Insight on estate planning

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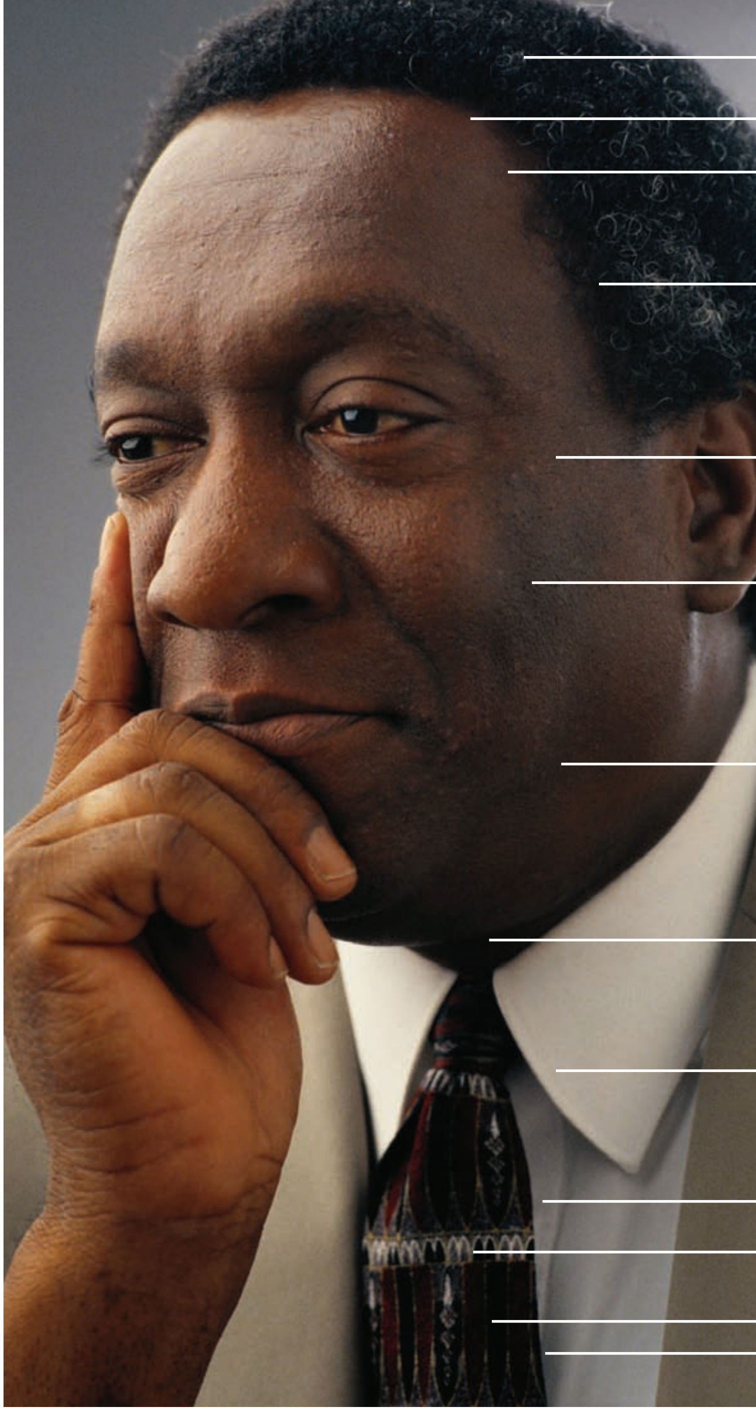

New estate planning opportunities available

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Live in your home and give it away, too

A QPRT can help you meet your estate planning objectives

How to avoid state estate tax surprises

Plus!

Estate Planning Pitfall:
Property has declined in value since the owner's death date

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New estate planning opportunities available

Recent tax law changes may require a review of your estate plan

Last year, the Pension Protection Act of 2006 (PPA) and the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) became law. Both of the acts' provisions provide estate planning opportunities related to your retirement accounts.

Nonspouse 401(k) rollovers to IRAs

Before PPA, a nonspouse beneficiary of an inherited 401(k) plan wasn't permitted to roll it into an IRA. He or she was subject to the employer's rules regarding future distributions, and companies typically require the beneficiary to pull the money out sooner rather than later. Thus, there was no ability for a nonspouse beneficiary to defer tax on an inherited 401(k) the way he or she could with an inherited IRA.

PPA changed all of that. As of Jan. 1, 2007, a nonspouse beneficiary can roll an inherited 401(k) directly into his or her inherited IRA. The beneficiary can then take distributions from the IRA over his or her life expectancy. Keep in mind that the beneficiary must roll the 401(k) assets directly from the 401(k) to an IRA.

By rolling over a 401(k) to an IRA, a 50-year-old beneficiary of a $500,000 inherited 401(k) will be able to take as little as if he or she had inherited a $500,000 IRA. The required minimum distribution (RMD) is less than $15,000 — saving thousands of dollars in tax liability compared to what would have been required before the new law. Plus, the nonspouse beneficiary can enjoy tax-deferred growth on the assets remaining in the account for the rest of his or her life.

Permanent higher contribution limits and Roth 401(k)s

PPA eliminates the 2010 sunset provisions related to higher contribution limits to IRAs and various defined contribution plans, such as 401(k)s, and it permanently extends the availability of the Roth 401(k). The extension of the increased contribution limits, including the "catch-up" amounts for those 50 and older, allows you to boost tax-deferred retirement savings, which in turn expands your estate planning opportunities.

The Roth 401(k) provides an even brighter opportunity. Because Roth 401(k)s have been made permanent, it's likely more employers will offer these plans. Roth accounts can be especially good estate planning tools because they not only grow tax-free, but also allow

The enhanced estate planning benefits of nondeductible IRA contributions

If you're otherwise ineligible to make either a Roth IRA contribution or a deductible traditional IRA contribution, consider making nondeductible IRA contributions starting with your 2006 contribution. With the Pension Protection Act of 2006's (PPA's) permanent extension of the increased contribution limits and the Tax Increase Prevention and Reconciliation Act of 2005's (TIPRA's) expanded eligibility for higher income taxpayers to convert to Roth IRAs, this strategy just got more attractive, especially if you don't currently have an IRA. And you can make 2006 contributions until April 16, 2007.

For example, by making nondeductible contributions from 2006 through 2010, Jim and Jill, a married couple in their 50s, could contribute (assuming no inflation adjustments to the amounts as currently scheduled) $56,000 into nondeductible IRAs. (They can each contribute $5,000 in 2006 and 2007, and $6,000 from 2008 through 2010.)

In 2010, the couple could convert the IRAs to Roth IRAs, and they would be liable for tax on only the appreciation the accounts enjoyed — the $56,000 in contributions wouldn't be subject to tax. Taking advantage of the ability to defer the income recognition into 2011 and 2012, Jim and Jill — and more dramatically, their heirs — could reap significant benefit down the road.

tax-free distributions to both you and your beneficiaries.

Charitable distributions from IRAs

Another significant, though short lived, planning opportunity afforded by PPA lets you make a charitable distribution of up to $100,000 directly from your IRA — but only if you're age 70½ or older, and only for years 2006 and 2007.

Here's how it works: You arrange with a qualified charity to make a contribution directly from your IRA. You don't receive a tax deduction for the contribution, but the distribution is excluded from your income for the year. The contribution will reduce or eliminate your RMD. If your RMD exceeds $100,000, your first $100,000 would be treated as made via the charitable contribution and the balance would still be required — and included in your income for the year.

An added benefit for the charitably inclined is that, because you're not receiving a charitable deduction, the AGI limits on charitable deductions don't apply.

Expanded Roth IRA conversions

Perhaps one of the biggest changes — and most significant planning opportunities — is one that was created not by PPA but by TIPRA and which won't go into effect until 2010: the elimination of the adjusted gross income (AGI) limit for converting traditional IRAs to Roth IRAs. Currently, you can't make such a conversion if your AGI (not including the converted amount) exceeds $100,000. Beginning in 2010, you can convert your traditional IRA to a Roth IRA regardless of your income.

Of course, by converting, you're obligated to report and pay tax on the taxable amount of the conversion. TIPRA has sweetened the deal considerably if you convert your IRA in 2010: You have the option of reporting all of the income in 2010, or deferring half of it to 2011 and the other half to 2012.

If you can afford to pay the income tax up front, this can be a significant benefit. From an income tax standpoint, it may keep you out of a higher tax bracket in future years because you must take RMDs from a traditional IRA after age 70½. From an estate planning standpoint, it allows you to pass on an asset that your heirs will never have to pay income tax on.

Plus, by paying the income tax you're reducing your estate, meaning that, if you are subject to estate tax at the top rate of 45%, every income tax dollar you pay will reduce your estate tax liability by $.45 — even more if you're in a state that assesses an estate tax. (See "How to avoid state estate tax surprises" on page 6 for more on state estate tax issues.) Of course, the federal estate tax is scheduled to be repealed in 2010, but without Congressional action it will return in 2011.

Further, Roth IRAs have no RMDs, so you can continue to accumulate funds without having to withdraw anything. And, because Roth IRAs allow you to contribute past age 70½ (provided you have earned income and your AGI doesn't exceed the limits), you may be able to continue to add dollars to the account.

Review and update your plan

The PPA (along with TIPRA) strengthens traditional pension plans, which may strengthen your estate if you have such a plan. In addition, the act enhances the estate planning opportunities other retirement plans offer. Now is a good time to have your estate planning professional review your plan and determine if any revisions are needed.

Live in your home and give it away, too

A QPRT can help you meet your estate planning objectives

A qualified personal residence trust (QPRT) provides a unique opportunity for you to make a significant gift to your heirs without having to divest yourself of any of your investment assets. While not for everyone, it may be the perfect way for you to meet your estate planning objectives.

QPRT inner workings

A QPRT may be ideal if your estate (or your and your spouse's estate) is large enough that you're likely to face estate tax liability at death. The trust allows you to gift your home, which isn't currently generating any income for you, to your children or other heirs, but you may continue to live in it.

By removing the property's future appreciation from your estate, you're leveraging the gift today so that, at your death, your children (or other beneficiaries) will inherit a greater amount at a lower estate tax cost than if you had not transferred the home to the QPRT.

Jerry, Ruth and a QPRT

Let's suppose Jerry, 80, and Ruth, 75, own a home worth $2 million, and that the couple has a combined estate of nearly $10 million. They're interested in a QPRT because their estate isn't terribly liquid and they want to retain the liquidity they have to ensure they can live comfortably for the rest of their lives. Also, they want to be sure there will be enough ready money at the survivor's death to pay the estate tax.

Even though it's possible the children will not choose to retain the property after their parents are gone, the family is hoping they'll be able to keep the home. Jerry and Ruth believe a QPRT will give them the best chance to do that.

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In addition, the couple likes the fact that they can decide how long the trust will last. The term of the trust is part of the gift calculation of the QPRT, which also uses the IRS Section 7520 rate and the age of the person(s) transferring the property to the trust to determine the value of the gift.

Jerry and Ruth have decided that Jerry will transfer his ownership interest in the home to Ruth, and she alone will make the gift to the QPRT. Because they're making the gift at a time when the Sec. 7520 rate is 6%, they determine that a seven-year term is appropriate. The value of the gift, therefore, based on the calculation using those factors, is slightly more than $900,000 (rather than the full $2 million fair market value of the home).

If Jerry and Ruth keep their home and it appreciates at an average of 8% per year, the house will be worth more than $3.4 million at the end of the seven years. Supposing the survivor of Jerry and Ruth dies at that time, and presuming the estate tax rate is 45%, estate tax in excess of $1.5 million is attributable to the value of the home.

QPRT risks

A QPRT is not without risk. First, there's the risk that Ruth will not survive the term. If she doesn't, the QPRT will have been for naught because the transaction will be disregarded: The house will be included in Ruth's estate. In their case, though, Jerry and Ruth decide that a seven-year term for Ruth is an acceptable risk to take because Ruth is in good health and both of her parents lived into their late 80s.

The other end of the risk spectrum is that Ruth will live far beyond the QPRT's term. After the QPRT terminates, Ruth no longer will own the home. Instead, the children will own it, either outright or in trust, and Ruth will be obligated to pay rent to live in "her" house. While the likelihood is that cash flow won't be an issue, and that Ruth will be able to afford to stay in the house, there is an unease related to the possibility that she'll be forced to leave the home.

Another consideration is that Ruth may not want to live in the house alone after Jerry's death. This is a genuine concern, but, again, they reason that, if that happens, Ruth will have sufficient cash flow — and other assets — to continue to live comfortably.

Jerry and Ruth also realize they're forgoing the $500,000 capital gain exclusion that would be available to them if they were to sell their home. But, they reason, they aren't planning to sell, so this isn't a concern. However, they also realize the lost step-up in basis could translate to significant extra income tax being paid by their children should they decide to sell the home after Jerry and Ruth die. They've weighed this, however, against the potential estate tax savings, and decide, again, that they're willing to take the risk.

Weigh the benefits

A QPRT can lead to significant tax benefits, but carefully consider all of the potential positives and negatives before deciding that you want to move forward. You may find that a QPRT is the right way for you to make a significant gift to your family without having to deplete your investment assets. ▮

How to avoid state estate tax surprises

These days, state estate taxes are catching many families by surprise. Why? Because state estate tax became somewhat convoluted when the federal estate tax exemption began increasing and the federal estate tax credit for state estate tax was phased out, both thanks to the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Some states decided to "decouple" from the federal estate tax system, and, in many states, state estate taxes have increased.

What is "decoupling"?

Decoupling refers to the fact that the federal and state estate taxes are no longer in sync with one another. Before the enactment of EGTRRA, almost every state had a "pick-up" tax with respect to estates.

The federal estate tax return allowed a credit for amounts paid to states for state estate tax. Most states, in turn, defined the state estate tax amount as equal to the maximum amount for which the estate was allowed the credit. In essence, the states said, "The federal government gives you a credit for this amount, so we may as well take it." It didn't cost the estate anything, because a federal credit was allowed if the tax was paid to the state.

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So, for example, if your estate had a $200,000 federal estate tax bill and was allowed a state estate tax credit of up to $50,000, the state estate tax bill was $50,000 and your estate paid $150,000 in federal estate tax and $50,000 in state estate tax. If the state didn't have an estate tax, your estate paid the entire $200,000 in federal estate tax. Either way, your estate paid the same amount.

Current law

Under current law, there's no federal credit for state estate tax paid. Instead, there's a deduction. The bottom line is that, to the extent a state estate tax is paid, the combined total estate tax paid will now exceed the amount that would have been the combined total under the old system.

States that previously relied on the "pick-up" tax to calculate the estate tax due to them have had to change the way they determine their state estate tax. Some states simply let their state estate tax die with the elimination of the federal credit. Those states that have retained the state estate tax generally have congregated into two camps:

1. States that have chosen to follow the federal estate tax exemption amount, and
2. States that have frozen the exemption amount at some level other than the current federal exemption amount.

Many states instruct estates to make the calculation that would have been in effect if the full state estate tax credit were still in effect, but to use the current state exemption amount. Thus, even though there no longer is a "pick-up" tax, the states calculate the state estate tax liability as if the pick-up were still in existence.

Knowing whether there is a discrepancy between your state's exemption amount and the federal exemption amount is relevant. For example, if your estate plan calls for assets up to the federal exemption amount to pass estate tax free into a family trust and the balance to go to your spouse, you might expect no estate tax liability. But if your state's exemption is just $1 million, there will be some state estate tax due at your death. The tax liability itself may not be significant, but it's important to know whether it looms on the horizon.

Multistate jurisdictional issues

If you have estate tax liability in more than one state, things get more complicated. Multiple calculations based on each state's allowable exemption may be required. For instance, if your home state has a $2 million exemption but you own land in a neighboring state with just a $1 million exemption, you may owe no tax in your home state but have a liability in the neighboring state. Again, the dollar amount might not be terribly significant, but having an expectation that no estate tax will be due and then learning that a tax is due could be disturbing.

One way to avoid — or at least minimize — state estate tax liability is to plan properly. Particularly when it comes to business interests or real estate holdings outside of your home state, you might be able to minimize your exposure to another state's estate tax by owning those assets through a revocable trust or some other entity.

Eliminate surprises

Bear in mind that each state is different, so it's vital you understand the rules that affect you. The bottom line is that, as with virtually anything, planning can reduce the surprises and help you face the future. Decoupling doesn't have to derail your estate plan.

Estate Planning Pitfall

Property has declined in value since the owner's death date

Property in an estate typically is valued on the date of the owner's death. But as executor, personal representative or trustee, you may elect to value the property six months later in certain situations.

Using this alternative valuation date may be beneficial if the estate includes property whose value has dropped significantly since the owner's death, such as stock or other securities, because it can reduce estate taxes.

Bear in mind that you can't apply this election selectively to certain property types. After you make the election, it's irrevocable, and it applies to all of the estate's property. There's an exception, however, for property sold or otherwise disposed of during the six-month period between the date of death and the alternate valuation date; it's valued on the date of the sale or other disposition.

Before taking action, be aware that lower valuation amounts also will lower the heirs' tax basis in the property. This can potentially increase their taxable gain if they sell the property. The estate tax savings, however, may outweigh any additional income taxes.

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Comprehensive Estate Planning Services

Founded in 1960, Weinstock, Manion, Reisman, Shore & Neumann offers estate planning, probate and trust administration, general business and corporate law, taxation, real estate and litigation services. Because 13 of our 15 attorneys are actively involved in estate planning, we specialize in helping clients meet objectives like these:

- Dispose of assets in a tax-efficient manner by using revocable living trusts.
- Minimize estate taxes by using sophisticated lifetime giving techniques, such as Grantor Retained Interest Trusts and Charitable Remainder Trusts.
- Provide liquidity and save estate taxes by using life insurance and irrevocable life insurance trusts.
- Efficiently administer probate and trust estates.
- Transfer business interests to younger family members in a tax-efficient manner.
- Minimize generation-skipping transfer tax on transfers to grandchildren and great-grandchildren.
- Implement deferred compensation and qualified retirement plans, including pension and profit sharing plans.
- Reduce income and estate taxes on the receipt of benefits from retirement plans.
- Avoid court intervention if disability strikes.
- Maximize employee productivity through the use of stock options and other incentive programs.
- Dispose of business interests among co-owners.
- Save on income taxes, both now and in the future.
- Select and form business entities, such as corporations, limited liability companies and family limited partnerships.
- Protect the interests of beneficiaries or fiduciaries in estate, trust or conservatorship matters.

The professionals at Weinstock, Manion Reisman, Shore and Neumann bring over 250 years of combined experience to the services we provide. The stability of our firm enables our lawyers to work closely together with business specialists to give clients outstanding individualized attention.

Many of our lawyers are instructors at UCLA Extension and highly sought after as speakers for professional organizations in the community. Because we are at the forefront of current developments in law, we excel in designing strategies which help clients balance their business and financial interests with their personal and professional objectives in order to preserve and transfer their wealth.