Estate Planning

Why It's Still Important

How Have Tax Law Changes Affected Estate Planning?

By now most of us are aware of the big changes to the tax laws since 2001. We have experienced income tax cuts first hand. We can sock more away in our retirement plans. And we have greater opportunities to help fund a child's or grandchild's education on a tax-favored basis.

There still remain, however, many misconceptions about the state of the estate tax and the need for estate planning. Has the need been eliminated or reduced? Or has the need actually increased? What is the new interplay between the estate and gift tax exemptions? And what role will charitable giving play in the overall planning process?

Contrary to the perceptions of some, the need for estate planning has neither been eliminated nor reduced. In fact, it may require more vigilance than ever before.

Seven Good Reasons Why Estate Planning Is Still Important

It's an unfortunate fact that some consumers are postponing estate planning on the notion that estate taxes are near extinction, and planning is, thus, superfluous. Wise consumers should not get lulled into such a false sense of security, but should proactively make new plans or revise existing plans to conform to the most recent —and inevitable future — tax changes. Here are seven good reasons why estate planning is still important in the aftermath of the estate and gift tax changes.

1. Federal Estate Tax Continues until 2010

Since 2001, the federal estate tax rate has declined to 45%. But, even at 45%, the top estate tax rate is higher than income tax rates. Are you willing to let your estate be cut to the quick by a severe tax rate? Or, if given the opportunity to avoid or reduce the tax by directing your social capital to a quality charitable organization such as ours, would you not prefer that option?

2. Estate Tax Repeal May Be Delayed or Never Happen

The federal estate tax repeal was not immediate with the enactment of the new tax law. In reality, estate tax repeal is not scheduled to go into effect until 2010. And the estate tax repeal will only be in effect for that one year as the law currently stands. After that, the 2001 estate tax rates will be reinstated automatically in 2011 unless Congress intervenes. However, Congress will likely address the estate tax law with new legislation in the near term.

3. Estate Tax Exemption Increases in Modest Increments until 2009

The equivalent exemption (applicable exclusion amount), or the amount of estate assets sheltered from estate taxation, will increase over the next several years. But the increase will be only gradual. The exemption is set at $2.0 million in 2008. The equivalent exemption amount will reach its peak of $3.5 million in 2009. These changes hardly remove the federal estate tax as a potential threat, though. Even with the increase in exemption amounts, estates that exceed those limits will be subject to taxation at the high estate tax rates.

4. Federal Gift Tax — No Repeal and Exemption Frozen at $1 Million

The federal gift tax and the federal estate tax — once unified as a system to encourage gifts of property during life to avoid the estate tax at death — will no longer be fully integrated beginning next year. Unlike the estate tax exemption, which will top out at $3.5 million in 2009, the gift tax exemption is frozen at $1 million; moreover, the gift tax is not scheduled for repeal in 2010, unlike the estate tax. With the annual exclusion for lifetime gifts now indexed — set at $12,000 in 2008 — a systematic program of lifetime gifts can still be used to reduce the overall tax burden substantially. Consult with your attorney about opportunities for lifetime giving.

5. State Death Taxes May Increase

Up through the end of 2004, estates subject to the federal estate tax could take a (partial) credit for state death taxes paid.

However, the state death tax credit was eliminated for 2005 (though its reinstatement is scheduled for 2011). What is the result? Some states tying their death tax to the federal credit have already taken legislative action to avoid revenue loss. State death taxes may become a more important planning consideration in some estates.

6. Planning for Carryover Basis

Until 2010, the current "stepped-up" basis rule will remain in effect. Under this rule your heir's basis in inherited property is generally the fair market value (FMV) of the property on the date of death. When an heir sells appreciated, inherited property, less taxable gain is recognized because the heir's basis is "stepped-up" from the decedent's basis in the property to the FMV of the property at the decedent's death. Thus, heirs often can sell inherited property without paying a huge capital gains tax.

In 2010, however, a new "carryover basis" rule will go into effect: Your income-tax basis in estate assets will carry over to your heirs. The loss of the stepped-up basis would result in a substantially higher tax bill for heirs when they sell the property. There are two important exceptions to the carryover basis rule. First, a limited increase in basis of up to $1.3 million will be allowed for certain estate assets. Secondly, a surviving spouse may increase basis by an additional $3 million (i.e., a total basis increase of up to $4.3 million potentially for the spouse).

The carryover basis rule will likely place a tremendous burden on all taxpayers. Unless you keep meticulous records of the basis additions to your assets, your heirs will be stuck with a lower tax basis and higher taxes when they sell inherited assets. If carryover basis actually comes into effect in 2010, the heirs of larger estates — those in excess of $4.3 million when there's a surviving spouse — could be subjected to heavy taxation when inherited assets are sold. Charitable giving would then play an even greater role as a strategy for controlling capital gains taxes than it does currently.

7. Estate Planning — More Than Just Taxes

Regardless of tax consequences, you can always be assured of benefiting your favorite causes through planned gifts such as charitable bequests and other testamentary arrangements. By including us in your estate planning, you are leaving a lasting legacy and ensuring that the causes you valued during life will be continued.

Donor surveys find that tax benefits are seldom the primary motivation for testamentary charitable giving. A survey by the National Conference on Planned Giving (NCPG) found that only about one-third of the survey's respondents indicated that tax savings was a prime factor in their philanthropic decision. About three-fourths indicated that their commitment to the organization was paramount.

WHAT IS THE DIFFERENCE BETWEEN CARRYOVER BASIS AND STEPPED-UP BASIS?

Let's look at an example. Susan purchased stock several years ago for $10,000. The stock greatly appreciated over the years. At her death, the stock's fair market value is $100,000. Susan's will bequeathed the stock to her daughter, Ann. Ann sold the stock two years later for $120,000. What are the tax consequences of the sale?

STEPPED-UP BASIS

Sale Proceeds	$120,000
Heir's Basis	$100,000
Gain	$ 20,000
Capital Gains Tax Liability (15%)	$ 3,000

CARRYOVER BASIS

Sale Proceeds	$120,000
Heir's Basis	$ 10,000
Gain	$110,000
Capital Gains Tax Liability (15%)	$16,500*

** This does not take into account the limited $1.3 million increase in basis potentially available under the EGTRRA.*

Charitable Giving and Estate Planning

With all of the uncertainty surrounding the future of the federal estate tax, you may question the old adage, "Nothing is as certain as death and taxes." But, estate taxes appear likely to remain with us. By actively engaging in estate planning now, you increase the odds that a sizable portion of your estate will not be inadvertently lost to taxation. You also have the opportunity to designate how your "social capital" will be used rather than leave that decision to federal and state governments.

By incorporating charitable giving into your estate plan, you accomplish two goals. First, your estate will receive favorable tax consequences. Unlike the income tax rules, estate tax charitable deductions are not limited to a percentage of the tax base, nor subject to particular valuation rules. Rather, the estate tax charitable deduction is based on the full fair market value of the donation.

More importantly, by including charitable bequests in your estate plan you are furthering the mission of your favorite charitable organizations. It's nice to know that the steps you take today will have a lasting impact on our future and that you can leave a lasting legacy.

Example: John Barker has a $3 million estate, and wants to accomplish two goals in his planning process. John wants to make a major contribution to our organization, but he also would like to reduce his estate tax liability. John decides to leave a $300,000 bequest in his will to us. The result? The full $300,000 will qualify for the estate tax charitable deduction. This means he will reduce his potential estate tax liability by $135,000. Equally important, John knows that the $135,000 — which would have gone to the federal government — will now go to our organization and help make a difference in our programs for generations to come. Both John's estate and our organization benefit from this bequest.

JOHN'S ESTATE TAX RESULTS

Estate tax base before charitable bequest	$ 3,000,000
Amount of charitable bequest	$ 300,000
Estate tax* without charitable bequest	$ 450,000
Estate tax* with charitable bequest	$ 315,000
Reduction in estate tax due to bequest	$ 135,000
After-tax cost of $300,000 bequest to charity	$ 165,000

** Assumes death occurs in the year 2008. Applicable Exclusion Amount is taken into account. The amount of tax savings will vary with the exemption amount and tax rate in the year of death.*

Why It Pays to Act Now

With many unanswered questions and lingering confusion over the federal estate tax law's numerous phased-in and phased-out provisions, you may be tempted to hold off making changes in your estate plan until the commotion subsides. But failure to act may do more harm than good. After all, who can predict when death or disability may strike? Why not explore the many new opportunities you may have to make certain more of your hard-earned assets go to your intended beneficiaries.

The smart thing to do right now is to review your existing plan. Check with your attorney to make sure that the latest tax changes have not undermined your plan and that you take advantage of any new tax-saving opportunities, which may include planned gifts to charitable institutions. You may be surprised to discover that your existing plan no longer carries out your intentions. Don't let that happen to you. By incorporating more flexibility into your plan, you may prevent unintended consequences and do more for both your surviving heirs and favorite charitable organizations.

We would be happy to talk with you about how you might want to include a planned gift in your estate plan to enjoy maximum benefits under the new tax changes.