Estate planning: important changes in tax law

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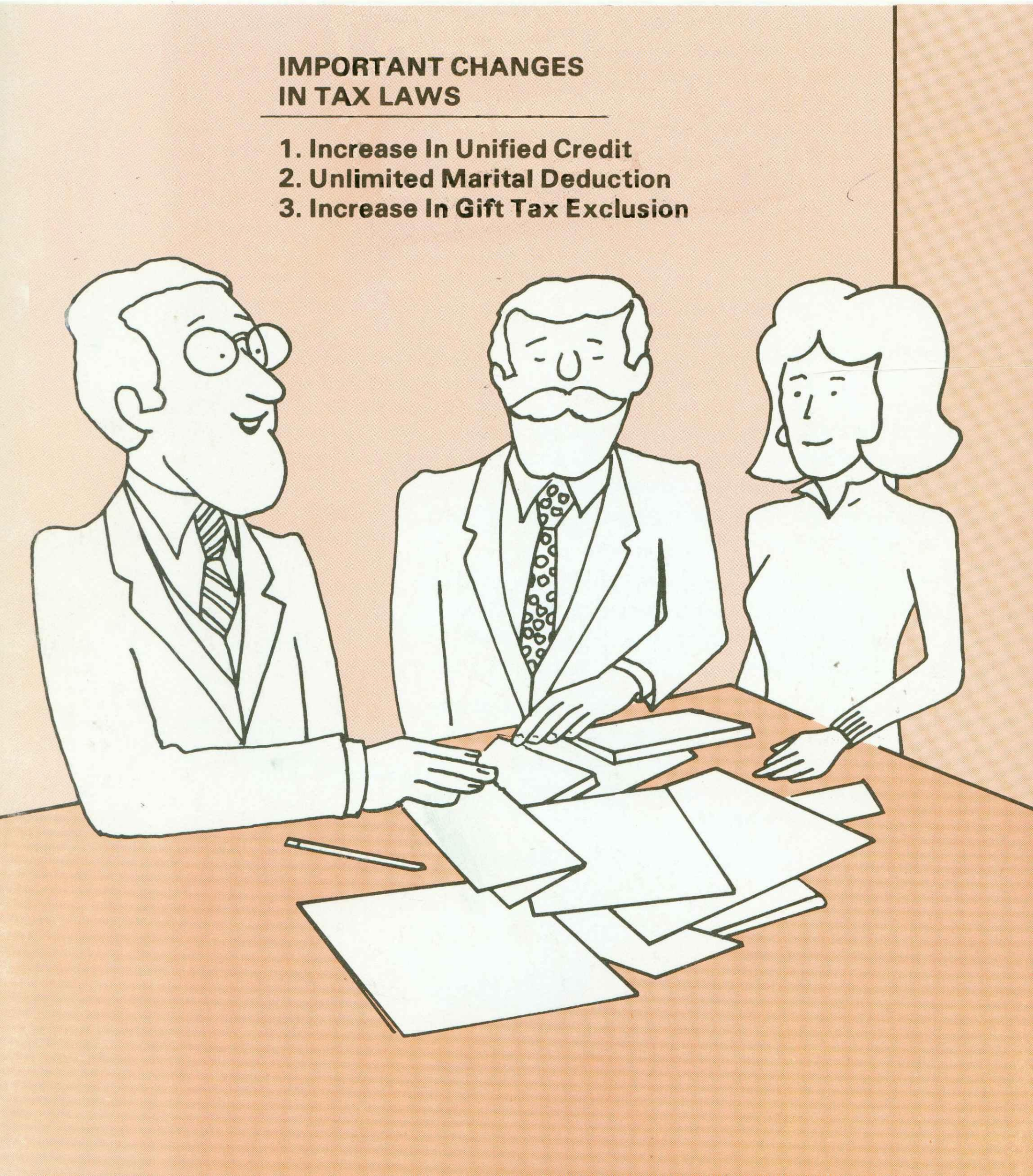
USA

Estate Planning



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Estate Planning

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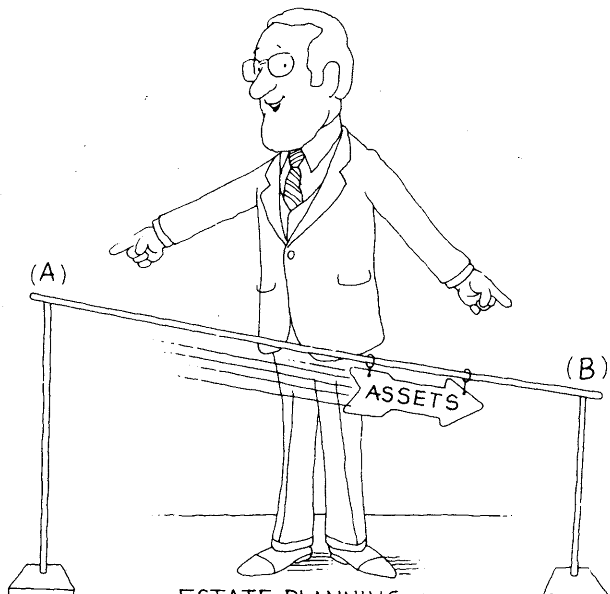
Introduction

Estate planning is a concept that is greatly misunderstood by many people. In simple terms it may be defined as lifetime planning for the passage of assets in accordance with the estate owner's wishes and at the least possible tax cost.

You already have an estate plan, even if you have done nothing. If you have done nothing, the problems with your plan are:

1. Assets will probably not pass according to your wishes.
2. The federal government and your state of domicile will be major beneficiaries of your estate.

By neglecting to make a will, you have left your estate planning to your state government, and additional adverse results may occur. First, a local court will have to appoint an administrator to manage your estate. This person, possibly a stranger to you, will have to be paid. Second, even if your surviving spouse is named administrator, a bond will generally be required. Third, the amount of time required to settle your estate will be unnecessarily long. Fourth, part of your estate may pass to the governments in the form of avoidable taxes. Clearly, one imperative of estate planning is—don't die without a will.

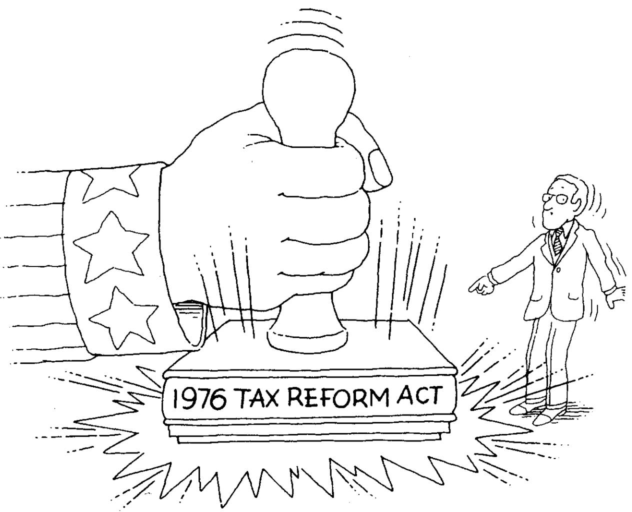


ESTATE PLANNING

Recent Estate and Gift Tax Legislation

In the span of five years, Congress has passed two major pieces of legislation dealing with estate and gift taxation.

The Tax Reform Act of 1976. You have probably read or heard about the dramatic impact on estate planning of the Tax Reform Act of 1976 (the 1976 Act) and subsequent technical corrections. The 1976 Act contained a major restructuring of the taxation of gifts and estates, most of the changes becoming effective January 1, 1977.



The 1976 Act brought relief to small and medium-size estates, increasing significantly the number of estates in this country that passed to beneficiaries free of any federal tax burden. At the same time, larger estates were subject to an increased tax liability.

The advantages of certain traditional estate planning techniques were substantially reduced or diminished. Gifts and estates are now subject to a unified tax which is based upon cumulative lifetime and testamentary transfers. Generation- skipping techniques are discouraged by subjecting such transfers to taxation.

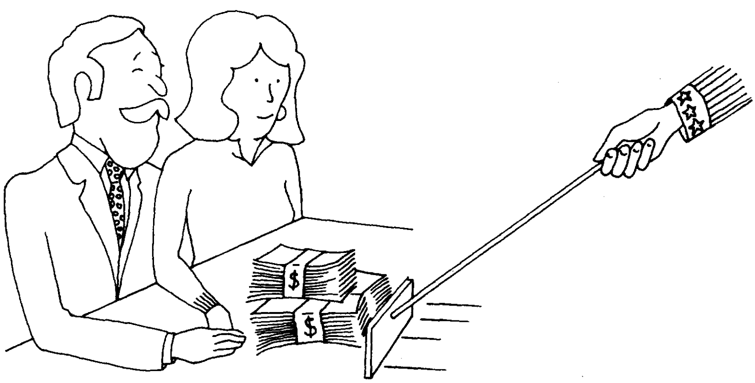
As a result of this major legislation, many estate plans in existence before 1977 were changed to reflect its impact.

Perhaps the most far-reaching and most publicized provision in the 1976 Act was the introduction of carryover basis. Briefly stated, under the carryover basis concept, property would no longer get a step-up in value for income tax purposes to its value at death. Rather, the basis of the property in the hands of the heir would generally be the same as the basis of the property in the hands of the decedent, with certain transitional adjustments. This concept caused dramatic changes in many estate planning techniques.

As originally enacted, carryover basis was to become law on January 1, 1977. It was subsequently retroactively postponed until January 1, 1980. Finally, in 1980 carryover basis was retroactively repealed to January 1, 1977. Thus, carryover basis never was in effect. (There was a special election for it to apply for decedents dying in 1977 and 1978.)

The Economic Recovery Tax Act of 1981. The Economic Recovery Tax Act of 1981 (the 1981 Act) provides for larger exemptions from the unified gift and estate tax, which will generally result in a smaller amount of tax or no tax at all on the large majority of estates. This has been accomplished by gradually increasing the unified gift and estate tax credit so that it will eventually shelter $600,000 of gifts or bequests. At the same time, the maximum gift and estate tax rate will be gradually reduced from 70 percent to 50 percent, thereby lowering taxes in the larger estates.

The 1981 Act has also dramatically changed the area of marital deduction planning by introducing an "unlimited" gift and estate tax marital deduction. In addition, certain "qualified terminable interest property" will be eligible for the marital deduction.



The 1981 Act provides further liberalizations in regard to jointly held property, installment payment of estate taxes, transfers made within three years of death, and the annual gift tax exclusion. All of these changes will be discussed in appropriate sections of this booklet.

It is apparent that the 1981 Act has provided all of us with new opportunities to realize significant gift and estate tax savings. However, Congress has not done the planning for us. Therefore, it is now more important than ever to review existing wills and estate planning strategies to make sure these new opportunities are utilized to the fullest extent.

How the Taxes Are Computed

The unified transfer tax (commonly referred to as either gift tax or estate tax) is an excise tax imposed on the transfer of property by gift or at death and, since 1976, on certain generation-skipping transfers. The tax is similar to the income tax in that one must determine what is includable and what is deductible. The tax is imposed at graduated rates and is subject to certain credits.

Includable Items. Almost everything you own is subject to tax at your death. Certain property given away during your lifetime may be subject to tax if you retained certain powers over the property. Under prior law, most gifts made within three years of death were included in the estate at the fair market value at date of death. The 1981 Act has now provided that gifts made within three years of death (with the exception of life insurance and a few other items) are not required to be so included.

Deductible Items. Your debts at death, funeral expenses, expenses in administering your estate (such as executor, legal, and accounting fees), certain medical expenses, certain losses, charitable contributions and the marital deduction are deductible from your gross estate.

Credits. The 1981 Act provides for an increase in the unified gift and estate tax credit as follows:

Year of Death	*Unified Credit*	*Size of Estate Exempt from Tax*
1981	$ 47,000	$175,625
1982	62,800	225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987 and thereafter	192,800	600,000

If some of your assets were inherited within ten years, there is a credit for some portion of tax paid on that property at the time you inherited it. There are also credits for certain state and foreign death taxes and federal gift taxes.

1982 Rates

Amount Subject to Tax	*Amount of Tax*	*Rate on Excess (%)**
$ -0-	$ -0-	18
10,000	1,800	20
20,000	3,800	22
40,000	8,200	24
60,000	13,000	26
80,000	18,200	28
100,000	23,800	30
150,000	38,800	32
250,000	70,800	34
500,000	155,800	37
750,000	248,300	39
1,000,000	345,800	41
1,250,000	448,300	43
1,500,000	555,800	45
2,000,000	780,800	49
2,500,000	1,025,800	53
3,000,000	1,290,800	57
3,500,000	1,575,800	61
4,000,000	1,880,800	65

* Without state death tax credit.

In addition, the 1981 Act reduces the maximum unified estate and gift tax rate as follows:

For Decedents Dying and Gifts Made in	*The Maximum Rate Will Be*
1983	60% for transfers in excess of $3,500,000
1984	55% for transfers in excess of $3,000,000
1985 & after	50% for transfers in excess of $2,500,000

It is important to note that, although the maximum unified estate and gift tax rate is being reduced to 50 percent, the tax brackets are not indexed for inflation (as are the individual income tax brackets after 1984). Therefore, the impact of inflation continues to be a very important estate planning consideration.

For example, if we assume an annual inflation rate of 10%, the following table reflects the present value as of January 1, 1982 of the new equivalent exemption:

Year of Death or Gift	*Amount of Credit*	*Equivalent Exemption*	*Approximate Present Value as of 1/1/82 of Equivalent Exemption at 10%*
1982	$ 62,800	$225,000	$225,000
1983	79,300	275,000	250,000
1984	96,300	325,000	268,600
1985	121,800	400,000	300,500
1986	155,800	500,000	341,500
1987 & thereafter	192,800	600,000	372,600

Example

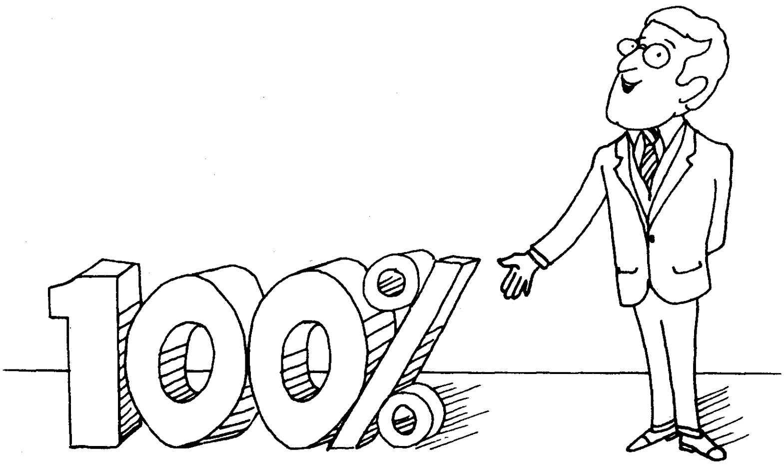
Mr. Brown dies in 1982 leaving assets and liabilities as shown below. His will specified that $5,000 be given to his church and that one-half of his adjusted gross estate be given to his wife.

Assets		
Car	$ 5,000	
House	180,000	
Stock	400,000	
Life insurance	200,000	
Checking account	4,000	
Total assets		$789,000
Deductions		
Mortgage	50,000	
Credit cards	1,000	
Funeral expenses	3,000	
Executor fees	4,000	
Legal fees	6,000	
Total	64,000	
Contributions	5,000	
Marital deduction	362,500	
Total deductions		431,500
Taxable estate		$357,500
Tax on first	$250,000 is	$ 70,800
Tax on excess is 34% of	107,500 is	36,550
Total	$357,500	107,350
Less:		
Unified credit (1982)		62,800*
Estate tax before other credits		$ 44,550

* The unified credit will be phased in to reach a maximum of $192,800 in 1987.

The Marital Deduction

One of the most basic estate planning techniques is proper utilization of the marital deduction. Under prior law, the marital deduction was limited to the greater of one-half of the adjusted gross estate or $250,000. The 1981 Act has eliminated this limitation effective January 1, 1982. Therefore, a deduction is allowed for the full value of qualifying property passing to one's spouse.



100% MARITAL DEDUCTION

Many existing wills and trusts include maximum marital deduction formula clauses that determine the amount of property to be transferred to the surviving spouse by reference to the maximum allowable marital deduction. As stated above, under prior law the maximum estate tax marital deduction was limited to the greater of $250,000 or one-half of the adjusted gross estate. Some individuals may not want any greater amount to pass to their surviving spouses. However, if the new unlimited marital deduction is used in the computation under a formula clause, the amount passing to the surviving spouse might be much larger.

Therefore, the 1981 Act contains a transitional rule which provides that the new unlimited marital deduction will not apply to transfers under a will executed or a trust created on or before September 12, 1981 that contains a formula marital deduction clause. The transitional rule applies provided that (1) the decedent dies after 1981, (2) the formula clause is not amended at anytime after September 12, 1981 and before the death of the decedent to refer specifically to the unlimited marital deduction, and (3) there is no state law that would construe the formula clause as referring to the unlimited marital deduction. Even where a testator wants to have the limited current rule apply, it would be advisable to redraft the marital deduction provisions of the will to avoid the possibility of state law changing the desired result.

Qualifying Property

What if your spouse is a poor financial manager or has no knowledge of investments? A marital deduction is available even if the property passes to a trust, managed by an experienced trustee, as long as the trust assets will be included in your spouse's estate at death and your spouse has the right to receive annual or more frequent income distributions of the entire income. For example, a local bank trust officer could invest the trust assets and distribute investment income monthly, and your spouse would have the right to determine who would ultimately receive the trust's assets.

The 1981 Act also allows the gift or estate tax marital deduction for the value of "qualified terminable interest property" if the donor or decedent's executor so elects. Qualified terminable interest property is property passing from the decedent to a spouse who is entitled to all income from the property (or a portion thereof) for life, payable at least annually. This income interest is known as a "qualified income interest" under the Act. No person, including the spouse, can have the power to appoint any part of the property subject to the qualified income interest to any person other than the spouse during the spouse's life.

This new provision should solve the dilemma faced by many testators who have second spouses. Under prior law, in such a situation, the testator would have to give his spouse the right to dispose of, as she saw fit, any property which would qualify for the marital deduction. Thus, it was possible that certain of his property could be diverted away from his heirs. Now, with the adoption of this new provision, he may leave her only an income interest in the property, with the principal going to his heirs at her death, and still allow his estate to avail itself of the marital deduction.

If this election is made, the property will be subject to transfer tax at the earlier of (1) the date on which the spouse disposes of all or part of the qualifying income interest (by gift, sale or other disposition), or (2) the date of the spouse's death.

The "Optimum" Marital Deduction

Since the marital deduction is unlimited, a bequest of all property to one's surviving spouse will completely defer federal estate taxes until her subsequent death.

However, in certain instances, utilization of the maximum marital deduction may actually result in a higher overall estate tax. This is because estate taxes are like income taxes in that higher marginal rates are charged as the estate's size increases. Utilization of the maximum marital deduction has the effect of lumping all of the assets into the estate of the second spouse to die. Therefore, it may be better to utilize only the amount of marital deduction which will reduce the overall estate tax through bracket equalization and efficient use of each spouse's unified credit.

Example

Bill Jones dies in 1987 survived by his wife and three children. His will provides that his wife is to receive everything. His estate is worth $1,200,000 ($1,300,000 in assets less a $50,000 debt and $50,000 in administrative expenses).

Gross estate		$1,300,000
Less:		
Debts	$ 50,000	
Administrative expenses	50,000	100,000
Adjusted gross estate		1,200,000
Marital deduction (unlimited)		1,200,000
Taxable estate		$ -0-

Upon Mrs. Jones' subsequent death, the estate tax on the property inherited from Mr. Jones is computed as follows:

Property inherited from Mr. Jones	$1,200,000
Estate tax before credits	$ 427,800
Unified credit (1987 and after)	192,800
Estate tax before other credits	$ 235,000

Thus, total taxes on the $1,200,000 amount to $235,000.

If Mr. Jones had left only one-half of his assets to his wife, there would have been no estate tax due at the death of either spouse because of the ability of each spouse to "shelter" up to $600,000 in assets (for years 1987 and after) through the use of their respective unified credits.

For estates with assets worth more than double the equivalent exemption (e.g., $1,200,000 beginning in 1987), the decision whether to use more than a 50% marital deduction depends upon a number of factors, including:

- the age of the surviving spouse
- the size of the survivor's estate
- liquidity of the decedent's estate
- potential financial needs of the survivor
- potential appreciation in value of the assets owned by the decedent
- financial needs of the heirs other than the surviving spouse.

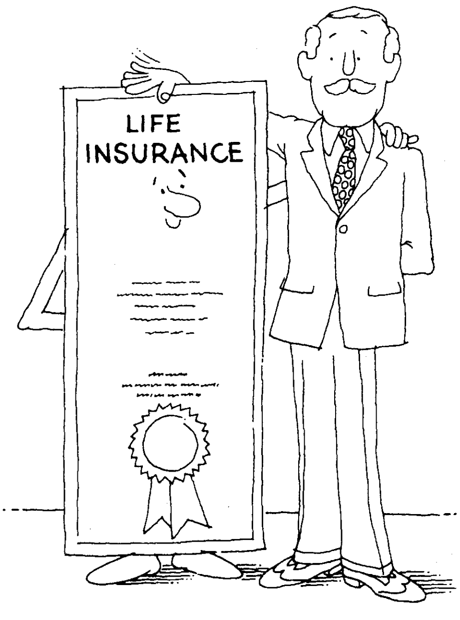
It appears that most married individuals will choose to utilize the unlimited marital deduction to eliminate all estate taxes upon the death of the first spouse to die. That is, all property in excess of the equivalent exemptioh will be left to the surviving spouse either outright or in a qualifying trust. The primary benefit of such a plan, of course, is to provide the survivor with the use of funds which otherwise would have been paid by the decedent's estate in the form of U.S. estate taxes.

In order to provide additional planning flexibility, the decedent's will may also give the spouse *or* his/her executor the right to disclaim the bequest in whole or in part. This will allow the survivor to consider all important factors and to adjust the size of the marital deduction bequest, if necessary.

Life Insurance

Life insurance proceeds are a large portion of many estates. Typically, when life insurance is acquired, the husband is listed as the owner of the policy and the wife as the beneficiary. Under these circumstances, the life insurance proceeds will be included in the husband's gross estate and taxed accordingly.

Of course, the best way to avoid estate taxes is to keep valuable property out of the estate. Under prior law, it was generally recommended in many smaller estates that the decedent's spouse own *all rights* in the decedent's life insurance. This was best accomplished by making the spouse owner as well as beneficiary of the policy at its inception. Later, it could be done by assigning all rights to the policy to the surviving spouse by executing an appropriate form which the insurance company supplies. (This also applied to group term insurance carried by many employers.) Failure to assign all rights, even incidental or insignificant ones, would result in *all* of the proceeds being included in the gross estate. It was and still is important to make such assignments early, since gifts of life insurance policies that occur within three years of death will be included in the decedent's gross estate.



The introduction of the unlimited marital deduction has eliminated the tax savings available under prior law for gifts of life insurance to one's spouse. This is true because simply naming one's spouse as beneficiary results in 100 percent of the proceeds qualifying for the marital deduction. Thus, it would seem that current planning techniques suggest the use of an irrevocable life insurance trust (discussed below) for the married couple. Where the insured is single, an outright gift of the life insurance policy to the beneficiary continues to be an attractive estate planning alternative.

Example 1

Suppose that Sam Smith dies in 1987, and his estate includes $200,000 in life insurance, $800,000 in other assets, a $50,000 debt, and $50,000 in administrative expenses. His son inherits everything:

Gross estate		$1,000,000
Less:		
Debts	$ 50,000	
Administrative expenses	50,000	100,000
Adjusted gross estate		900,000
Marital deduction		-0-
Taxable estate		$ 900,000
Estate tax before credits		$ 306,800

If the son were the owner of the policy:

Gross estate		$ 800,000
Less:		
Debts	$ 50,000	
Administrative expenses	50,000	100,000
Adjusted gross estate		700,000
Marital deduction		-0-
Taxable estate		$ 700,000
Estate taxes before credits		$ 229,800

The potential tax saving is $77,000 ($306,800 – $229,800).

For the married couple, significant savings may be obtained by assigning the life insurance to an irrevocable trust for the benefit of the surviving spouse and the insured's other heirs. Typically, the terms of such a trust are:

1. The surviving spouse receives income for life. Upon his or her death, the trust terminates and distributes its assets to the surviving heirs.
2. The trustee has the power to invade principal for the benefit of the surviving spouse.

Example 2

Assume that Joe Jackson dies in 1987 and his estate includes $400,000 in life insurance, $1,400,000 in other assets, debts of $75,000, and $20,000 in administrative expenses. His will provides for marital and residual trusts, with one-half of his adjusted gross estate funding the marital trust.

Gross estate		$1,800,000
Less:		
Debts	$ 75,000	
Administrative expenses	20,000	95,000
Adjusted gross estate		1,705,000
Marital deduction		852,500
Taxable estate		$ 852,500
Estate tax before credits		$ 288,275

If he had assigned his life insurance to an irrevocable trust with the terms set forth above, his taxable estate and taxes would be as follows:

Gross estate		1,400,000
Less:		
Debts	75,000	
Administrative expenses	20,000	95,000
Adjusted gross estate		1,305,000
Marital deduction		652,500
Taxable estate		$ 652,500
Estate tax before credits		$ 212,225

The potential tax saving is $76,050 ($288,275 - $212,225) at the husband's death and another $76,050 at the wife's death—a total savings of $152,100.

Further, this saving can be accomplished without any real economic detriment to the surviving spouse, since she not only has the right to receive the income from the proceeds for life but also has, in the trustee's discretion, the ability to reach the proceeds, if necessary.

Such a transfer in trust raises problems with respect to the payment of future premiums. These problems require careful analysis and planning to avoid related income and gift tax implications.

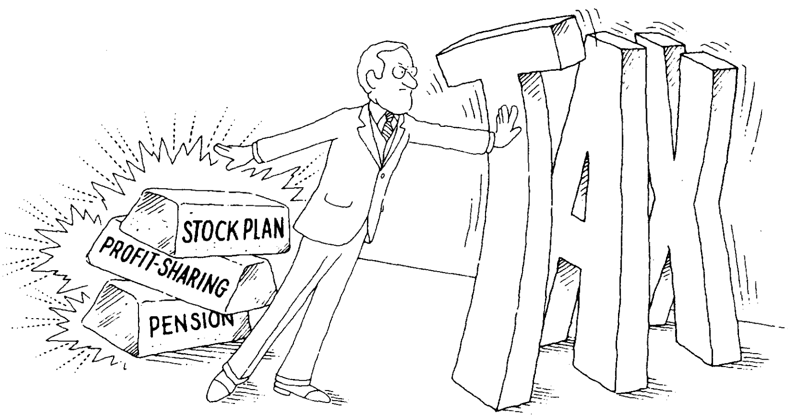
Normally, the transfer of ownership of a group term life insurance policy will not produce a gift tax liability, but any policy having a cash surrender value may create gift tax problems. One may borrow the cash surrender value before the transfer or simply pay the gift tax, if any (see the discussion of gift taxes below).

Pension, Profit-Sharing or Stock Plans

Annuities from qualified pension, profit-sharing or stock plans that are part of an employee's gross estate are excludable except to the extent of the employee's contribution to the plan. However, if an employee's beneficiary of such a plan receives a lump-sum distribution that is eligible for special ten-year averaging, the distribution will be excludable from the estate only if the beneficiary irrevocably agrees not to use the special income tax averaging provision. The higher unified credit and the new lower tax rates, coupled with the unlimited marital deduction, will in many cases make the decision to elect the ten-year averaging provision much easier, since the effect of including the lump-sum distribution in the estate should be lessened or eliminated. In many cases, though, the possible trade-offs between estate taxes and income taxes in this kind of situation will be quite complex and will require a careful analysis.

If one disregards the income tax effects, the benefits of making one of the heirs the beneficiary of any pension, profit-sharing or stock plan would be the same as those of transferring the ownership of a life insurance policy (see the example on life insurance above). Note that this is not a change of ownership; rather, it is a designation of any beneficiary other than the estate.

For many executives, if their life insurance and retirement plans are not included in their gross estates, no tax liability will remain after the marital deduction and the unified credit.



Example

Assume Bob White has the following assets and liabilities and that his will provides for the standard optimal marital and residual trusts:

Life insurance		$ 300,000
Qualified pension plan benefits (payable as an annuity)		200,000
Other assets		1,200,000
Total assets		1,700,000
Less:		
Debts	$50,000	
Administrative expenses	20,000	70,000
Net assets		$1,630,000

If White assigns the life insurance to an irrevocable trust as described in the preceding section and names his wife as the beneficiary of the annuity under the qualified plan, his taxable estate in 1987 will be computed as follows:

Other assets		$1,200,000
Less:		
Debts	$50,000	
Administrative expenses	20,000	70,000
Adjusted gross estate		1,130,000
Optimum marital deduction		530,000
Taxable estate		$ 600,000
Estate tax before credit		$ 192,800
Unified credit		192,800
Estate tax before other credits		$ -0-

In this case, the maximum allowable marital deduction would be $1,130,000. However, from a tax viewpoint, the taxable estate of the first spouse to die should not be reduced below $600,000, the amount necessary to absorb the $192,800 unified credit available for years 1987 and after.

Lifetime Gifts

Another method of reducing an estate is through lifetime gifts. Under the 1981 Act, an individual can now give $10,000 per year in cash or any other property to any number of different people without incurring a gift tax liability. A married couple can jointly give $20,000 per year to different individuals. This is true even if one spouse owns all of the gift property. Sizable amounts of wealth can be transferred tax free by the early formulation and implementation of an estate plan that utilizes such gifts. Effective control of the sums transferred can be retained by making gifts to trusts managed by independent trustees who follow the written directions of the trust's creator. If the donor wishes to retain investment, administrative, or dispositive powers, extreme care must be exercised in drafting the trust instrument to prevent the gift from being pulled back into the estate at death. Such a program of giving, however, must be carefully reviewed because of other economic considerations.

Once the $10,000 per donee per year is exceeded, the "excess" may create a gift tax liability. Initially, no tax will actually be paid because of the unified credit. However, once the unified credit has been fully utilized (the credit will shelter $600,000 of lifetime gifts in 1987), an actual tax payment will be required.

Advantages. The two primary advantages of a gift are:

1. Any postgift appreciation is not subject to the transfer tax unless the gift is pulled back into the estate. For example, if property worth $10 is given and at death the property is worth $50, $40 escapes transfer taxes. (However, $40 in potential capital gain could have been avoided by having the asset included in the estate.)
2. Any gift taxes paid on gifts made more than three years before death will not be subject to estate tax. For example: a donor in the 50% transfer tax bracket has $1.50, which permits a gift of $1 and $.50 for taxes; if the $1.50 is in the donor's estate, the heirs will receive only 50% of the $1.50, or $.75, compared to the $1 gift. Thus, heirs may benefit by early transfers even when the maximum transfer tax is extracted.

Consider a typical estate planning situation in which a husband and wife have three children, each of whom is married and has two children. A gift of $20,000 per year ($10,000 from the husband, $10,000 from the wife; or all from the husband or wife, if gift splitting is elected) may be given to each child, grandchild, and son or daughter-in-law. Each year $240,000 could be removed from the parents' combined estates (more, if one considers that, if not given, the $240,000 would grow by the after tax interest until death, and, not infrequently, the children and grandchildren will have lower income tax rates than the parents).

It is important that a donor understand the effect of lifetime gifts on the computation of the estate tax which will be due at his death. As pointed out earlier, if you make a gift in excess of the allowable exclusions and deductions, you will generally have made an "adjusted taxable gift" which will be added back to your taxable estate. The computation of the gift tax and its impact on the computation of the estate tax are illustrated at the end of this booklet.

Disadvantages. There are three main disadvantages to making taxable gifts:

1. The donor loses the enjoyment of the gifted property.
2. The transfer tax will be paid early.
3. The donee's basis for determining gain or loss will be equal to the donor's cost plus a fraction of the gift taxes equal to the percentage of the gift that would be gain to the donor if sold, but not more than fair market value.

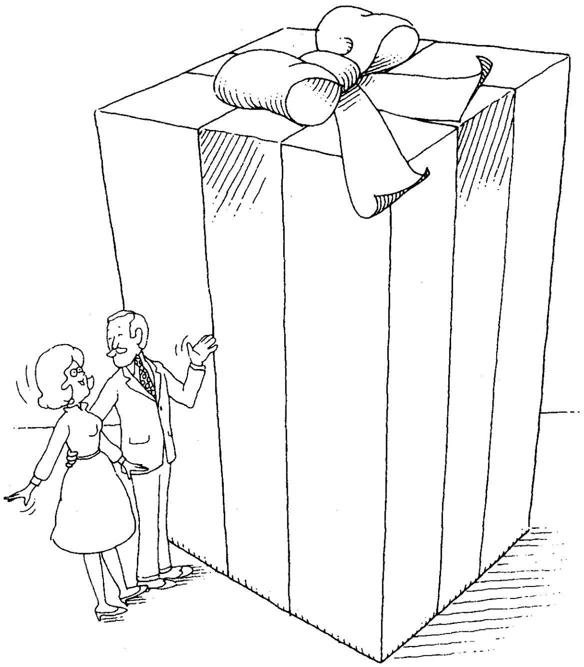
Assume that property worth $30, which cost the donor $10, is given and a gift tax of $3 is paid. The donee's basis will be $12, determined as follows:

Donor's basis	$10
Gift tax on appreciation element ($3 x 20/30)	2
Donee's basis	$12

Property that passes through an estate has a basis equal to the value used in computing the taxable estate, which is usually the fair market value of the property at the date of death. In general, if appreciated property is to be sold by the donee, it may be best to inherit the property rather than receive it as a gift, since a higher basis will reduce capital gain taxes.

Gifts to Spouse

Under prior law, the first $100,000 of gifts to your spouse was excludable in the determination of taxable gifts. This was after the old $3,000 annual exclusion, so that in the first year $103,000



could be transferred to one's spouse without tax. All of the second $100,000 of gifts was subject to tax. After $200,000, there was a 50 percent marital deduction, so only one-half of the gift was subject to tax. Where the amount of taxable gifts was less than $200,000, an adjustment of the minimum marital deduction for estate tax purposes was required. The effect of this adjustment was to give a combined deduction on gifts and estate transfers equal to the old estate limitation of $250,000 or 50 percent of the adjusted gross estate plus taxable gifts.

The 1981 Act provides for an unlimited gift tax marital deduction. Therefore, property may be transferred freely between spouses without incurring any federal gift tax liability. This provision presents a new planning opportunity by allowing spouses to equalize their potential estates through lifetime gifts without incurring gift taxes.

Jointly Held Property

Property is often held jointly without adequate thought as a means of avoiding the drafting of wills and the cost of probate, and, in some jurisdictions, to save state inheritance taxes. You should realize that all jointly held property passes to the surviving joint tenant by operation of law. Disposition is not governed by terms of your will. Thus, if too much property is held in joint names, adverse tax consequences could result.

Beginning in 1982, one-half of the value of property held jointly by spouses with right of survivorship will be included in the estate of the first spouse to die. This is a major change from prior law and could be either beneficial or detrimental to an estate plan. No change was made in the taxation of property held jointly with someone other than your spouse. This property continues to be taxed in the estate of the person who furnished the consideration for the property.

Example

A married couple owns a $250,000 home purchased years ago for a cost of $50,000 (all consideration furnished by the husband). The husband dies and one-half of the home's value ($125,000) is included in his estate which, because of the new unlimited marital deduction, owes no tax. Under the old law, if the home had been fully included in his estate, the wife would receive a $250,000 basis in the home. Under the new law, her basis will be $150,000. As long as the wife keeps the home until her death, the lower basis should not affect her. However, if she sells the home or gives it to her beneficiaries who eventually sell it, the lower basis could result in a significant income tax disadvantage.

Accordingly, if you presently hold a significant portion of your assets jointly with your spouse, it is important that you have your current estate plan reviewed.

Farms and Closely Held Businesses

The farm or closely held business may be a very valuable asset, causing a large amount of estate tax to be due. Often, however, there is very little cash available for the payment of this tax. The estate's assets usually consist of land, crops, and livestock, in the case of a farm; or buildings, receivables, and inventories, in the case of a business; and the owner has usually been unable to invest in other assets that would create liquidity for his estate.

The 1976 and the 1981 Acts expanded the provisions that provide relief for the owner of the farm or closely held business. The purpose of these provisions is to allow a family farm or business to be passed down through generations without the necessity of a partial sale to pay estate taxes.

Real Estate. Current law allows real estate used in a farm or closely held business to be valued on the basis of its current rather than its potential use. However, the benefits of this provision cannot reduce your gross estate by more than an amount equal to $700,000 in 1982 and $750,000 in 1983 and years thereafter.

If in 1983 your estate contains real property used in a farming operation or closely held business, and its "highest and best use" value is $2,500,000, while its farming or other current-use value is only $1,500,000, it would be valued for estate tax purposes at $1,750,000. The law provides complicated and difficult methods of valuing qualifying property on the basis of its current use.

The benefits of the special valuation may be limited, since there are strict qualifications for its use:

1. The value of the farm or closely held business must be at least 50 percent of your gross estate reduced by mortgages and indebtedness on property included in the gross estate. Both real and personal property may be counted for this test, even though only the real property qualifies for the special valuation.
2. The value of the real property must be at least 25 percent of your gross estate reduced by mortgages and indebtedness on property included in the gross estate. The "highest and best use" value may be used for both the 50 percent and the 25 percent tests.

3. The real property must pass to a qualified heir. This would include your spouse, your children, and close relatives.

4. The property must have been used for farming or in a business for five years out of a specified eight year period.

A further restriction on the benefits of the special valuation applies if the property is transferred to someone outside the family or if it is no longer used for farming or in a business within the next ten years. In either event, the benefits of the special valuation will have to be paid back.

Qualifications for use of the special valuation limit its availability, and its use may not always be advisable. Your property may not get a full step-up in basis to its fair market value at date of death if that value is higher than the special use valuation. The income tax savings of a basis increase may exceed the reduction in estate tax generated by the special valuation.

Extended Payment Period. The statute grants further relief to the estate with a liquidity problem caused by its ownership of a closely held business. This business interest can be in the form of a proprietorship, partnership or corporation, and any type of operating business or farm may qualify. There are certain requirements, however, regarding the estate's percentage of ownership of the business interest. There are also limitations on the number of stockholders of an incorporated business.

The 1981 Act consolidates the two provisions under prior law that provided for installment payments of estate taxes attributable to an interest in a closely held business. The new law provides that if the value of a closely held business interest exceeds 35 percent of the adjusted gross estate, the estate taxes attributable to that interest may be deferred for up to 14 years, with the estate making an annual interest payment for the first four years and thereafter paying the balance in up to ten annual installments of principal and interest. A special four percent interest rate on the first $1,000,000 of value of the business is applicable under this provision. However, if one-half or more of the business is disposed of, the payment schedule will be accelerated.

Generally, only property determined to be held at death may be used to qualify for the extension. Therefore, it is very important that you consider the composition of assets that will be held at death when formulating any lifetime gift or sale-of-assets programs. Gifts of your holdings of farm or other closely held business interests will reduce the percentage of your estate made up of that business. It may be better to give other assets and retain the business interests in order to meet the strict percentage requirements of the extension provision.

Stock Redemption. Current law also provides methods by which closely held stock passing from a decedent may be redeemed with capital gain treatment. Without these provisions, such a redemption might be considered a dividend, thereby resulting in ordinary income tax treatment.

In order to qualify, the closely held stock must exceed 35 percent of the adjusted gross estate. Two or more businesses may be combined to meet the 35 percent test, but additional requirements are imposed. It is important to remember that property disposed of before death should be carefully selected in order to allow your estate to pass the 35 percent test.

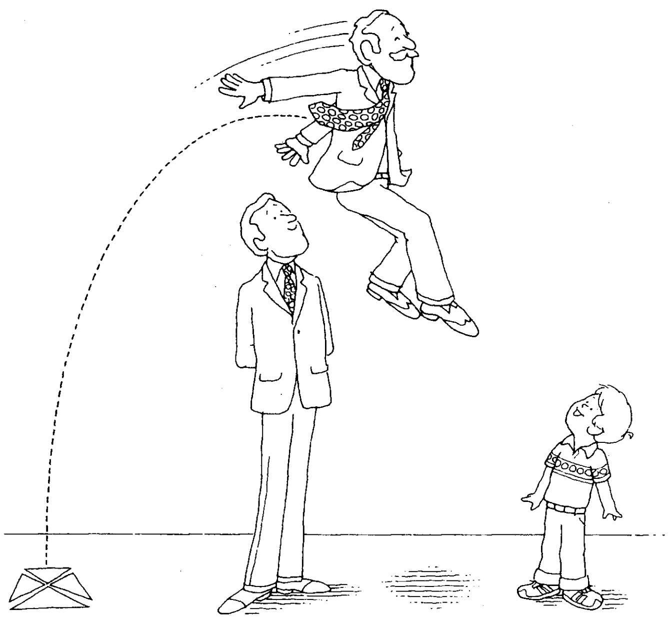
Another requirement is that the stock to be redeemed must be inherited by a beneficiary who shares in the taxes and debts of the estate. Therefore, most bequests of closely held stock qualifying for the marital deduction will not qualify for this redemption provision. Further, the closely held stock that can be redeemed is limited to an amount equal to the estate's taxes and funeral and administrative expenses.

The general rule is that the stock must be redeemed within approximately four years of the decedent's death. However, the redemption period may be extended to match the period over which the estate qualifies and elects to pay its taxes (the extension discussed above). If stock is redeemed at a pace faster than that of the required estate tax payments, the proceeds may have to be used to reduce the outstanding estate tax liability. Therefore, the redemption agreement should be carefully drafted to match the payout of estate taxes. This will provide both the estate and the corporation with maximum cash flow.

The owner of a farm or closely held business has unique estate planning problems. It is especially critical to plan the estate carefully, not only to avoid liquidity problems but also to prevent control of the business from passing into the wrong hands.

Generation-Skipping Transfers

Tax planners have often suggested the use of trusts and other devices to pass property down through several generations without any estate tax burden. For example, a father at his death would pass property to his son in trust; the son would be entitled to receive the income from the trust during his life; and upon his death the property would pass under the terms of the trust to the grandchildren. The obvious advantage of such a plan was in providing the economic benefit of the property to one generation without incurring any transfer tax upon passage to the next generation. The son would enjoy the income from the property without incurring any estate tax upon his death. Of course, plans have been formulated to allow avoidance of estate or gift taxes for several generations.



The Tax Reform Act of 1976 imposed a new tax and a new tax return requirement on such arrangements. The tax is essentially equivalent to the estate tax that would have been payable if the property had been passed outright from one generation to the next. The rules regarding this tax are extremely complex. It should be noted that this tax is not limited to trusts and is imposed on other generation-skipping methods (e.g., life estates).

There is an important exception, however. You may leave up to $250,000 per child in such a generation-skipping arrangement without having these provisions apply. For example, if you have two children, you are generally allowed a maximum of $500,000 in generation-skipping transfers to your grandchildren free of this tax. Also, outright bequests to your grandchildren or others are not subject to this tax.

These provisions are generally applicable to generation-skipping transfers made after June 11, 1976. However, there are several transitional rules that are extremely important for previously established transfer plans. The tax on generation-skipping transfers does not apply to trusts that were established and irrevocable as of June 11, 1976. This safe haven is not available, however, for additional funding of such trusts after June 11, 1976. Another exception applies to revocable trusts and wills that were in existence on June 11, 1976, but only if the grantor or testator dies before 1983. An additional requirement, which is especially important in future planning, is that such revocable trusts and wills may not be amended in any respect so as to result in the creation of, or an increase in the amount of, a generation-skipping transfer.

Pending Legislation. As this booklet goes to press, legislation is pending in the United States Senate to repeal or substantially revise these provisions. The pending legislation for repeal is supported by both the American Institute of Certified Public Accountants and the American Bar Association.

Community Property

Eight states utilize the community property system of determining the interest of a husband and wife in property acquired during marriage (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington). If you presently live in one of these states, or if you have previously lived in one of these states, you should be aware that some special rules apply to community property. Any property you may have acquired while living in one of these eight states is probably community property even today.

Under the community property system, the general rule is that all property acquired during the marriage is community property, owned one-half by each spouse. Property received by inheritance or gift, however, and property owned before marriage are separate property. Upon death, only the decedent's one-half of community property is taxed. *Both* halves of such property, however, receive a step-up in basis for income tax purposes. Thus, community property enjoys a significant advantage over jointly held property.

Under pre-1982 law, property which was or had ever been community property generally did not qualify for the marital deduction. Current law has removed these restrictions, so that both community and separate property qualify for the new unlimited marital deduction.

If a life insurance policy is community property, only one-half of the proceeds is taxable at death. If the beneficiary of the policy is someone other than the surviving spouse, however, the survivor will be deemed to have made a gift of one-half of the proceeds to that beneficiary.

If you and your spouse have lived in several states, one of which uses the community property system, it is especially important that you be able to characterize your property properly. You should try to keep the best possible records regarding the date and method of acquisition and the source of funds used.


"YOU MAY HAVE COMMUNITY PROPERTY IF YOU HAVE LIVED IN ANY OF THESE EIGHT STATES!"
WASHINGTON
IDAHO
NEVADA
CALIFORNIA
ARIZONA
NEW MEXICO
TEXAS
LOUISIANA

Computation of Gift Tax and Estate Tax

Taxable gifts in the current period are combined with all previous taxable gifts, and the tax is computed on the total. The tax on prior gifts (computed using the current rate schedules) is then subtracted, leaving the tax due on the current gifts. The unified credit, to the extent not previously used, is then applied against the tax to determine the amount currently payable.

The estate tax is computed by combining the taxable estate with taxable gifts made after 1976 and applying the current rate schedule to the total. The computed estate tax is then reduced by gift taxes paid on the post-1976 gifts and by the unified credit.

There are two very important points to note here. First, taxable gifts that you made before 1977 are taken into account in computing the tax on gifts after 1976. Such gifts are included in the cumulative total, thereby increasing the marginal tax rate applied to gifts after 1976. Pre-1977 gifts are not included, however, in computing the estate tax. Only taxable gifts after 1976 are included in determining the cumulative lifetime and testamentary transfers subject to estate tax.

To illustrate these computations, assume that in 1975 you made taxable gifts of $250,000. In 1982, you make additional taxable gifts of $250,000. Upon your death in 1987, your remaining property is worth $1,500,000.

1. Tax on 1982 gifts:

1975 gifts		$ 250,000
1982 gifts		250,000
Cumulative taxable gifts		$ 500,000
Gift tax (new rates)		$ 155,800
Less:		
Tax on prior gifts of $250,000 (new rates)	$ 70,800*	
Unified credit (1982)	62,800	133,600
Net gift tax payable		$ 22,200

* Disregard actual tax paid on pre-1977 gifts.

2. Estate tax:

Taxable estate		$1,500,000
Taxable gifts after 12/31/76		250,000
Amount subject to tax		$1,750,000
Estate tax (before credits)		$ 668,300
Less:		
Gift tax on post-1976 gifts	$ 22,200	
Unified credit (1987)	192,800	215,000
Net estate tax payable		$ 453,300

Conclusion

Estate planning, as you can see, is an important and highly complex procedure. It requires a great deal of thought by the property owner as well as by a skilled professional adviser. A certified public accountant is invaluable to your estate planning decisions and plan implementation and can assist your attorney as he drafts the necessary legal documents.

Estate planning *is* for everyone. Proper lifetime planning can assure the orderly transfer of the maximum amounts of assets to desired beneficiaries with the least possible depletion by taxes. It is the means by which an estate owner can preserve that for which he or she may so long have labored.

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