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Understanding estate and inheritance taxes

Developing a plan for the disposition of assets throughout your lifetime and after death is a key tenet of estate planning. Thoughtful estate planning may minimize your estate, inheritance, and generation-skipping transfer taxes.

By the numbers

- **Two for one:** With thoughtful estate planning you can reduce your tax bills and gain peace of mind.
- **$2 million** is the estate tax exemption amount in 2006.[1]

[1]Source: irs.gov

Federal estate tax

The federal estate tax is a transfer tax imposed on the value of property you own at the time of death. When applicable, estate tax is levied on an entire estate before it is distributed to beneficiaries, and any tax owed is paid out of the estate's funds. An estate tax return must be filed with the IRS within nine months after death for each decedent whose gross estate exceeds the applicable exemption amount. Over the next few years the exemption will increase as follows:[2]

Estate tax

Year	Top estate tax rate	Exemption
2006	46%	$2 million
2007	45%	$2 million
2008	45%	$2 million
2009	45%	$3.5 million
2010	repealed	N/A
2011	55%	$1 million

Under current tax law, individuals generally can leave their heirs up to $2 million tax free. Estates larger than $2 million may be subject to estate tax at graduated rates up to 46%. All in all, less than 3% of decedents will have federal estate tax liability.

State estate and inheritance taxes

Some states have their own estate tax, which, like the federal tax, is a transfer tax on property you own at the time of death. If you own real property in a state other than your state of residence, additional tax may be imposed by that state.

Certain states also impose a separate tax on beneficiaries, known as an inheritance tax. These taxes are calculated for each

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[2]These amounts were set by the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and are scheduled to expire after December 31, 2010. Unless extended by Congress before then, these provisions will revert back to tax laws in effect prior to the passage of EGTRRA, as shown in the figures for the year 2011.

Key points

How can you take control of, and possibly eliminate, estate taxes? First, start planning with your legal advisers as soon as possible.

Estate planning professionals can help you fully understand estate and inheritance taxes — and take full advantage of any planning opportunities.

A sound estate plan will help you
- reduce your tax bill
- help ensure that your wealth is transferred according to your wishes

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beneficiary according to the value of the inherited assets. However, spouses, children, and grandchildren may be taxed at a lower rate than other heirs. A friend, for example, may have to pay taxes of 20% of the amount inherited, while a grandchild's tax rate may be only 2%. You also should be aware of the estate-tax and inheritance-tax exemptions your state may offer.

Generation-skipping transfer (GST) tax

The generation-skipping transfer (GST) tax is another federal tax that generally is applied to property and is paid directly by the estate. This tax is applied to property that is left to a beneficiary who is at least two generations younger than the property owner. It is designed to ensure that property does not skip a generation without a transfer tax being assessed. The beneficiary is known as the skip person, and the tax rate applicable to generation-skipping distributions is the highest marginal estate tax rate. Each transferor can shelter up to $2 million in 2006 from the GST tax, the same as the highest estate tax exemption.

A generation-skipping transfer takes one of three forms:

- **direct skip:** a transfer to a skip person that is also subject to estate or gift tax
- **taxable termination:** trust property that is held for or distributed to a skip person after an interest in the trust has terminated
- **taxable distribution:** any distribution from a trust that is not a taxable termination or direct skip

Transfers that are not subject to gift tax because of the $12,000 annual exclusion or the unlimited exclusions for direct payment of medical and tuition expenses are not subject to GST tax.

How estate taxes are assessed

The following is a general overview of how federal estate taxes are calculated. It's important to remember, however, that every estate is different and the laws governing federal estate taxes are complex. Make sure to consult with your attorney, tax adviser, or estate planning professional about your specific estate planning needs and possible tax liability.

Determining gross estate value

The first step in computing the estate tax is to figure out the value of the gross estate. The gross estate may include

- all property you owned at the time of death
- certain transfers made during your lifetime if you retained an interest in the property
- the value of an annuity receivable by any beneficiary as your survivor
- half the value of all property held in joint tenancy (with rights of survivorship and not as tenants in common) with a spouse
- the value of all property over which you had a general power of appointment at the time of death
- the value of certain life insurance proceeds
- the value of certain types of transfers and releases if occurring within three years before death

Keep in mind that 529 prepaid tuition and college savings plan assets generally are not considered part of the donor's estate. The only exception occurs if you are spreading a gift over five years for gift tax purposes. If you die within that five-year period, the gifts for the years up to and including the year of your death are removed from your estate and the subsequent year's gifts are included in your estate. (For more information, ask your investment professional for the MFS Heritage Planning® infosheet *529 college planning*.)

In general, the value of your estate is the fair market value of all property as of the time of death. However, if the executor elects, the property may be valued on an alternate valuation date, which is six months after death. This alternate date becomes the date for valuation of all property in the estate and must be applied to all assets on an all-or-nothing basis.

Determining taxable estate value

Once the gross estate value has been determined, the next step is to find the taxable estate value.

The gross estate value minus

- estate administration expenses (including final expenses)

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- certain types of uncompensated losses
- indebtedness
- bequests to surviving spouse
- charitable bequests
- state estate or inheritance tax

equals the value of the taxable estate.

Determining actual estate tax

Once the value of the taxable estate is determined, a preliminary estate tax is calculated using graduated tax rates. At this point the applicable estate tax credit (and in certain circumstances, other credits) is subtracted from the preliminary estate tax — the result is the actual tax due.

In 2006, the maximum estate tax credit is equal to the tax liability on a taxable estate of $2 million. Therefore, subtracting the applicable 2006 tax credit from the estate tax on an estate of $2 million or less will result in zero estate tax liability. In other words, taxable estates of up to $2 million essentially can be left to beneficiaries tax free, and usually only taxable estates worth over $2 million would owe estate tax.

Planning ahead

After a person dies, the disposition of his or her estate — for good or bad — is generally fixed. Although some tax-saving options may still be available to your beneficiaries, planning ahead gives you the greatest opportunity to make informed choices about the disposition and preservation of your assets. In order to create an estate plan that fits your specific circumstances and preferences, you may need to consider not only taxes but also state and federal laws regarding wills, trusts, property ownership (including community property rules), asset transfers, and probate administration. Contact your investment professional, attorney, or tax adviser for help with putting the most worthwhile plans in place.

Resources

Condon, Gerald M., and Condon, Jeffrey L., *Beyond the Grave: The Right Way and the Wrong Way of Leaving Money to Your Children (and Others)*, revised edition. (HarperCollins Publishers, Inc., 2001)

Esperti, Robert A., and Peterson, Renno L., *Protect Your Estate: Definitive Strategies for Estate and Wealth Planning from the Leading Experts.* (McGraw Hill, 2001)

Apolinsky, Harold and Welch, Stewart, III, *J.K. Lasser's New Rules for Estate and Tax Planning.* (John Wiley & Sons, Inc., 2002)

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Nolo Self-Help Law Center
www.nolo.com

For more information on estate planning, contact your investment professional or visit **mfs.com**.