person's death that does not result in state inheritance tax. However, the death benefit paid from life insurance proceeds IS considered when calculating the total value for federal tax purposes.

Remember that the amount transferred when someone dies is what HE OR SHE OWNED on the day he or she died. In our scenario, let's see how the numbers work depending on which spouse died first. Remember, at this point, our couple has done NO estate planning.

If John died first, he would own $600,000.00 individually and one-half of the joint assets ($547,500.00), or a total of 1,147,500.00. At first, you might think he is okay because he falls below the $2 million exclusion. However, when you add in the $1 million insurance payment, his estate now equals $2,147,500.00 and is over the exclusion limit. As long as Marsha is the recipient of the money, she will have a marital deduction and will not have the pay the tax. However, when Marsha dies, the full amount will be taxable at the 45% tax rate.

What if Marsha died first? Marsha owns $95,000.00 individually and $547,500.00 of the joint assets, for a total of $642,500.00. Even when you add in her insurance proceeds of $500,000.00, her estate is still below the level that the tax would be assessed. BUT, where is the $1,142,500.00 going when she dies? Probably to John. Eventually, all this money will be subject to the 45% tax when John dies.

You see, regardless of who died first, the 45% tax was assessed on the full amount because the $2 million exclusion was only used ONCE (at the death of the second spouse).

How can I arrange things so that we use BOTH exclusions?

One simple method is to designate your children or a more remote descendant as the final recipient of some of the funds. This is accomplished by setting up a "bypass trust" in your Last Will and Testament, sometimes referred to as an "exemption trust".

The Bypass Trust

- Is funded with the most amount of money possible from your estate that does not push it into being subject to federal estate tax (or the minimum amount possible if the tax cannot be totally avoided).
- The spouse may receive all of the income from the Trust during his or her lifetime.
- The spouse may also receive funds from the principal.
    - Subject to the Trustee's discretion. (Surviving spouse may be the Trustee).
        - If the spouse is the Trustee, any invasion of principal must be made for ascertainable reasons, such as health, maintenance, and/or support to avoid an inference of a general power of appointment.
    - When that second spouse dies, the Trust ends; the remaining money in the Trust goes to the residuary beneficiaries (usually the kids). This keeps the balance from being included in the second spouse's estate.

The money that does not go into the bypass trust goes into the "marital deduction" trust.

The Marital Deduction Trust

- Is funded only with money that properly qualifies for the marital deduction and results in a zero tax to the spouse.
- Is fully available to the surviving spouse for whatever he or she needs.
- Upon the second spouse's death, all remaining money is included in his or her estate.

This "splits up" the assets into two estates and takes advantage of both unified credits. Care must be taken to examine how assets are owned during the marriage. There may be instances where it is advantageous to change ownership of some assets to "even out" how much is left in each Estate so that full advantage of both unified credits obtained.