Tax Law Creates Estate Planning Opportunities

BY DAVID J. SCHILLER
Special to the Legal, PLW and WPL

Headlines tell us that estate taxes have been repealed. The fine print describes the sobering reality that estate taxes will remain through at least 2009 and if they then go away, they will be replaced with additional capital gains taxes.

Under the new tax law, the amount exempt from the federal estate tax increases from $675,000 this year to $1 million next year and gradually increases to $3.5 million in 2009.

In 2010, the estate tax disappears, only to magically reappear on Jan. 1, 2011.

Once it reappears, the law prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 again applies, so the exemption changes to $1 million, the way the exemption would have been had there been no change in the law.

Unless one can accurately predict their date of death, it is quite challenging counseling clients on whether to count on an increased exemption, no tax at all or the more modest exemption provided in the old law.

Our approach continues to rely upon planning as though death is more imminent, since one can later change their will as the exemption phase-in increases and we have a better idea of whether the elimination of the repeal of estate taxes will occur in 2011.

New regulations allow most people to slow down their required retirement plan distributions, which will likely result in greater amounts being held by retirement plans at the time of death.

We hope that the structure of the law sunsetting the tax exemption at the end of 2010 does not result in life support being discontinued for relatives prior to Jan. 1, 2011.

BY-PASS TRUST

In the past, it has been a common strategy to establish a by-pass trust so that each spouse can exempt $675,000 (the 2001 limit) from federal estate taxes resulting in the married couple exempting $1.35 millions dollars together for the benefit of their children.

Since estate tax laws preclude the spouse from having unlimited access to the amount in the by-pass trust, sometimes one spouse objects to only having limited access to these monies (which may make up a substantial portion of the estate) and it is necessary to convince a spouse to agree to limited access.

Since the exemption amount is $1 million

DAVID J. SCHILLER,
J.D., LLM (taxation)

He concentrates his practice in the estate planning and retirement plan fields for professionals.

starting Jan. 1, if a will was drafted with a formula approach, the amount that will automatically go into the by-pass will increase dramatically and the surviving spouse will therefore have only limited access to a much greater sum. Therefore, it is necessary for clients to make the difficult choice of intentionally limiting their access to a much greater sum, with the goal of saving their children additional estate taxes.

For the past 20 years, the exemption on large gifts has paralleled the estate tax exemption. For example, since the estate tax exemption in 2001 is $675,000, one can gift up to this amount without incurring gift taxes. Although the gift tax exemption will increase to $1 million in 2002, it does not thereafter increase. This change will have no bearing on one's ability to also gift $10,000 annually / $20,000 from a couple (increasing to $11,000 / $22,000 on Jan. 1) which is exempt from gift taxes.

Unlike when assets are passed to the next generation by gift, in the case of death, people have enjoyed a "stepped up basis" on capital assets such as stocks and real estate. This unlimited step up in basis has allowed one to avoid capital gains tax at death which would normally be calculated on the difference between "basis" (usually the acquisition cost for stock) and the fair market value at the date of death.

Instead, after 2009, beneficiaries must use the carryover basis of the decedent, which is the decedent's basis at death. Therefore, it is imperative that your clients maintain adequate lifetime records and track acquisition costs and other relevant data (for example, a stock split) that would affect basis per share.

If one lives past 2009, their executor and beneficiaries will need this information. After 2009, the beneficiary receives the asset with a basis equal to adjusted basis of the decedent or the fair market value of the asset, if less. Because of this special rule, if a client has substantial unrealized losses and death is imminent, they will forfeit those losses if they die with such assets and it therefore makes sense (after 2009) to dispose of such assets to offset taxes while alive.

There will be a new limited allowance for one to step up their basis by up to $1.3 million dollars (and an additional $3 million dollars for a surviving spouse).

EXECUTOR WILL DECIDE

After 2009, when these new rules apply, the executor of each estate will have the authority to determine how the basis step up is apportioned among the beneficiaries. As the drafter, it is important that you make sure the testator recognizes this issue so that the will can guide or require the executor on how to apportion the limited step up in basis.

The executor could be given discretion or could be compelled to follow a predetermined formula or approach. In any case, the step up in basis can increase the basis to no greater than the fair market value of each asset.

The executor will also be required to report the basis and the holding period (indicating date of acquisition) to the Internal Revenue Service so that the IRS can verify that appropriate capital gains taxes are paid by the beneficiaries of the estate.

For the past few years, upon the sale of one's principal residence, they could exclude the first $250,000 of gain ($500,000 if a married couple) so long as for two of t past five years the property has been th principal residence.

With the ending of the stepped up basis 2010, there will be a new exclusion fr income tax of gain from the sale of the pr cipal residence of a decedent, not requiri the use of the $1.3 million dollar exemptio described above. New regulations all most people to slow down their requir retirement plan distributions which will li ly result in greater amounts being held retirement plans at the time of death.

Although qualified plans and IRAs controlled by beneficiary designation for as they are not probate assets, the est planner must recognize that in addition the assets being included and taxed as part one's estate, they are also subject to inco taxes which are incurred by the beneficiar as funds are withdrawn.

Therefore, in planning, one must we this additional tax burden in determinin fair division of one's estate. For example child "A" received $500,000 from a reti ment plan and child "B" received $500,(in cash in a personal brokerage acco child "B" would have received the m valuable gift, since child "A's" inherita would be subject to income tax as it is wi drawn from the retirement plan. Particula because of the estate tax exemption amo increasing in January to $1 million, it ma sense to review each client's estate plann documents to be sure that they are up-to-d in light of the new tax laws. •