

# TAXATION OF ESTATES

## 2011

### I. FEDERAL ESTATE TAX

A. **What are federal death taxes?** The federal government taxes estates at death when the net value exceeds the exempt amount. The current exempt amount is \$5.0 million; it is scheduled remain at that level until the end of 2012. Currently, estates which are in excess of the exempt amount are taxed at 35% **of the excess**; there is no tax on the exempt amount.

B. **When are taxes due?** As a general rule, the federal estate tax is due nine months after the date of death. Extensions are available, but only under dire circumstances. For example, when the entire estate consists of a closely-held business, the taxes may be paid over time (with interest, of course).

C. **When are assets valued?** The estate tax value of assets is determined as of the date of death; however, they may be valued six months after date of death (the "alternate valuation date") if that would reduce taxes.

D. **What assets are subject to the federal estate tax?** All assets (world-wide) owned or controlled by a person at the time of his death are subject to the tax. This includes assets titled in the individual's name and assets held in his revocable trust. Also included in the taxable estate are the following:

1. Assets held in joint tenancy with another person (unless that person is a spouse or has contributed to the joint asset)
2. Life insurance proceeds when the insured has any "incidents of ownership" such as the ability to change the beneficiary or access the cash value (even if the policy is held in an irrevocable trust).
3. Assets which have been transferred to another person but have continued to benefit the original owner in some way, such as the transfer of a home with a retained life estate.

E. **What items are deductible against the value of the estate before it is taxed?** Debts of the decedent, expenses of his last illness, funeral costs, and estate administration costs (such as legal fees, accounting fees and probate fees) are all deductible in determining the net value of the estate for tax purposes. Unpaid income taxes on retirement funds are **not** deductible.

F. **Who is liable for the estate tax?** The personal representative (executor) of the estate and the trustee of decedent's revocable trust are both liable for the tax, up to the amount of assets which come under their control; if they distribute assets to heirs before paying the tax, they become personally liable for the tax (out of their own assets). To the extent the probate and trust assets are not adequate to pay the tax, the recipient of assets (such as a beneficiary of a life insurance policy which is included in the estate and a surviving joint tenant of a joint bank account) becomes liable for the tax, up to the amount of assets he received.

G. **Example of hypothetical federal estate tax:**

Gross assets	\$6,000,000
Deductible debts & expenses	(\$250,000)
Net Estate	\$5,750,000
Tax-Exempt amount	\$5,000,000
Taxable amount	\$750,000
Tax	\$262,500
Tax Rate (on taxable amount)	35%

II. **STATE DEATH TAXES**

A. There are two types of state death taxes:

1. **Estate tax** - chargeable against the estate (like the federal estate tax)
2. **Inheritance tax** - chargeable against the heir(s) who inherit the estate

B. A state may have one, both or neither tax. Arizona has neither.

C. As of January 1, 2005, there is no more credit for state death taxes against the federal taxes owed. As a result of elimination of the federal estate tax credit for state death taxes, the states (like Arizona) which previously collected only the amount of the federal credit have lost that revenue; most are considering a new law.

D. Very few states have an inheritance tax; they are mostly in the eastern part of the country; each heir pays his or her own tax, based on the size of the inheritance.

III. **AVOIDING ESTATE TAXES**

A. A living trust does not avoid estate taxes; assets held in a living trust, just like assets held in an individual's name without a trust, are subject to estate taxes.

B. Assets held in an **irrevocable** trust are not subject to estate taxes if:

1. The trust was created by someone other than the decedent and the decedent had no “ownership” powers over the trust.

**EXAMPLE:** A third person (including a deceased spouse) created a trust giving decedent the right to income, access to principal for health care, maintenance and support, and a power to appoint to family members (during life and/or at death); none of the foregoing are ownership rights, so the trust is not considered part of decedent’s taxable estate. THIS IS A TYPICAL CREDIT SHELTER OR BYPASS TRUST.

2. The trust was created by decedent but he or she did not have any ownership rights or any retained powers which would keep the trust in his or her taxable estate.

**EXAMPLE:** Decedent created an irrevocable trust for his or her grandchildren. Each beneficiary has a separate trust share. The decedent was the trustee but could only distribute for health care, education, maintenance and support. Decedent was **not** named as a beneficiary. The trust is not considered part of decedent’s taxable estate.

**NOTE:** If a life insurance policy on decedent’s life is transferred to an irrevocable trust (whether or not the trust was created by decedent) or to any person(s) directly within three years of decedent’s death, it is considered part of decedent’s taxable estate.

C. Using life insurance to pay taxes. A popular estate tax planning device is the use of life insurance held in an irrevocable trust, to fund all or a portion of the estate taxes.

1. When decedent is unmarried, the life insurance will usually be on his or her life.

2. When decedent is married, the life insurance will usually be on both spouses (“survivorship” life insurance) or the spouse who is insurable (if one spouse is uninsurable).

3. When the estate taxes are not completely deferred until both spouses are deceased, the life insurance will be on each spouse who has a taxable estate.

**EXAMPLE:** Community property \$5,500,000 and Husband’s separate property \$5,500,000. Husband’s plan: give community property to wife, give sole and separate property to heirs. Husband will want enough insurance to cover estate taxes on the \$500,000 taxable amount which goes to the heirs at his death. Husband and wife will also want enough survivorship insurance to cover the \$500,000 taxable amount which will go to the heirs after both spouses are deceased.

**NOTE:** When using life insurance for estate tax planning, it is usually advisable to project the increased value of the taxable estate at death, taking into account expected growth between now and then.