

## Minimizing Estate and Income Taxes

If your estate is worth between \$2 million and \$3.5 million, estate planning has become a lot more complicated than it was before the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). How so? Over the next few years, the amount that can pass taxfree at death to your heirs gradually increases (see chart).

Increases in Estate Tax Exemption	
2007–2008	\$2,000,000
2009	\$3,500,000
2010	no exemption
2011	\$1,000,000*

*\*unless Congress takes further legislative action*

While these increases in the estate tax exemption are good news for taxpayers, there are several things to keep in mind when planning to minimize estate taxes.

1. Although the estate tax is slated for repeal in 2010, it will be reinstated in 2011 (with a \$1 million exemption) unless Congress makes the repeal permanent.
2. Although the exemption for estate taxes increases, the amount that can be “gifted” during a lifetime without paying gift tax remains at \$1 million, even after repeal of the estate tax.
3. For deaths prior to 2010, the income tax basis of assets owned at death will be adjusted to their current fair market value. Typically, this results in significant income tax savings for the heirs when the assets are sold. In 2010, this basis “step-up” will be limited.

### What About Bob?

Consider the hypothetical case of Bob, a recent widower. Bob’s estate is worth \$2 million, and he plans to leave everything to his children. His assets have appreciated substantially in value since he acquired them, and he expects that trend to continue.

If Bob were to die prior to 2009, it’s very likely his heirs would incur a significant estate tax bill, since only \$2 million would be sheltered by his estate tax exemption. Even if he lives beyond 2009, the appreciation of his assets may overtake the increases in the exemption.

If estate taxes were the only consideration, Bob might decide to make gifts to his children, at least to the extent of the annual exclusion (\$12,000 per person in 2007), and possibly use a portion of his \$1 million gift tax exemption to remove future asset appreciation from his estate. But estate taxes are not the only consideration. If Bob gives his children an asset that has appreciated in value, the income tax basis of the asset carries over to them, and they will have to pay income tax when the asset is eventually sold, assuming it doesn’t decrease in value. On the other hand, if Bob owns the asset when he dies and his children inherit it, the basis will be adjusted to fair market value (FMV) at that time.

Therein lies a dilemma: a) If Bob gives away assets which would have been sheltered from estate tax by future increases in the exemption, he has “wasted” the opportunity to have the income tax basis of those assets increased upon his death; b) on the other hand, if Bob owns assets at death worth more than the available estate tax exemption, there will be an estate tax liability.

### What to Do?

Death tends to come on its own timetable. So how can you plan for the inevitable with frequently changing legislation? There is, unfortunately, no perfect answer to this problem since a lot depends upon personal circumstances, but here are a few ideas to consider:

1. Make gifts of “high basis” assets (basis close to or above current market value) first. This will minimize the loss of income tax benefits from the basis step-up at death.
2. Avoid making gifts that will reduce your potential taxable estate below the available estate tax exemption.
3. Think about using a family limited partnership (FLP) or limited liability company (LLC) as a hedge against estate taxes and income taxes.

And of course, your first course of action should be to consult with your legal and tax professionals. They can help you navigate the nuances of tax laws for the benefit of both you and your heirs.

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