

Chapter 8

DEATH AND TAXES

Ever since Caesar Augustus imposed an estate levy to pay for imperial Roman exploits, death and taxes have walked hand in bony hand.

This chapter discusses some of the issues everyone, no matter how wealthy, ought to know about death and taxes. Going beyond that presents a dilemma for this chapter. Tax planning is the core of much estate law, but it is most important to people with substantial assets—at least \$800,000 or \$900,000—which might appreciate to at least \$1 million, the current estate tax threshold. (This threshold will rise gradually; see below.) Even if you aren't rich and don't expect to become so, this chapter provides a very brief discussion of the basic tax-reduction methods for estates. Then, if your estate grows or the law changes, you'll know what to talk to your lawyer about.

Passing an estate at death may also have income tax consequences, and this chapter discusses these briefly.

The federal estate tax: general principles

Your estate isn't liable for federal estate taxation unless it exceeds the available exemption amount. This is the value of assets that each person may pass on to beneficiaries without paying federal estate tax. The Economic Growth and Tax Relief Act of 2001 provides for a gradual increase in the exemption. It is now \$1 million; in the year 2004 it will go up to \$1.5 million, and then to \$2 million in 2006. In addition, you can pass your entire estate, without any estate taxes, to your spouse. (This is referred to as the **unlimited marital deduction**.) If you simply leave your estate to your spouse and

don't create an appropriate trust to take advantage of your \$1 million exemption, your spouse's estate will pay taxes on this sum when he or she dies.

To decide what the property in your estate is worth, the IRS does not look at what you paid for it, but generally uses the fair market value of property you own at your death--or, if there is a tax that is payable by reason of your death and the total value six months from date of death is lower, your executor may elect to use that alternate valuation. In many cases--especially if you've owned your home for many years--the appreciation in value of large assets could put you over the limit. For appraisal purposes, the government uses the face value of insurance policies in your name, including most group policies from work or professional organizations, but only cash value on someone else's life if you die before it has matured.

To the extent your estate exceeds the available exemption, the federal estate tax rates start at 37 percent. The assets subject to tax at death may include the family home, the family farm, life insurance, household furnishings, benefits under employee benefit plans, and other items that produce no lifetime income. In short, you may be richer than you think. If your estate is likely to exceed the threshold, however, good estate planning can sharply reduce the amount of money that goes to the government instead of to your beneficiaries.

Although the federal estate tax misses most people, it hits the rest hard: it is at least at 37% and may be as high as 50%. So if you are in jeopardy of exceeding the threshold, be sure to perform an asset inventory as suggested in the appendix, and then see your lawyer if you need tax planning.

Tax laws frequently change. Unfortunately, most people do not review their estate plans regularly. In light of the 2001 Act, you must check your estate planning documents to ensure that they still effectively shelter your estate tax exemption. If your will or living trust specifies a dollar amount, it will have to be revised. Have other specific aspects of your plan reviewed to assure that it is still effective.

Sidebar

JOINTLY OWNED PROPERTY AND THE FEDERAL ESTATE TAX

In valuing jointly owned property, the IRS generally divides all **joint tenancy** property held by spouses equally between them, no matter who paid for it; so your estate will be credited with half the value of the family home, even if your wife paid for the whole thing. (In the ten community property states, married couples hold most property jointly by law.)

If you are well-off, holding all of your property in joint tenancy with your spouse may waste one of the two \$1 million **federal estate tax exemptions** each couple currently holds. (See above.)

Furthermore, in most cases, property you own in joint tenancy with right of survivorship with someone other than your spouse may be taxed on the basis of its total value, not just your share of it. For example, if you co-own a \$90,000 house with your sister, all \$90,000 may be considered part of your estate when you die, unless your executor can demonstrate that your sister paid a portion of the purchase price and any improvements. For this reason, many lawyers urge clients to avoid owning too much property in joint tenancy.

If you co-own property as a **tenant in common**, in contrast, your estate is only liable for tax on the percentage of ownership you had in the property: If you owned 25% of a \$100,000 house, the government would add \$25,000 to the value of your estate.

There is a way to convert jointly held property into two trusts that can combine many of the benefits of joint tenancy with the tax advantages of a trust. **Joint tenancy undisclosed trustee titleholding**, as it is known, is too complex to go into here, but you might ask your lawyer about it,

especially if you have a large estate. (end sidebar)

State taxes on estates and inheritances

The federal estate tax rules apply to everyone in America. Some states also impose various taxes that effect estates or inheritances. Some states charge an additional estate tax similar to the national one, and some impose an inheritance tax. (**Inheritance taxes** are charged to beneficiaries, **estate taxes** to a person's estate.) Some states impose a separate gift tax, on top of the federal gift tax. (**Gift taxes** are imposed upon gifts made above a certain amount; see below.) What's taxed and at what rate depends on the law of the state you live in for intangible personal property, whenever located, and of the state in which it is located for real estate and tangible personal property. Some states have only a "pick-up" tax, which is equal to the maximum credit the Internal Revenue Code allows to the taxpayer for state inheritance taxes.

Unless your state has an inheritance tax, your beneficiaries don't pay tax when they receive money from your estate. But they will have to pay income tax on any earnings after they invest the bequest.

Capital Gains Taxes

Death itself produces a large amount of extraordinary expenditures for taxes, expenses of administering the estate, and frequently the forced early payment of outstanding debts. To obtain the cash for such payments, sales of assets are frequently made, and if the sale is for more than the date-of-death value, it may trigger a capital gains tax at the time of sale. The asset selected for sale is critical, as the tax may be deferred or accelerated depending on present or future anticipated tax brackets.

Employee Benefits

Payments under company-deferred compensation and pension plans produce a bewildering array of possible choices (lump sum, installments, etc.), with differing income and estate tax results. The federal estate tax may not apply to some employer-provided annuities or death benefits paid to your beneficiaries. Social Security payments to your dependents are not subject to federal estate tax.

Proceeds from pensions and benefit plans generally pass directly to whomever is named as a beneficiary in those plans. If, however, the proceeds are payable to the deceased's estate, they are part of the gross estate for estate tax purposes. You need to ask your lawyer or accountant about the possible tax consequences of your particular plan.

Taxes on Insurance Benefits

Many states impose an inheritance or estate tax on insurance proceeds payable to the estate, and may also do so if insurance proceeds are payable to a named beneficiary, including the trustee of either a living trust or a trust created by a will, as long as the decedent owned this policy or held incidents of ownership (see below). (The proceeds of an insurance policy paid to a named beneficiary are exempt from all federal income taxes, and almost all state income taxes except to the extent that they include interest.)

You can save on estate taxes by transferring ownership of your life insurance policy to a trust that meets certain requirements. This means the value of the proceeds won't be included in your estate.

However, you must follow strict requirements:

- The life insurance trust must be irrevocable ([see chapter 4](#)).
- You cannot retain any kind of ownership (**incidents of ownership**), such as-making decisions

about the policy, or name yourself trustee.

- You must transfer the ownership at least three years before you die; otherwise, the proceeds will be taxed as part of your estate. The three-year rule doesn't apply if you were never the owner of the policy; for example, you could originally take out the policy in the name of the trust or of your spouse.

Income Tax Planning

An estate and a trust each constitutes a separate taxpayer for income tax purposes (with exceptions for living trusts--see [chapter 5](#)), and this offers a broad range of tax-planning options. For example, the timing of paying estate expenses and making distributions have critical tax implications. Moreover, there are income tax options for series E and H savings bonds, the filing of a joint return with the surviving spouse, the deduction of medical expenses, and highly sophisticated techniques for timing of distributions to beneficiaries.

Expenses of administration may be used as either an income tax deduction on taxes owed by the estate or estate tax deduction (but not both). In the last year of the estate, such expenses can even be handled so as to be deductible directly or indirectly from the tax return of the individual beneficiaries.

This means that your survivors may have to make some tough calls about how and when to take certain deductions or make certain tax payments after you die. It's a good idea to plan ahead for competent financial and legal advice.

Selection of a legal and tax adviser after death is only half the battle, though, for no adviser can help if the family member in charge (whether an executor, surviving spouse, trustee, etc.) lacks the powers and discretion to make the proper tax choices. Most states give the necessary authority by statute, unless the person making the will provides otherwise, but none covers all possible conflict-of-

interest questions. Furthermore, no state statutes cover the need for specific will clauses governing distribution of family home, car, furnishings, and the like. If you don't put such information in your will or trust, your beneficiaries may suffer unexpected income tax consequences after your estate assets are eventually distributed.

If you don't specify otherwise in your will, many states that have a death tax force the executor of your will to charge each person who receives anything from your estate a portion of the taxes on the estate. Other states provide that death taxes will be taken out of the residue of your estate.

Tax Planning If You Know You're Dying

This may sound morbid, but if you know you're going to die soon, you may be able to give more to your survivors by manipulating your income today. For example, you might choose to take capital losses while you're still alive, which, because of tax law treatment at death, can save your survivors money at tax time.

You can also make your annual, tax-deductible IRA contribution sooner than usual and give charities the gifts you'd planned to leave in your will, removing those assets from your estate and also giving you an income tax deduction, which won't matter to you after you're gone but will leave more money in the estate for your beneficiaries. (You can make such gifts even if you're incapacitated as long as you had the foresight to include such giving powers under a power of attorney.) If you do make such gifts, ask the recipient to give you a receipt, (as required under a 1993 law for any gift of \$250 or more to charity). This will help your executor show that the gift satisfies the bequest that was going to be made in the will (if that was your intention); it will avoid confusion at probate time.

You could also make charitable gifts in your will. These, too, would reduce the value of your estate and so reduce taxes.

Of course, if you're able, you'll also want to consider quickly implementing some of the other tax saving devices mentioned in this chapter, like interspousal transfers and annual tax-free gifts. But consider doing all this planning *now*, instead of on your deathbed, when you'll have other, more eternal concerns to occupy you.

Sidebar

REFUSING BEQUESTS

Don't laugh--to reduce taxes or for other reasons, sometimes your beneficiaries may not want their bequests. For example, if you go bankrupt, then your father dies, your creditors may be entitled to first shot at the assets he leaves to you. You might want to give up the gift so that it will go to your children instead of your creditors. Or you may receive property that's subject to liens and mortgages greater than its market value.

Most states permit you to **disclaim** (i.e., renounce or refuse) the inheritance or benefit. The Internal Revenue Code describes how a beneficiary may disclaim an interest in an estate for estate tax purposes. State law also defines how to disclaim for purposes of state death taxes; usually the two standards are the same. The beneficiary typically has to disclaim all the gift and must do so within nine months of becoming eligible for it.

Once you disclaim a gift, the law generally acts as if you died before the testator so far as the gift is concerned. If the will or trust provides that should you die before the decedent, your share will go to your children, the children will take it if you disclaim the gift. You should see a lawyer if you intend to disclaim any gift. (end sidebar)

Tax Planning for Larger Estates

As your assets approach the available exemption amount, you need to consider a number of tax issues in your estate planning over and above those discussed earlier in this chapter. You assuredly need a lawyer's help in this complex matter; here we very briefly discuss a few options.

Any estate whose gross, not net, assets exceed the available exemption amount must file an estate tax return, even if deductions and other tax-avoidance methods mean the estate ultimately owes no tax. If the estate does owe a tax, and nothing in the will specifies which assets will be used to pay it, state law will usually charge the taxes to the beneficiaries on a proportional basis; in other words, the more you inherit from an estate, the more of the estate tax you have to pay out of the assets you inherit. Or state law may take taxes first from the residuary estate. Most people, however, specify in their wills certain funds to be used specifically to pay taxes; the tax is due in cash nine months from the date of death.

On the other hand, no asset received from a deceased individual is subject to income taxes on receipt. Once received, however, all income generated by that asset is subject to income tax on the tax return of the beneficiary. So your daughter who inherited your MTV stock wouldn't pay tax on the gift itself, but would pay tax on any income earned.

* **Bypass trusts.** The best way to minimize estate taxes is to use trusts. One of the most common of these is the **credit shelter trust**, also called the **exemption trust**. This trust is one of the primary estate-planning tools. It employs one of the main provisions of federal estate tax law, the **unified credit**, which gives each person a \$1 million total exemption from estate and gift taxation. It's called a bypass trust because as much as \$1 million bypasses the surviving spouse's taxable estate and goes directly to a trust that ultimately benefits the children, grandchildren, or other beneficiaries when the

second spouse dies.

Here's how it works. Assumed that a husband dies survived by his wife and several children. The adjusted gross estate (his estate after deducting funeral expenses, expenses of administration, and claims) totals \$2 million. His will (or trust) creates a marital trust or gift of \$1 million for his wife; the remaining \$1 million goes into a family trust. If a gift is left to her in trust, the income of both trusts are payable to her for as long as she lives. She also is entitled to the principal of the family trust under an ascertainable standard of living, and she can have special power of appointment and act as trustee. On her death, her estate and the trust go to the children.

This arrangement minimizes or eliminates federal estate taxes. On the husband's death, his estate owes no estate taxes. Because unlimited property can be passed to a spouse without being taxed, the gift to his spouse is exempt for federal taxes when he dies. It is added to his wife's taxable estate, but then her available exemption kicks in, so no taxes will be owed on her death if her taxable estate is not larger than the available exemption amount. The family trust utilizes the husband's exemption as a credit shelter trust on his estate, but is not included in the wife's adjusted gross estate on her death.

* **Spousal trusts.** If you and your spouse's combined estate exceeds \$2 million under current law, a bypass trust alone won't be enough to avoid the estate tax. In such cases, you have several options. But most attorneys would probably recommend that you next use a **spousal or marital deduction trust** (in addition to the bypass trust) to help you take full advantage of the second major estate tax planning device, the marital deduction. Spousal trusts are only available to married couples.

One of the most basic tax-planning devices is the unlimited **marital deduction**. It allows one spouse to pass his or her entire estate, regardless of size, to the other--and not pay federal estate taxes. No matter how large the estate, no taxes are due where it is passed to the spouse. If you only cared about leaving your property to your spouse, that would end your tax worries. Most people, however,

want to leave property to their families at the death of the second spouse--and this is where tax planning pays off. Special rules apply to qualify for the marital trust if the spouse is not a U.S. citizen.

Using the marital deduction properly, usually in conjunction with a tax-saving trust (as explained below), you should be able to transfer at least \$2 million free of estate taxes to your children or other beneficiaries no matter which spouse dies first or who accumulated the wealth.

There are two commonly used spousal trusts.

* **Power of appointment trust.** This is structured so that one spouse gives a trustee property to be held for the benefit of the other spouse, providing the other spouse with the use of the principal and all the income. At the death of the donor, the surviving spouse receives a **general power of appointment** which permits her to determine where the property should go after her death--to the children, charity, other beneficiaries, etc. Like all trusts, it avoids probate. It will generally qualify for the marital deduction and thus escape taxation at the first spouse's death. The only major problem with a power of appointment trust is that it gives your surviving spouse total discretion over what happens to your money after you die.

* **OTIP trusts.** People who are afraid of giving up so much control to the spouse often turn to the second principal spousal trust. A **qualified terminable interest property--QTIP--trust** is a spousal trust that doesn't grant the spouse a power of appointment. It's especially favored for people who want to make sure their children aren't slighted if their surviving spouse remarries or has her own children or other beneficiaries whom she prefers.

There are many other tax-saving trusts, among them **generation-skipping trusts** (sometimes known as **wealth trusts**). Trusts generally benefit your children, but you can keep saving taxes and provide for your descendants for several generations after your death using a generation-skipping trust. Such a trust is quite versatile, allowing your family to use the money for college costs, medical expenses,

large purchases such as homes, and general support. And it avoids or limits estate taxes on the estates of your children.

In a generation-skipping trust, instead of distributing all the money in the trust to beneficiaries upon your death, you can use your federal exemption to leave the available amount to future generations. This way, you can keep at least some of your assets out of the hands of children who might squander it or lose it in a divorce. If you put more than that the tax-exempt amount in a generation-skipping trust it is subject to taxation, but it can grow tax-free to more than \$1 million through investments and interest. Generally, you use more than one trustee: an adult child and a lawyer or trust company to provide continuity.

Giving it away--while you're still alive

Trusts are the devices of choice for minimizing taxes on estates of up to \$1 million or a single person or \$2 million for a couple.. The most common way to avoid taxes on estates larger than these amounts is to use lifetime gifts. The law allows you to give up to \$11,000 worth of assets per recipient to as many people as you wish each year (married donors giving a gift as a couple are allowed a \$22,000 per recipient per year gift tax exclusion.) This is called an **annual exclusion** in IRS-speak. You can also make tax-free, direct payments of tuition and medical expenses beyond the \$11,000 limit. There is no gift tax on any gifts made between spouses in any amount, nor on gifts to charitable organizations. You can use such lifetime gifts to reduce your estate to the tax-exempt level.

The gift tax marital deduction. Similar to the estate tax marital deduction, this lets spouses (who are both U.S. residents) transfer an unlimited amount of money to each other any time without gift tax concerns of any kind. Your lawyer can use these tax-free gifts to shift ownership of property between you and your spouse so that each spouse may make full use of his or her unified credit.

Gift-giving with trusts. The drawback to lifetime gifts is that you lose control of the money. Even assuming you leave yourself enough to live on comfortably, the beneficiary (usually a child) may not be responsible enough to handle that kind of money wisely. There are a couple of options to avoid this total loss of control. The first is to use life insurance; see below. The second method of retaining some control over your gift is to give the money via a trust.

Charitable gifts. Any gift to an approved charity you make during your lifetime, or bequeath at your death, is exempt from federal (and almost all state) gift taxes. And the value of any bequests to charity is subtracted from the value of your estate when the federal estate tax is computed, meaning you can reduce those taxes by giving gifts to charity. There are many ways to help a good cause and help yourself at the same time. You can give to a charity stock that has appreciated in value, for example, and that way, your estate won't have to pay the taxes on the increased value of the stock.

A **split gift** is typically where the grantor has retained some interest either for himself or for his beneficiaries and given the other interest away either to his beneficiaries or charity. Be aware, though, that such gifts may be taxed to your estate because you have retained an interest. Consult your lawyer.

Charitable remainder trust. This mechanism is typically used by older people whose estates exceed \$1 million and include appreciated assets, such as real estate or securities. You donate the assets to the trust, live off the income from the assets for the rest of your life, and then the trust principal goes to the charity you choose on your death (or on the death of your spouse if it's set up in both your names and he or she dies last). You avoid estate taxes and capital gains taxes, while helping a charitable cause.

Remember also that taxes aren't the only factor in estate planning. Be careful not to give away too much money or too many assets that you might need for emergencies, living expenses after you retire, or even some late-in-life fun.

Using life insurance to avoid taxes

Most people don't like to think much about life insurance because it involves two unpleasanties: dealing with insurance companies and thinking about their own deaths. But life insurance makes a great tax-saving gift because it's valued for tax purposes not at what the proceeds will be when you die, but at the cash value of what you've paid in--a far smaller amount. And the beneficiary doesn't pay income tax on the proceeds either. You can also use life insurance to help your charitable giving.

Many people think life insurance proceeds aren't taxable. Wrong! Life insurance proceeds don't count for income tax purposes, but proceeds paid to anyone other than your spouse or a charity do count toward your estate for estate tax purposes, if you are both the insured person and the owner of the policy. And though the proceeds of a life insurance policy paid to, say, your spouse won't be taxed when you die (because of the marital deduction), the money augments her estate, so that when she dies it may exceed the exemption threshold. To escape estate taxes, you must see that the policy is not owned by your estate. There are two common ways to do this:

Third party owners. In the first method, you take out a policy on your life that benefits your children or other beneficiaries.

Next--this is the critical move--you place ownership of the policy not in your name, but in your beneficiaries' names--usually your children. You can then give them the money each year to pay the premiums, making sure to keep your total gift to each person below \$11,000 per year to avoid the gift tax. As long as you live more than three years after transferring ownership, the policy is out of your estate.

Life insurance trusts are a popular way of accomplishing the same goals. Here's how it works. A married couple has a combined taxable estate of over \$2 million after using other tax-avoidance

devices. They set up a life insurance trust in which the trust owns the policy on their lives--they do not. They can do this with an existing policy (by transferring ownership to the trust) or a new one. Each year, the husband buys \$10,000 worth of premiums in the policy. When he dies, the policy pays off \$400,000--none of it taxable as a part of his gross estate--to the trust. The wife lives off the income from the trust. When she dies, the children, take the principal remaining--again, tax-free.

Life insurance trusts are only one example of using irrevocable trusts to create a tax-free estate. While life insurance can be one of the investments in that trust, it is not the only investment that can grow in that manner. The cash assets in the irrevocable trust can then be used to buy assets from the estate, providing the estate with cash to pay taxes.

Federal Exemptions Growing

YEAR	EXEMPTION
2002/3	\$1 million
2004/5	\$1.5 million
2006/7/8	\$2 million
2009	\$3.5 million

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