

## INDIVIDUAL

### Basic Estate Planning Techniques

#### *Part 3 in a Series*

The vast majority of estates—about 98%, according to IRS estimates—are not subject to federal estate tax under current regulations, and changes to the tax code may push that percentage even higher. But for those estates that do face the possibility of taxation, the unified credit can be a useful tool for minimizing or even eliminating estate tax liability. To be used most effectively from an estate planning perspective, the unified credit should be utilized in conjunction with the annual gift tax exclusion.

The unified credit is a federal tax credit that offsets gift and estate tax liability. For estate tax purposes, the unified credit is being gradually increased from \$555,800 this year to \$1,455,800 in 2009. Those figures are equivalent to applicable exclusions from estate tax of \$1.5 million and \$3.5 million, respectively.

#### **Using the Unified Credit**

A unified credit applies to both the gift tax and the estate tax. Taxpayers must subtract the unified credit from any gift tax they owe in a given year, and any unified credit used against the gift tax in one year reduces the amount of credit that can be used against the gift tax in a later year. The total amount used against gift tax during the taxpayer's lifetime reduces the credit available for use against the estate tax.

Under prior tax law, the same unified credit amount applied to both the gift tax and the estate tax, but recent changes in the law have altered that treatment. Beginning in 2004 and extending at least through 2009, the unified credit amount for gift tax purposes holds steady at \$345,000. This figure is equivalent to the applicable exclusion from gift tax of \$1 million. However, the unified credit and applicable exclusion amounts for estate tax purposes increase, as mentioned above.

#### **Gift Tax Rule Exceptions**

According to IRS Publication 950, the general rule is that any gift is a taxable gift unless it falls under one of the many exceptions to the gift tax rule, such as:

- Gifts totaling less than the annual exclusion amount for the calendar year.
- Tuition or medical expenses paid directly to a medical or educational institution for someone.
- Gifts to the taxpayer's spouse.
- Gifts to a political organization for its use.
- Gifts to charities.

A separate annual exclusion (\$11,000 in 2005, which may be increased due to a cost-of-living adjustment in subsequent years) applies to each person to whom the taxpayer makes a gift. The spouse of a married taxpayer may also give up to \$11,000 to the same recipient in the same tax year. Gift splitting allows a married couple to claim the full \$22,000 exclusion for a gift to an individual, even if one spouse provides most, or all, of the gift.

Similarly, in order to make maximum use of the unified credit from an estate-planning perspective, married couples who may be subject to estate tax are often advised to divide or "balance" their assets between husband and wife. Another strategy is to establish a Bypass Trust, also known as a Credit Shelter Trust. This trust is created in the testator's will to utilize the testator's exemption equivalent amount. Its purpose usually is to hold assets for the benefits of a testator's surviving spouse during the survivor's lifetime and then to pass to the testator's children without the trust assets being included in the survivor's estate. This strategy also allows each of the spouses to claim the maximum allowable exclusion at the time of their deaths.

#### **Determining the Taxable Estate**



For estate tax purposes, the taxpayer's taxable estate is determined by subtracting allowable deductions from the gross estate, which consists of the value of all property in which the taxpayer had an interest at the time of death. Some examples of items generally included in the gross estate include, among others, cash, securities, real estate, life insurance proceeds payable to the estate or heirs, and the value of certain annuities payable to the estate or heirs. Some examples of allowable deductions used in determining the taxable estate include funeral expenses paid out of the estate, charitable bequests, debts owed by the taxpayer at the time of death and the marital deduction, which generally consists of the value of the property that passes from the taxpayer's estate to the surviving spouse.

In most cases, any unified credit not used to eliminate gift tax during the taxpayer's lifetime can be used to reduce or eliminate estate tax. In light of recent changes to the tax code in this area and the strong possibility of additional changes in the near future, high-net-worth individuals in particular should consult their tax advisers to make sure they use the unified credit to their maximum advantage.

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