DEBUNKING POLITICAL SPIN ON "DEATH TAXES"

Politicians are fond of sound bites decrying the "evil" of the "Death Taxes," claiming they threaten the family farmer and small business owner, and are destroying the fabric of American society. Such inflammatory language sells well in stump speeches, but is a fundamental misrepresentation of what the tax is or how it applies to financial planning in the real world.

To begin with, there is no such thing as a "death tax" (implying that there is a tax on dying). What does exist are wealth transfer taxes (five of them actually) that have been around since the Civil War and trace their justification back to George Washington. The underlying idea of a wealth transfer tax come from the notion that there is no Royal Family in the United States. In virtually every other country (including especially 18th century England at our Nation's founding), there is (and was) a class distinction between the privileged (who existed above the common laws) and everyone else. The notion of a wealth transfer tax is that no person, by virtue of their birth and fortunes of perpetuity, can live above the rest without supporting the country (by paying taxes) that supports them. Without such a tax, it would be easy for the children of the wealthiest families, to receive untaxed wealth, live on it, then pass it onto their children and their grandchildren, etc. Curiously, the wealth transfer tax system was not actually implemented for this purpose. Rather it was introduced as a means of generating revenue to pay for the Civil War – by taxing only those who were not actually out fighting it.

In modern society, the existence of wealth transfer taxes has lead in other directions. One is that it is the financial source for charitable organizations and churches. Through the use of estate planning techniques, wealthy families make charitable donations as a way of limiting their exposure to the tax, as well as give something back to society in a very meaningful way. Essentially, the modern transfer tax system has evolved to most tax the wealthy *who are also stingy.*

What are the Wealth Transfer taxes? There are actually five different transfer taxes. In four cases, there are threshold limits that exempt people whose wealth transfers are below those prescribed amounts. The fifth is currently a tax exemption rather than a tax.

- **Gift Tax –** A "gift" is defined as any transfer of ownership during a person's lifetime that does not involve a sale for fair market value. In 2006, a person is permitted to gift up to $12,000 per donor per donee, without having to report and/or pay tax. In addition, the donor may give a total of $1 Million his/her lifetime in excess of the $12,000 annual gift allowance.
- **Federal Estate Tax –** This is tax levied by the IRS on estate transfers after death. In 2006 and 2007 the exemption amount is $2 Million. For estate in excess of that, the Federal Estate tax is due within 9 months from the date of death of the estate owner. There are, however, three exceptions:
    1. Transfers to the spouse
    2. Transfers to a qualified charity
    3. 6166 election (for qualified small business owners and family farmers).
       NOTE: The current tax code includes numerous breaks and exceptions for small business owners and family farmers – to the extent that the only ones who would ever suffer a transfer tax problem are those who fail to plan. There provisions of tax code date back to the 1970's.

- **State Inheritance Tax –** This tax is levied by the States. Prior to 2004, it was fully included within the tax calculation for Federal Estate Tax and follows the same exemption amounts. Starting in 2004 most states have imposed a State Inheritance Tax above and beyond their "included share." State inheritance Taxes are due with the Federal and also recognize the same three exceptions.
- **Generation-skipping Transfer Tax (or GSTT) –** This little known tax is designed to plug a "loophole." When wealth is transferred from the first generation to the second, then to the third, a wealth transfer tax would occur at each transition. By skipping a generation, the IRS is denied the tax. Thus the GSTT was developed to keep everything fair and level. In 2006, it alwo has an exemption of $2 Million.
- **Step-up in Basis (for Capital Gains Tax).** This is a current tax exemption that benefits wealth transferees. In this case, the appreciated value of an asset is credited to the individual who inherits it so any capital gain that would otherwise be taxed is eliminated. For example, a man purchases some land for $100,000 that at his death is worth $1.1 Million. If he sold the land the day before he died, he would owe a Capital Gains tax on $1 Million. However, if his son inherits the land and sells it, he would owe no tax on the gain because his "basis" (acquisition value) is stepped up to the $1.1 Million (there is no capital gain to tax).

Under current law (tax act of 2001), the Federal Estate, State Inheritance and GSTT taxes all increase their thresholds step-wise to $3.5 Million by 2008. The Gift Tax does not enjoy an increase in limit. Then, in 2010, the Gift, Federal Estate, and GSTT taxes disappear (are eliminated) but so is Step-up in Basis, meaning they are replaced by the Capital Gains tax. In addition, the State Inheritance taxes are now "naked," meaning estate is now fully exposed rather than being nested within the Federal Estate tax. Thus, the "repeal" of the "death tax" is nothing more than a reallocating of how and when the tax is due- not an outright elimination of it. Rather than eliminating a transfer tax, the 2010 repeal merely shifts the burden from those with net worth of more than $3.5 Million to everyone. Then, in 2011, the entire tax structure "sunsets" to its pre-2001 levels of $1 Million for gifts, Federal and State inheritance, GSTT, but increased over $1 Million by an inflation adjustment and restoration of Step-up in Basis.

Estate Planning techniques offer real solutions to transfer tax liability. Rather than rely on Congress or the President to "fix" the tax problem for everyone, take advantage of some age-old planning strategies that will fix it for you. Unless your estate is worth tens of hundreds of millions of dollars, there are rather simple techniques that will allow you to legally reduce or eliminate exposure to wealth transfer taxes.

1. *Life Insurance Planning* – With the proper use of Life Insurance, it is possible to not only reduce the size of a taxable estate but simultaneously increase the size of the inheritable estate (sometimes substantially). Good insurance planning or inheritance stands as on of the most powerful planning techniques possible.
2. *Funding Tax-deferred Annuities through progressive gifting* – By using the annual gifting exclusion, parents can establish annuities for their children that grow tax-deferred but have restricted access, until the children are 59½. In doing so, the parents can reduce the size of their taxable estate by the size of the net annual gifts, see the gift received by their children and have confidence that it won't likely be squandered.
3. *Charitable Remainder Trust (CRT)* – Possibly on of the most powerful planning techniques in existence, a well-established CRT permits the grantor to:
    - Make a charitable donation to a worthy cause or church of his/her choosing

    - Receive income for life from that transfer
    - Receive a sizable income tax deduction that can apply for as many as six years
    - Ensure the heirs receive an equivalent amount of wealth transfer as the original gift made to the charity or church.
    - Immediately reduce the size of the taxable estate by the full amount of the gift.
4. *Charitable Leads Trust (CLT)* – Similar to a CRT but one where the charity gets the income and the heirs ultimately inherit the original donation but at a taxable value far less than the inheritance and with less or no taxes due on the transfer.

These are just a few of the strategies available to estate planners. While some will require the services of an Estate Planning attorney, many do not. The key is knowing the facts and working with someone who can offer specific solutions to your particular situation. To find out if transfer tax planning applies to you, take the following test:

1. Is your total estate (in 2006) worth $1.5 Million or more?
2. Do you own a home worth (in 2006) at least $500,000?
3. Do you have an investment portfolio worth (in 2006) at least $500,000?
4. Do you have the combination of real estate (including your own home) worth at least $750,000 plus financial portfolio worth at least $300,000?
5. Do you own life insurance worth more than $500,000.

If you answered "Yes" to any of these, you may well have an estate that would be subject to a wealth transfer tax. To find out more, contact an AIN representative for a free analysis. Doing so could save your heirs thousands of dollars.