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Facing Death and Taxes

These seven key estate-planning tools are essential for advisors who want to help clients with complex issues.

Woody Allen captured the attitude of many people when he said, "It's not that I'm afraid to die — I just don't want to be there when it happens."

Estate planning forces people to face difficult issues, such as death, taxes and family dynamics. The associated anxiety can lead to procrastination. But, with a little planning now, you can save your clients a bundle in taxes later and help foster family harmony.

Not surprisingly, many clients do not get motivated about estate planning until their peers begin to die. Unfortunately, this can be too late to maximize its value.

It's important to engage clients in the estate-planning process as early as possible. As a trusted advisor, part of your job is to stimulate the client's desire to plan sooner rather than later.

When speaking with clients, recognize that making the estate-planning process sound too complicated only intensifies a client's anxiety. There is, however, an elegance that lies beyond complexity.

The process of creating an estate plan can be simplified for most folks, if you help them do two things from the start: First, understand precisely what they own and why they own it, and second, clarify what they want to happen upon their demise.

Once these two issues are nailed down, a solid estate plan can be created in a straightforward fashion. Of course,

there are a variety of sophisticated tools and techniques for extremely complex matters or mega-estates. Nonetheless, the following nine estate-planning tools can form the foundation of most estate plans.

MARITAL DEDUCTION

Under the marital deduction, any property (regardless of value) that is passed from one spouse directly to the other is deducted from the estate before estate taxes are computed. The deduction can be taken for property that passes through a will or a living trust, is jointly-owned, or has beneficiary designations (e.g., a retirement account).

As with most things, moderation is recommended. For instance, it may be wise not to take full advantage of the marital deduction, because that can put the entire tax-planning burden on the shoulders of the surviving spouse. It can also result in a waste of the deceased spouse's unified credit. Estate planning prior to the death of a spouse is crucial to maximizing the benefit of the unified credit for both spouses.

GIFTING

Gifts of cash or property can avoid both estate and gift taxes. Each spouse can give away $11,000 to a recipient per year. In addition, each person has a $1 million lifetime gift-tax exemption for gifts above the $11,000 annual exclusion. Only after the lifetime exemption is exhausted are gifts above the annual exclusion taxed.

It's best to give property that's likely to appreciate, so future appreciation doesn't upwardly skew the value of the estate. However, if the recipient is in a low tax bracket and will sell the property, you might want to give property that already has a built-in gain; this way, the gain will be taxed at the recipient's lower rate. Otherwise, property with high built-in gains should be kept in the estate to take advantage of the step-up basis rules.

Assets that are in a loss position should not be gifted. Instead, the client should sell the asset, take the tax loss and then gift the after-tax proceeds.

Many clients tithe with cash. A

smarter strategy can be to have the client tithe appreciated property rather than cash, so the client gets a deduction for giving an asset for which taxes would otherwise be due. This gifting strategy can be a real win-win, because the religious (or other) organization can sell the asset and avoid paying taxes.

EQUALIZE ESTATES

The lifetime estate tax exemption (currently $1.5 million per spouse) can't be used unless each spouse owns legal title to enough assets. With many couples, one spouse holds legal title to a disproportionate share of the total estate. Unfortunately, this is often overlooked, especially with couples in which one spouse has a large IRA that creates the unequal split.

MARITAL DEDUCTION TRUST

Often referred to as the A Trust in an A-B Trust plan, this trust pays income to the surviving spouse. The spouse can also be paid principal, as needed. Because the trust is drafted to qualify for the marital deduction, no assets in the estate of the first spouse to pass away are taxed. However, assets of this trust are included in the estate of the surviving spouse. The surviving spouse has the right to decide who eventually inherits the remainder of the trust.

THE BYPASS TRUST

Often called the B Trust in an A-B Trust plan, this tool is used to ensure maximum use of each spouse's lifetime exemption.

Under current tax law, the bypass trust allows a married couple to avoid federal estate tax on a total of $3 million ($1.5 million each). The B Trust can provide income for the surviving spouse.

In addition, most trusts provide that the surviving spouse can invade principal, when necessary, to pay for health, maintenance and welfare. After the second spouse passes away, the trust remainder goes to the children or other named beneficiaries — not to the estate of the surviving spouse.

> First, understand precisely what they own and why they own it, and second, clarify what they want to happen upon their demise.

THE QTIP TRUST

A qualified terminable interest property (or QTIP) trust is typically used in second-marriage situations. It not only provides income to the current spouse, but also ensures that the principal is passed to children from the previous marriage(s).

A QTIP trust serves two primary functions: It protects assets for the next generation, and it qualifies for the marital deduction. Within the QTIP trust, the client specifies to whom the assets will pass upon the client's death.

If the assets were simply left to the current spouse, there is a chance that the current spouse could remarry and leave the assets to a new spouse or to his or her own relatives. The surviving spouse might also consume or squander the assets, leaving the client's kids high and dry. A QTIP addresses these concerns.

To qualify for the marital deduction, the QTIP trust must pay all income to the surviving spouse, at least annually. Plus, the trustee can pay additional amounts to the surviving spouse (if that is authorized by the terms of the trust agreement).

A QTIP trust can also help to maximize the applicable exclusion amounts of both spouses. Usually, a married couple with substantial assets will set up both a bypass and a QTIP trust. Enough assets from the estate of the first spouse to die will be transferred into the bypass trust to completely use his or her applicable exclusion amount ($1.5 million in 2004 and 2005).

The remainder of the assets of the first spouse to die will then be transferred to the QTIP trust. These assets will be includable in the estate of the surviving spouse for estate tax purposes, if imposed. But he or she can then use the applicable exclusion amount to protect some or all of these assets from federal estate taxes.

ESTATE PLANNING FOR IRAs

Sadly, many inheritors are making irreversible mistakes that can cost them thousands of dollars in extra taxes and lost potential earnings. It's important to understand that the inheritance rules differ for surviving spouses and non-spouse beneficiaries, such as chil-

FOR MORE INFO ON ESTATES AND TRUSTS:

http://www.aarp.org/money/financial_planning/estate_planning/

http://www.actec.org/public/links; see estate & trust planning

http://gift-estate.com

http://www.nolo.com; see wills & estate planning

http://www.pueblo.gsa.gov/cic_text/money/estate/estate.htm

TRUST ABCs

- **An A-Trust pays income to surviving spouse; qualifies for marital deduction.**
- **A B- (or Bypass) Trust allows couple to avoid tax on estate of up to $3 million; can provide income to surviving spouse.**
- **A QTIP Trust allows spouse in a second marriage to receive income and ensure that principal goes to children of first marriage.**

dren or siblings.

A surviving spouse has three primary options when inheriting an IRA from the deceased spouse. First, the spouse can simply cash-in the IRA and pay income tax on the proceeds. Second, the spouse can leave the IRA in the deceased's name (an inherited IRA). The third option is to roll it over into an IRA account in the survivor's name. The decision will be influenced by the survivor's age, the age of the IRA owner at the time of death, whether required withdrawals had already begun, income requirements and other financial circumstances.

Let's suppose that the inheriting spouse is under age 59$^1/_2$ and needs income from the IRA. If the survivor leaves the IRA in the deceased's name, he or she can make withdrawals before age 59$^1/_2$ without paying the 10 percent early-withdrawal penalty, though ordinary income taxes will still be due on withdrawals. However, if the survivor rolls the IRA into his or her own IRA, then early withdrawals may be subject to the 10 percent penalty, plus ordinary taxes.

It usually makes more sense for inheriting spouses over age 59$^1/_2$ to roll over the inherited IRA into their own IRA. This makes it easier to manage, allows them to name new beneficiaries and lets those new beneficiaries "stretch" distributions when they inherit the IRA.

There is an additional benefit for survivors who have not yet reached age 70$^1/_2$. If the deceased spouse had already begun making required minimum distributions (no later than April 1 of the year following age 70$^1/_2$), the inheriting spouse must continue making withdrawals based on what would have been the deceased's life expectancy. However, by rolling over the IRA into the survivor's own IRA, the surviving spouse can delay distributions until he or she is 70$^1/_2$. Then, the required distributions will be based on the surviving spouse's life expectancy.

Non-spousal heirs inheriting IRAs have more limited options. If the IRA has no designated beneficiary, and the owner had already started required distributions, then the heir must continue taking distributions based on the owner's remaining single life expectancy at death. If distributions had not started, then the heir must take all the money out within five years and pay ordinary income taxes. The withdrawals are, however, exempt from the early withdrawal penalty, even if the heir is younger than 59$^1/_2$.

If the IRA owner designated a non-spouse beneficiary, then that beneficiary can take minimum withdrawals based on his or her own life expectancy, regardless of whether the owner had already started required distributions. Unlike spouses, non-spouses cannot roll an inherited IRA into their own IRA.

Multiple non-spouse heirs, such as siblings, can split the inherited IRA into separate IRAs. This is often advisable; if they don't split the IRA, the minimum withdrawals are based on the life expectancy of the oldest beneficiary, which can be detrimental to the younger beneficiaries.

Inheriting an IRA can be tricky business. A client should not make any decisions before consulting a financial professional well-versed in IRA distribution rules.

Caution: Not all IRA custodians give IRA holders all of these options, even though federal law does. It's wise to send an IRA distribution document to the clients' IRA custodian and obtain agreement that the custodian will follow the terms of your IRA distribution paperwork.

To round out the estate plan, the above items should be accompanied by a health power of attorney, a financial power of attorney, and properly documented beneficiary designations on all retirement plans, life insurance policies, annuities and the like. If the joint estate is less than $1.5 million, you might use only the marital deduction, marital deduction trust or QTIP trust.

When the estate is of a higher value, consider adding a bypass trust and perhaps making some lifetime gifts. With larger estates, consider other ways to get assets out of the estate, such as charitable giving.

Business owners and those with complicated estates or special assets should consider additional strategies. Nonetheless, for all estates, these nine tools are the fundamentals. R

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As principal of Brian Puckett Retirement Advisors, LLC (www.puckettadvisors.com), **Brian Puckett, JD, CPA/PFS**, draws from his expertise in the areas of investments, taxation and estate planning to help clients preserve assets, increase income and reduce taxes.

For additional financial planning tips and related information, read *Just Give Me the Answer$: Expert Advisors Address Your Most Pressing Financial Questions* by Sheryl Garrett, CFP®, with Marie Swift and the Garrett Planning Network (www.garrettplanningnetwork.com).