

## Estate Tax Boomerang

By Deborah L. Jacobs

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*The federal estate tax is coming back, while some state levies never went away. Act now to protect your family's assets.*



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**Family first:** Sara and Joshua Mancell want their assets to go to son Eli, not Uncle Sam.

Like many couples in their 30s, Sara and Joshua Mancell didn't even have wills before they became parents. But early this year, a few months before their son Eli's first birthday, the Minneapolis couple finally tackled this essential task. As a first priority, should the unthinkable happen, they needed to pick a guardian for Eli and a trustee to manage the money left to him. But with a net worth nearing \$1.4 million, Sara, a Westinghouse engineer, and Joshua, an Ameriprise investment advisor, also had to take steps to reduce potential state and federal estate taxes that could cut into the resources left for Eli.

The federal estate tax lapsed on Jan. 1, 2010. But under current law, it will rise from the ashes on Jan. 1, 2011, and at that point--unless Congress intervenes--only \$1 million per estate will be exempt from a stiff 55% tax. That compares with a \$3.5 million exemption and a 45% rate in 2009.

The prospect of a \$1 million exemption means many more families need to plan for the federal tax. Tally up the value of a house, life insurance (if you are foolish enough to die owning it yourself), retirement and other accounts, and you may be surprised to find yours is one of them. "It's amazing to me that you can go from not having a problem to potentially having a problem that quickly," says Joshua Mancell.

Assets left to a citizen spouse or to charity generally aren't subject to either state or federal estate tax. But leaving assets to other beneficiaries will now take significantly more planning, says Ann Burns, a lawyer with Gray Plant Mooty in Minneapolis. Moreover, even if Congress returns the federal exemption to \$3.5 million (as President Obama is on record as favoring), 19 states and the District of Columbia impose their own estate and/or inheritance taxes, some at far lower levels. Minnesota, for example, exempts only \$1 million per estate from its tax, which starts at 41% and goes down to 9% as an estate's size increases--a highly unusual system.

Regardless of your age or where you live, here are simple steps to help preserve your assets for your family.

**Review life insurance policy ownership.** "Don't die owning life insurance," says Joshua S. Rubenstein, a lawyer with Katten Muchin Rosenman in New York. "It's like giving away money." While life insurance proceeds aren't subject to income tax, money from insurance a decedent owned is subject to estate tax if not left to a citizen spouse or charity. Yet with a little planning, insurance can be moved beyond the reach of the tax. The easiest way: make the family member who will receive the insurance proceeds (say, an adult child) owner of the policy.

As owner, your child must pay the premiums. But you can give the beneficiary the money to do this using the yearly \$13,000 gift tax exclusion--anyone can give anyone else up to that amount every year without worrying about estate or gift taxes. If the beneficiary is a minor or you don't want him or her to receive the proceeds outright, you can set up an irrevocable life insurance trust to own the policy. With this setup, too, you can make annual gifts to finance the premiums, but it's a little trickier. One condition for the \$13,000 annual gift exclusion is that the gift must be a present interest--meaning something the recipient can use right away--rather than a future one. The most common way to satisfy this requirement is to give beneficiaries (or their parents, if the beneficiaries are minors) what's known as Crummey powers--the right for a limited time, usually 30 or 60 days, to withdraw from the trust the yearly gift.

The Mancells have set up his and her trusts to hold their insurance policies, with a death benefit of \$1.5 million apiece. Sara Mancell's sister is the trustee, and Eli and any other children the couple might have are the beneficiaries. This arrangement removes the insurance proceeds from their estates.

**Put some assets in your own name.** Couples in a stable first marriage generally set up estate plans designed to make use of the estate tax exemption of the first spouse to die, without leaving the surviving spouse short of funds. So, for example, the Mancells have left everything to each other. But for maximum flexibility they have also created a family trust benefiting Eli and any other children they might have. When one spouse dies, the survivor, depending on the couple's net worth and the federal and state estate tax laws at the time, can disclaim (or turn down) some assets, funneling them into this trust to make use of the deceased spouse's estate tax exemption. If need be, the survivor can still receive income or principal from the trust, but whatever remains in it bypasses the survivor's estate.

The problem is that for this to work each spouse must have some property in his or her own name--otherwise there won't be assets available to fund the bypass trust. Jointly held property (for example, real estate or bank accounts) doesn't count because when one owner dies, full ownership automatically passes to the other. So do what the Mancells did: Look over your balance sheet to determine whether any property should be transferred from one spouse to the other or out of joint ownership into the name of one of you individually. Unfortunately, this strategy doesn't work for retirement accounts; you can't give them away while you are alive. Another consideration: If you shift assets to a spouse who is not a U.S. citizen, you may have to pay gift tax.

**Maximize annual gifts.** If you are confident you'll have enough for your own retirement, start making annual gifts. Remember, you can give up to \$13,000 a year to as many recipients as you like; spouses can combine their exclusions to give \$26,000 jointly to any person. If you want to give away more than that, you can count your gift against your \$1 million lifetime gift tax exemption--the total of taxable gifts each person can make without incurring tax. (Each dollar of gift exemption used reduces your estate tax exemption by a dollar.)

Although cash is the most common type of gift, you can transfer assets, too. For gift tax purposes you count the value of the asset at the time of the transfer. Any appreciation after that is not subject to estate or gift tax. You may want to give appreciated stock, if the recipient can sell it at a lower capital gains rate than you would pay. But don't transfer stock with a built-in loss--the recipient's basis will be the current market value. Instead, sell the stock, book the tax loss yourself and give the cash.

**Fund college savings plans.** A popular use of the annual exclusion is to fund a Section 529 state college savings plan for each family member you want to benefit. Earnings in a 529 are exempt from federal and state income tax, provided the money is withdrawn to pay tuition or certain college or graduate school expenses. The law permits lump-sum deposits of as much as \$65,000 a person (\$130,000 for married couples), provided you file a gift tax return that treats the gift as if it had been spread over five years. If you die before the five years is up, however, part of the gift goes back into your estate.

While 529s are often thought of as an estate planning tool for grandparents, they can work for parents, too. Young parents can each establish a 529 with the child as the beneficiary, use annual exclusion gifts to fund it and name the other parent as the successor owner of the account. Should one spouse die prematurely, the surviving spouse has control of the money as successor owner--and can tap the money if he or she needs it (although any earnings that are withdrawn for purposes other than college are subject to income tax and a 10% penalty). If the survivor doesn't touch the money, it won't be counted as part of either spouse's estate, Rubenstein says.

**Pay tuition and medical expenses.** Without eating into your \$13,000 annual exclusion, you can pay tuition, dental and medical expenses for anyone you want--provided you pay the providers of those services directly. This rule allows you to pick up big-ticket health care expenses, including health insurance premiums, orthodontia, medically necessary home improvements or home-care attendants.

**Convert to a Roth IRA.** In a conversion you declare a traditional individual retirement account or 401(k) taxable, pay any income taxes on pretax contributions and earnings (preferably from funds outside the retirement account) and hold the funds in a Roth, where all future growth is tax free. With a Roth you avoid the requirement to take yearly minimum distributions starting at age 70<sup>1</sup>/<sub>2</sub>, which can leave more for beneficiaries if you don't need to use the money for your own retirement. What's in the Roth IRA still counts in your estate and is subject to estate tax, assuming your estate is big enough to be taxable. But the taxes you prepay at conversion reduce the size of your estate, and your heirs get an income-tax-free pot of money that they can husband and stretch out over their own life spans.

**Deborah L. Jacobs**, a lawyer and journalist, is the author of *Estate Planning Smarts: A Practical, User-Friendly, Action-Oriented Guide* (DJWorking Unlimited, 2009). To learn more, visit [estateplanningsmarts.com](http://estateplanningsmarts.com).