Estate Planning
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Legal Matters®

The federal estate tax is back in 2011

The federal estate tax is back – with a vengeance.

Barring some unexpected quick action from Congress, the tax is in effect as of January 1, 2011. And it affects far more people than it did over the past decade, because it now applies to all estates over $1 million (vs. $3.5 million back in 2009).

Plus, the tax rate has increased to 55%.

The estate tax is no longer a problem just for the rich. A huge swath of the middle class could now be affected if the value of their house, their retirement savings and their life insurance tops $1 million.

That makes it critically important to plan your estate – or re-evaluate your estate plan – if you haven't already done so.

Over the past year or so, some people have shied away from estate planning. The combination of the repeal of the tax in 2010 and the general uncertainty about the future of the tax has led many people to hold off planning until the situation was resolved.

But with a 55% tax now looming, anyone who might be subject to the tax needs to take steps quickly to protect their loved ones.

Many different estate tax proposals have been proposed in Congress, and a good plan needs to be flexible enough to protect you regardless of how the rules change.

But procrastination is no longer an option. The tax is here. And failure to plan around it now is a risk that no one who may be subject to the tax should be taking.

On the positive side, the current economic environment – with ultra-low interest rates and depressed valuations of real estate and businesses – is a great time to plan transferring assets to the next generation. There might never again in our lifetimes be so many opportunities to transfer wealth at a tax discount.

For instance:

• If the value of your house has declined, considering putting it into a "qualified personal residence trust" for your children. You can continue living in the house for a specific number of years, after which it will pass to your children (or other trust beneficiaries). The key is that you will have given the house to your children at its current, lower value for estate and gift tax purposes. If the house increases in value in the

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What many people don't realize is that if you own your life insurance policy, then the proceeds will be considered part of your taxable estate when you die.

Return of estate tax creates a danger for life insurance policies

With the federal estate tax now applying to estates as small as $1 million, many people need to take a second look at their life insurance policies.

Life insurance proceeds are not subject to income tax. But what many people don't realize is that if you own your life insurance policy, then the proceeds will be considered part of your estate when you die. If those proceeds – combined with your other assets – amount to more than $1 million, then your estate may be subject to estate taxes … at a whopping 55% rate!

If the beneficiary of your policy is your spouse (and your spouse is a U.S. citizen), then no estate tax will be due at the time of your death. However, the proceeds will now be part of your spouse's estate when he or she dies, and will be subject to estate taxes then.

A good solution is to transfer ownership of the policy. You could transfer ownership to your children, but it's usually better to put the policy into a trust. The advantage of a trust is that, when you die, the proceeds in the trust can be used to benefit your spouse during his or her lifetime if necessary, and when your spouse dies, the remaining proceeds can pass tax-free to your children or other heirs. In this way the bulk of the proceeds can go to your heirs without being taxed either as part of your estate *or* as part of your spouse's estate.

There are some complexities to life insurance trusts. For instance, if you transfer a policy to a trust and you die within three years, the tax benefits will be lost. (You can avoid this problem if you set up the trust first and have the trust buy the policy.)

Also, there are some notice and paperwork requirements each year in order to properly pay the premiums without jeopardizing the tax advantages. But for many people, the huge tax savings and added control provided by a trust are worth it – especially with the new estate tax rules in 2011.

There may be better alternatives to charitable gifts in your will

Many people include charitable gifts in their will. Not only do they want to help certain charities, but doing so can reduce estate taxes.

But suppose that at some point, it becomes clear that your estate will likely incur little or no estate tax. You might consider removing all or part of such a bequest from your will, and instead making a gift while you're still alive. Doing so could give you a large income tax deduction, while having no effect on your estate tax – leaving more assets for your heirs.

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You might also want to amend your will and your power-of-attorney document so that if you become unable to manage your affairs, your agent can "pre-pay" a charitable bequest while you're still alive in order to save taxes in this way.

Most power-of-attorney documents allow an agent to make gifts. But allowing an agent to make gifts is different from allowing an agent to pre-pay a bequest, so you might want to check your estate planning documents to see if they specifically allow this.

Here's a variation on this idea. Suppose that in your later years your children's income is considerably larger than yours. If you're planning to make a charitable gift in your will, but it won't save much in estate taxes, you might be better off leaving the money to your children with the understanding that they will use it to make the same charitable donation. That way, the charity will still get the gift, but your children will also get a valuable income tax deduction. (Of course, you have to be able to trust that your heirs will actually make the gift, and not just keep the money!)

Be careful with joint property and 'payable on death' accounts

If you intend to leave your children equal shares of your estate, don't forget to consider any money or property held jointly with a child. If you have recently added a child to a bank account, own property jointly with one of your children, or have set up a payable-on-death account with a child as the beneficiary, you might want to revise your will, or at least reconsider how the asset is titled.

Here's why: Property in a joint account passes outside of your estate. If you add a child to one of your bank accounts, perhaps as a convenience because the child is helping to manage your finances, the account will pass to that child alone when you die. This is true for any property held in joint tenancy, or any property in a payable-on-death account.

If your will says that your estate will be divided equally between your children, then only your *other* property will be divided equally between them. The child named on the joint account will get all that money or property alone.

If you don't intend for that child to receive a bigger share of your estate, you can add a provision in your estate planning documents stating that any property passing to a beneficiary through joint ownership will be treated as an advance on that beneficiary's share. In that way, all your children will be treated equally (assuming you have enough assets in addition to the joint property to equalize the shares).

In some states, there's an additional problem with "payable on death" accounts, which has to do with who pays the estate tax.

Consider the case of James Sheppard, a Wisconsin man who died in 2007, leaving an estate of about $12 million. Among Sheppard's chief assets were two accounts totaling $3.8 million, which were set up so they were "payable on death" to his goddaughter Jessica. After Sheppard died, Jessica received the money.

The $3.8 million in the accounts was counted as part of Sheppard's estate for purposes of calculating his estate tax. Since the tax was considerable, Sheppard's executor asked Jessica to contribute her "fair share" toward paying the tax. But Jessica refused.

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A lawsuit resulted, which went all the way to the Wisconsin Supreme Court.

The result? Jessica won, and didn't have to contribute a penny toward the estate tax.

In general, the executor of an estate is supposed to pay all the taxes out of the probate assets. Since the "payable on death" accounts were outside of probate, they couldn't be tapped to pay the taxes.

Now, there are some exceptions to this rule. For instance, in some cases an executor can recoup money to pay estate taxes from a spouse who inherited non-probate assets, or from the beneficiary of a life insurance policy. But Jessica didn't fall into any of these categories.

Also, some states have their own rules saying that people who receive certain non-probate assets have to contribute to estate taxes. But Wisconsin doesn't have such a rule, and the court refused to create one.

So in the end, Sheppard's other heirs bore a disproportionate share of the tax burden … which might not have been what Sheppard intended.

The bottom line is that you should always let your estate planner know any time you add someone as a joint owner of an asset or you add a transfer-on-death provision to an account. Otherwise, even though you divided your assets "fairly" in your will, the actual result might be very different from what you intended.

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The federal estate tax makes a return in 2011

The renewed estate tax, plus many planning options that result from low interest rates and asset valuations, make this a great time to transfer wealth.

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coming years, that increase in value won't be subject to taxes. In addition, you can further lower the taxable value of the house by the subtracting the value of your right to live there for a number of years.

• You can also sell your house to a "grantor trust" in return for a promissory note, and then rent it from the trust for as long as you like. This has many similar tax advantages.

• If you're nearing retirement and the value of your family business is temporarily depressed, consider selling it to a family trust in return for an annuity. If it's done properly, the sale will be considered a fair trade and it won't trigger gift taxes. You'll get a steady stream of revenue for life, funded by the business operations. And when you die, no estate taxes will be owed on the value of the business. If the value of the business is temporarily depressed, you'll have a lot more flexibility now to set lower annuity payments, which will allow more assets to pass to your heirs without taxes.

• Make a long-term loan to your children. With interest rates at historic lows, you can lend money to children at extremely low interest rates without the IRS considering the loan to be a gift that is subject to taxes. If your children can use the money to invest or to start a business, you'll have helped them out tax-free.

• Even better, make a long-term loan to a trust for your children. If you loan money to a grantor trust for their benefit, the interest payments on the loan will not be considered taxable income, and you can pay the income taxes on the trust's investments, thus shifting more money to your children.

• If the value of your investments has been reduced, now might be a great time to get some of them out of your estate for tax purposes. One way to do this is to put investment assets into a trust that will pay you an annuity for a term of years, after which the assets will go to the children. This avoids any tax on the appreciation of the assets over the term of years, *plus* you can get a further tax break based on the value of the annuity. The amount of this tax break depends on an IRS interest rate – the lower the interest rate, the bigger the tax savings. And with interest rates at record lows, this can be a great time to use this technique.

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