

## The Federal Death Tax Might Be Taking a Holiday, But Keep an Eye on Your State's Estate and Inheritance Tax Policy

With the 24/7 rush to get health care reform legislation through the U.S. Senate in the waning days of 2009, Congress let the federal estate tax die for 2010 as planned by the Bush Administration back in 2001. That's not expected to stay the case for long – many experts anticipate that Congress will re-apply exemption levels with retroactive legislation sometime this year to help tame rising deficits.

But, individuals and families should keep their eye on another big estate tax issue – a potentially huge hit from their home state.

A recent report in *The Wall Street Journal* says taxpayers with significant assets need to keep a close watch on what's going on with their home state's exemption levels because most states with estate or inheritance taxes haven't matched the federal exemption levels of recent years. For example, in 2009, all individuals with less than \$3.5 million in assets and married couples with less than \$7 million were exempt from federal estate taxes – this is likely to be the level that Congress may act to reinstate this year.

Working with estate attorneys, tax experts and financial advisors such as CERTIFIED FINANCIAL PLANNER™ professionals can help individuals determine their estate tax situation, an even more important issue now that many states have significant budget woes and may be looking for more revenue to fix them. For some individuals and families, there may be no adjustments in estate tax strategy, but others in extreme circumstances might be advised to move out of state to avoid a potentially big impact.

Individuals and couples should also realize that Congress is considering eliminating the federal deduction for amounts paid for state estate taxes. It's expected to affect individuals with more than \$3.5 million in assets, but it's potentially another big hit.

According to CCH Wolters Kluwer, 17 states and the District of Columbia currently impose estate taxes. Eight states have inheritance taxes, which are levied on heirs, not estates. Maryland and New Jersey have both.

Every state puts its own wrinkle on estate tax issues, and that's why it's particularly important for retirees not only to check how those laws might affect their assets if they settle in a particular state for good.

One possible solution is a bypass trust – a trust that essentially allows the assets of a deceased spouse to access a trust that can be drawn on by the survivor. When the spouse dies, the assets in the trust can go tax-free to designated heirs, preserving the benefit of both individual exemptions. In other words, if a married couple lives in a state with a \$1.5 million individual exemption and establishes such a trust, it would allow them to pass as much as \$3 million to their heirs. Additionally, purchasing life insurance is an effective estate planning technique and is regarded by some experts as the safest way to avoid estate taxes, particularly if the insurance is purchased within an irrevocable life insurance trust.

As the federal government and states start flipping their taxpayers' couch cushions for more revenue, experts say it's also important for individuals and couples to be particularly careful about domicile issues – the actual amount of time individuals live (and therefore can be taxed) in a particular state. In an audit, revenue officials might check the minute details on a taxpayer's lifestyle to determine where they owe tax – car registrations, club and church memberships, health care providers, burial sites and voting records. In other words, the tax planning behaviors of the mega-rich are increasingly becoming relevant for the borderline rich.

One more thing to watch – Congress may eventually act to diminish or eliminate other methods long used by individuals and couples to cut estate taxes. Reports have surfaced that family limited partnerships, grantor retained annuity trusts (GRATs) and qualified personal residence trusts (QPRTs) might go the way of the dodo since they provide the means to freeze or cut the value of assets being transferred out of the owner's home state.

Taxpayers concerned about their estate tax situation might also bring another key group of people into the discussion – their heirs.

When talking about extensive assets, it's good to discuss the tax situations of the giving and the receiving parties to make sure the chosen solutions are best for both sides. It is best to hold a financial planning family meeting to discuss charitable giving intentions, and the protection of the total family's wealth. Clear communication on planning strategies will ensure maximum family wealth preservation.

*January 2010 — This column is produced by the Financial Planning Association, the membership organization for the financial planning community, and is provided by Paul Lemon, CPA, CFP®, a local member of FPA.*