

UNDERSTANDING ESTATE TAXES

1. Who has to pay estate taxes?

Depending on how much you own when you die, your estate may have to pay estate taxes before your assets can be fully distributed. Estate taxes are different from, and in addition to, probate expenses (which can be avoided with a revocable living trust) and final income taxes (on income you receive in the year you die). Some states also have their own death/inheritance taxes.

Federal estate taxes are expensive--they now start at 41% and quickly go up, to 49% in 2003. And they must be paid in cash, usually within nine months after you die. Since few estates have this kind of cash, assets often have to be liquidated. But estate taxes can be substantially reduced or even eliminated--if you plan ahead.

Your estate will have to pay estate taxes if its net value when you die is more than the "exempt" amount set by Congress at that time. Here is the current schedule:

Year of Death..... "Exemption" Amount

2002 & 2003.....	\$1 million
2004 & 2005.....	\$1.5 million
2006, 2007 & 2008.....	\$2 million
2009.....	\$3.5 million
2010.....	N/A (repealed)
2011.....	\$1 million

In addition, family-owned businesses and farms that qualify can take a special deduction of up to \$675,000, making a total of up to \$1.3 million exempt from estate taxes. (This deduction will be eliminated in 2004.)

2. How is the net value of my estate determined?

To determine the current net value, add your assets, then subtract your debts. Include your home, business interests, bank accounts, investments, personal property, IRAs, retirement plans and death benefits from your life insurance.

3. How can I reduce or eliminate my estate taxes?

In the simplest terms, there are three ways:

1. If you are married, use both estate tax exemptions.
2. Remove assets from your estate before you die.
3. Buy life insurance to pay remaining estate taxes.

4. Using Both Exemptions

If your spouse is a U.S. citizen, you can leave him or her an unlimited amount when you die with no estate tax. But this can be a tax trap, because it wastes an exemption.

Let's say, for example, that Bob and Sue together have a net estate of \$2 million and they both die in 2003. Bob dies first. He leaves everything to Sue, so no estate taxes are due then. When Sue dies, her estate of \$2 million uses her \$1 million exemption. The tax bill on the remaining \$1 million? \$435,000!

But if, instead, Bob and Sue plan ahead, they can use both their exemptions and pay no estate taxes. A tax-planning provision in their living trust splits their \$2 million estate into two trusts of \$1 million each. When Bob dies, his trust uses his \$1 million exemption. When Sue dies, her trust uses her \$1 million exemption. This reduces their taxable estate to \$0, so the full \$2 million can go to their loved ones.

If you are married and qualify for the family business deduction, this arrangement will let you and your spouse leave your family up to \$2.6 million estate tax-free.

This planning can also be done in a will, but you would not avoid probate or enjoy the other benefits of a living trust.

5. Removing Assets From Your Estate

A great way to reduce estate taxes is to reduce the size of your estate before you die. So, spend some and enjoy it!

Also, you probably know whom you want to have your assets after you die. If you can afford it, why not give them some assets now and save estate taxes? It can be very satisfying to see the results of your gifts--something you can't do if you keep everything until you die. Appreciating assets are usually best to give, because the asset and future appreciation will be out of your estate.

Assets you give away keep your cost basis (what you paid), so the recipients may have to pay capital gains tax when they sell. But the top capital gains rate is only 15% (assets held at least 12 months). That's a lot less than estate taxes (41-49%) if you keep the assets until you die.

Some of the most commonly-used strategies to remove assets from estates are explained below. Note that these are all irrevocable, so you can't change your mind later.

6. Tax-Free Gifts

This is easy and it doesn't cost anything. Each year, you can give up to \$11,000 (\$22,000 if married) to as many people as you wish. So if you give \$11,000 to each of your two children and five grandchildren, you will reduce your estate by \$77,000 (7 x \$11,000) a year; \$154,000 if your spouse joins you. (This amount is now tied to inflation and may increase from year to year.)

You can give more, but it will use up some of your estate tax exemption. That's because it's a combined gift and estate tax exemption. While you're living, it's a gift tax exemption; after you die, it's an estate tax exemption.

Charitable gifts are unlimited. So are gifts for tuition and medical expenses if you give directly to the institution.

7. Irrevocable Life Insurance Trust (ILIT)

An easy way to remove life insurance from your estate is to make an ILIT the owner of the policies. As long as you live three years after the transfer, the death benefits will not be in your estate. Usually the ILIT is also beneficiary of the policy. So when you die, the money can provide for your spouse, children or others according to the instructions you put in the ILIT when you set it up.

8. Qualified Personal Residence Trust (QPRT)

A QPRT lets you save estate taxes by removing your home (a substantial asset) from your estate now; yet you can continue to live there. Here's how it works.

You transfer your home to a trust for a period of time, usually 10 to 15 years. During this time, you continue to live in your home. When the time is up, it transfers to the trust beneficiaries, usually your children. If you wish to stay there longer, you may make arrangements to pay rent. If you die before the trust ends, your home will be included in your estate, just as it would without a QPRT.

There's more. A QPRT "leverages" your estate tax exemption. Since your children will not receive the house until the trust ends, its value as a gift is reduced. For example, if the current value of your home is \$250,000 and you put it in a QPRT for 15 years, its value for tax purposes could be as little as \$75,000. That leaves much more of your exemption for other assets.

9. Grantor Retained Annuity Trust (GRAT) and Grantor Retained Unitrust (GRUT)

These are much like a QPRT. The main difference is that a GRAT or GRUT lets you transfer an income-producing asset (stock, real estate, business) to a trust for a set number of years, removing it from your estate, and still receive the income. (If the income is a set amount, the trust is called a GRAT. If the income fluctuates, it's called a GRUT.)

When the trust ends, the asset will go to the beneficiaries (usually your children). Since they will not receive it until then, the value of the gift is reduced. If you die before the trust ends, the asset will be in your estate.

10. Family Limited Partnership (FLP)

An FLP lets you reduce estate taxes by transferring assets like a family-owned business, farm, real estate or stocks to your children now -- yet you keep full control.

For example, you and your spouse can set up an FLP and transfer assets to it. In exchange, you receive partnership shares. You control the general partner shares and can give limited partner shares to your children, removing up to 99% of the value of the assets from your estate.

Because you control the general partner shares, you have full control of the FLP. Limited partners (your children) have none. Their shares cannot be sold or transferred without your approval. And because there is no market for these shares, their value is highly discounted. So you can transfer the assets to your children at a reduced value—without losing control.

11. Charitable Remainder Trust (CRT)

A CRT lets you convert a highly appreciated asset (like stocks or investment real estate) into a lifetime income without paying capital gains tax when the asset is sold. It also reduces your income and estate taxes, and lets you benefit a charity that has special meaning to you.

With a CRT, you transfer the asset to an irrevocable trust. This removes it from your estate. You also get an immediate charitable income tax deduction.

The trust then sells the asset at market value, paying no capital gains tax, and reinvests in income-producing assets. For the rest of your life, the trust pays you an income. Since the principal has not been reduced by capital gains tax, you can receive more income over your lifetime than if you had sold the asset yourself. After you die, the trust assets go to the charity you have chosen.

12. Charitable Lead Trust (CLT)

A CLT is just about the opposite of a CRT. You transfer an asset to the trust, which reduces your estate. But instead of paying the income to you, the trust pays it to a charity for a set number of years or until you die. Then the trust assets will go to your spouse, children or other beneficiaries.

13. Buying Life Insurance

Depending on your age and health, buying life insurance can be an inexpensive way to pay remaining estate taxes. Also, the three-year rule mentioned earlier does not apply to new policies. But don't be the owner of the policy—that will increase your taxable estate and estate taxes. To keep the death benefits out of your estate, set up an ILIT and have it purchase the policy for you.

14. How To Reduce or Eliminate Estate Taxes Summary Chart

1. If Married, Use Both Exemptions

(Living Trust with Tax Planning)

- Uses both spouses' estate tax exemptions
- Protects up to \$2.6 million from estate taxes (for family businesses that qualify)

2. Remove Assets From Estate

(Make Annual Tax-Free Gifts)

- Simple, no-cost way to save estate taxes by reducing size of estate
- \$11,000 (\$22,000 if married) each year per recipient (amount now tied to inflation)
- Unlimited gifts to charity and for medical/educational expenses paid to provider

(Transfer Life Insurance Policies to Irrevocable Life Insurance Trust)

- Removes death benefits of existing life insurance policies from estate
- Included in estate if you die within 3 years of transfer

(Qualified Personal Residence Trust)

- Removes home from estate at discounted value
- You can keep living there

(Grantor Retained Annuity Trust / Grantor Retained Unitrust)

- Removes income-producing assets from estate at discounted value
- You can continue to receive income

(Family Limited Partnership)

- Discounts value of business, farm, real estate or stock
- Lets you start transferring assets to children now to reduce your taxable estate
- You keep full control

(Charitable Remainder Trust)

- Converts appreciated asset into lifetime income with no capital gains tax
- Saves estate taxes (asset out of estate) and income taxes (charitable deduction)
- Charity receives trust assets after you die

(Charitable Lead Trust)

- Removes asset from your estate, saving estate taxes
- Income goes to charity for set time period, then trust assets go to loved ones

3. Buy Life Insurance

(Through Irrevocable Life Insurance Trust)

- Can be inexpensive way to pay estate taxes
- Death benefits not included in your estate