volume 26, number 2

assets
a business, tax, and financial newsletter

Patrick J. McNamara, MSFS
E-mail: pmcnamara@finconcepts.com

Financial Concepts, Inc.
A Member Firm of M Financial Group
617 Detroit Street, Suite 120
Ann Arbor, MI 48104-1112

Tel: (734) 214-9770 • Fax: (734) 214-9771

- Professional Based Expertise
- Knowledge Based Solutions
- Trust Based Relationships
- Solutions for Advisors
- Order • Creativity • Value

Trust $= \frac{\text{Integrity x Competence}}{\text{Risk}}$

www.finconcepts.com

Securities offered through
M Holdings Securities, Inc.,
a Registered Broker Dealer
Member NASD/SIPC
Financial Concepts, Inc. is independently owned and operated.

in this issue:

Benefit Trade-Offs in Property Titling

Term Conversion—Changing Times, Changing Needs

From a Step Up to a Step Back: The Return of Carryover Basis in 2010

For a single year, 2010, the estate tax is scheduled to disappear, but it will revert to its pre-2002 structure in 2011 unless Congress takes further action. This temporary repeal, mandated by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), goes into effect following a gradual increase in the estate tax exemption amount and a decrease in the highest estate and gift tax rates. But even as certain types of tax burdens are phased out, other types of taxes will be levied on the heirs of estates. Until December 31, 2009, inherited property receives a "step-up in basis," but in 2010, property becomes subject to "carryover basis" rules.

Step-Up vs. Carryover Basis

Generally defined as the purchase price of the property minus certain adjustments, basis is used to calculate the amount of capital gains tax owed when an heir to an estate sells the property. Under the step-up provision, the basis of inherited property is increased to the fair market value (FMV) of the property on the date of death. In practice this means that, when inherited property is sold, the stepped-up basis—sometimes referred to as the "fresh start basis"—is subtracted from the proceeds of the sale. Heirs then owe capital gains taxes only on the remaining amount.

Under carryover rules, inherited property receives a basis equal to the amount the deceased originally paid for the item. Depending on how much the property rose in value between the time of purchase by the deceased and the time of sale by the heir, the recipient of the property could owe much more in capital gains taxes under the carryover basis provision than under step-up basis rules.

In 2010, carryover basis applies to assets above $3 million inherited by the spouse of the deceased and assets of more than $1.3 million inherited by anyone other than the spouse. Inheritances below these limits are subject to the step-up basis rules. Following the expiration of EGTRRA provisions on December 31, 2010, the step-up basis is scheduled to go back into effect, and estate tax will be assessed on property in excess of $1 million, with a maximum tax rate of 55%.

continued on page two

from a step up to a step back: the return of carryover basis in 2010

continued from page one

Critics of carryover basis charge that it will potentially complicate tax matters for heirs, as it may be difficult to establish how much the deceased originally paid for a particular piece of property.

Future of the Estate Tax

Meanwhile, Washington lawmakers are debating whether the estate tax should be permanently abolished after EGTRRA sunsets in 2010. The House of Representatives voted in April 2005 to make the estate tax repeal permanent, but the Senate is still considering the issue. The complete elimination of the tax would cost the federal government an estimated $75 billion a year between 2014 and 2024.

An alternative proposal by Sen. Jon Kyl (R-AZ) would fall short of a permanent repeal of the estate tax, instead making the estate tax rate equal to the 15% tax rate on capital gains and allowing exemptions of $3.5 million for individual estates and $7 million for married couples. Yet even this proposal, opponents argue, would be the equivalent of three-quarters of the cost of a full repeal.

Planning Ahead

Unresolved questions about the future of estate tax rates, gifting, exemptions, and the tax basis of assets make estate planning very challenging. Because it is impossible to predict what laws will be in force at

the time of death, it is important to prepare for a number of different scenarios. If you are currently involved in the estate planning process, prepare for the possibility that your inherited assets will be subject to carryover basis rules by collecting the documents your family would need to establish the original price paid for your assets. Your tax professional and attorney can help you craft a plan that will protect your estate under a variety of circumstances.

Benefit Trade-Offs in Property Titling

A fairly common occurrence among married couples is the holding of most, if not all, of their property as *tenants by the entirety*. Quite often, couples are unaware of the alternative methods of titling, as well as some of the trade-offs involved in selecting a particular form of holding property.

There are four primary ways to hold property:

1. *In Your Own Name*. Anyone may choose to own property in his or her own name. Owning property outright gives the owner complete control over the property, but such property is generally included in the owner's gross estate for estate tax purposes and will usually have to pass through the *probate* process.
2. *As Tenants in Common*. This method allows two or more parties to own property together, with each owner maintaining the right to sell his or her interest without the consent of the other co-owner(s). Generally, such ownership interests must be bequeathed through a *will* and do not pass automatically to the co-owner(s) at death. Consequently, such property typically will be subject to probate.
3. *As Joint Tenants*. Also called *joint tenancy with right of survivorship*, this form of ownership provides each "tenant" with an undivided interest in the entire property. An owner may not sell without the consent of the other co-owner(s). If one owner should die, the surviving owner(s) automatically inherits the decedent's interest (i.e., the property passes "by law" and does not go through probate). Joint tenants should be aware that a creditor may force the sale of such held property to satisfy the debts of only *one* owner. Negligence, for example, may create potential liability exposure beyond the limits of currently held insurance policies.
4. *As Tenants by the Entirety*. This is a special form of joint tenancy solely for married couples with one significant difference: the property *cannot* be sold to satisfy the debts of one of the owners.

Benefit Trade-Offs

Each form of property ownership has specific implications, and when

continued on page three

benefit trade-offs in property titling

continued from page two

using one particular method, the benefits gained must be balanced against the benefits lost.

Consider Simon and Ellen Howard (a hypothetical scenario) who have two college-aged children, Andrea and Jason. Life has been good to the Howards, and they have built an estate worth $4 million, with all of their assets jointly held as tenants by the entirety. (For the sake of simplicity, we will not consider retirement plan assets, which cannot be held jointly.)

While on vacation, the Howards are involved in a tragic fire. Simon dies instantly; Ellen lives for four days and then dies. In this unfortunate set of circumstances, what are the estate tax implications for their jointly-held $4 million estate?

At Simon's death, his interest in all jointly-held property automatically passes to Ellen free of federal estate taxes by virtue of the *unlimited marital deduction*. For the four intervening days that Ellen is alive, she is the sole owner of the previously joint $4 million estate. At her death, $2,000,000 of the estate would be offset by her $2,000,000 *applicable exclusion amount* in 2006. (This amount is scheduled to rise gradually to $3,500,000 by 2009.) Because all property was jointly held, Simon's $2,000,000 exclusion amount was lost. Failure to plan for the use of Simon's exemption ultimately decreased the amount passing to Andrea and Jason.

"Bypass" to a Solution

Had the Howards "equalized" their estate (i.e., each owned $2,000,000 outright), each could have set up a *bypass trust* with $2,000,000. In this example of nearly "simultaneous" death, the assets in Simon's bypass trust would pass to the children free of estate taxes (the $2,000,000 exemption offsets the assets in the trust). Since Simon died first, Ellen's bypass trust effectively terminates. When Ellen dies four days later, the assets that were in her bypass trust would also pass to the children free of estate taxes by using her $2,000,000 exemption. With equalized estates, $4 million in 2006 passes to the children free of federal estate taxes.

Now the "trade-off" may be more apparent. By owning their property as tenants by the entirety, the Howards achieved creditor protection (remember, for a husband and wife who title assets this way, a sale cannot be forced to satisfy one spouse's debts), but they also exposed their joint estate to the possibility of higher estate taxes. On the other hand, had they chosen to minimize estate taxes (Ellen and Simon each making use of their $2,000,000 exemption), the property that each held outright (or as tenants in common) might have been exposed to claims by creditors.

Consult and Assess

We have used the Howards to demonstrate one of the dilemmas of property ownership: If you want maximum estate tax reduction, you must usually sacrifice maximum creditor protection, and vice versa. How important is creditor protection? It depends. Unfortunately, there are no easy answers in this area of estate planning. However, examining the trade-offs involved in using various forms of property ownership may be a good first step toward developing a strategy that most benefits *your* family. In addition, be sure to check with your attorney for applicable state laws concerning methods of property titling.

Term Conversion—Changing Times, Changing Needs

Suppose you had purchased *term insurance* when you were just starting out in life to help protect your growing family. At the time, term insurance may have offered the flexibility to help meet your family's immediate needs at an affordable price. Indeed, the initial low cost and relatively high death benefit of term insurance are often its most attractive features. However, as your children grow and you become more financially successful, your concerns may shift toward strategies that can help maximize savings for retirement, fund a child's college education, or do both. Concerns about the financial security of your surviving spouse and the resources that may be needed to pay any estate taxes owed at your death will also factor into your long-term plans.

Although term insurance premiums are relatively low when a person is young, premiums can substantially increase with age. In some cases, the premiums may remain level, but either the death benefit decreases

continued on page four

term conversion—changing times, changing needs

continued from page three

yearly or a significant premium increase is eventually experienced. Thus, over time, you may become interested in *converting* your term policy to a permanent one.

Advantages of Converting

Like term insurance, *permanent life insurance* also provides a guaranteed death benefit. Some other appealing benefits of permanent life include the following:

- Provided that premiums are paid on time, benefits will never decrease. Also, premiums will never increase and cannot be canceled due to any health changes that you may experience over the years.
- With time, permanent policies accumulate cash values. As the values grow, the insured will have the opportunity to withdraw money from the policy. These loans are tax free and can be used in a variety of ways, such as supplementing retirement income, helping younger generations with college expenses, contributing to the purchase of a second home, or assisting with any other purpose. Loans do not have to be repaid, but if they are not, they will decrease the value of the policy's death benefit.
- Some permanent policies offer non-guaranteed dividend payouts. Such payouts occur when the insuring companies' earnings exceed original projections. Dividends have a wide range of uses. They can be reinvested into the policy to accumulate cash values, taken as cash payouts, or used to fund policy premiums.
- Guaranteed purchase options are another feature that some permanent policies will provide. These options allow the insured to purchase additional amounts of coverage without a medical exam.
- Should the insured decide to cancel the policy, he or she will be guaranteed to receive the full amount of the cash values that accumulated during the life of the policy.

The conversion privilege available in most term policies offers those who cannot initially afford cash value insurance a great opportunity to convert at a later date. Some term policies may offer a *conversion credit* that makes converting to cash value even more economical. Another particular advantage of *converting* from term to cash value, rather than purchasing a new cash value policy, is that there is no need for medical or financial requalification.

More Than Immediate Security

Converting your term insurance to a cash value contract may allow you to continue to provide coverage for your family at a more affordable cost. You will be comfortable knowing your family will be provided for in the event of your untimely death. In addition, you will also feel a great sense of confidence knowing your premiums are building tax-deferred cash values that may be important in the years to come.

While this approach may not be for everyone, it is always wise to review *all* your insurance options. Therefore, you may wish to consult your tax professional for advice regarding *your* particular situation.

The information provided is not written or intended as tax or legal advice and may not be relied on for purposes of avoiding any Federal tax penalties. Individuals are encouraged to seek advice from their own tax or legal counsel. Individuals involved in the estate planning process should work with an estate planning team, including their own personal legal or tax counsel.

Assets is published for the Society of Financial Service Professionals by Liberty Publishing to help keep you up-to-date on the issues which may affect your financial well-being. The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. For specific advice on how to apply this information to your particular circumstances, you should contact your insurance, legal, tax, or financial professional.

Copyright © 2006, Liberty Publishing