Estate Planning Basics

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What is estate planning?

It is the preparation of a comprehensive plan designed to create the desired economic and legal consequences in the disposition of your estate. Estate planning has the following major objectives:

1. To provide adequate resources for your retirement.
2. To transfer assets from one generation to the next so as to assure distribution of property to the person or persons of your choice.
3. To conserve as much of your estate as possible for your survivors.

Everyone has an estate plan

Whether you know it or not and whether you like it or not, you have an estate plan. The State of Idaho has a set of rules for disposing of your property if you die intestate - or without a will. If you're willing to accept that plan - the plan of the state - you're in excellent shape. If however you wish to have some control over the distribution of the assets in your estate, you should proceed to develop a set of rules and an estate plan that will accomplish your individual objectives.

Basic estate planning questions

As you begin thinking about planning your estate, you may wish to ask - and answer - the following questions:

1. What would you like to have happen to your property if either you or your wife should die?
2. What would you like to have happen to the property if both you and your wife should die?
   a. What would you want to do with the children? Who would you want their guardian to be?
   b. What would you want done with the childrens' property? Who should be named to legally manage it?
3. What would you like to have done with your property if the entire immediate family should die?

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The latter doesn't happen often but when it does, it can create very serious problems. For example, if the entire family is killed in an automobile accident the order in which they die determines who gets the property. In most states if the husband dies last, all of the property goes to his side of the family. If the wife dies last, all of the property goes to her family.

Objectives of the farmer

The first step in planning your estate is to identify your objectives. Typical objectives are:

1. Provide financial security for retirement.
2. Distribute assets fairly to the children.
3. Minimize death taxes and estate settlement costs.
4. Transfer the farm business to the heirs without selling part of the farm or subdividing it among the heirs.
5. Determine who is going to manage or control the property during life, death of one spouse and finally, death of both the husband and wife.

CHECKLIST OF STEPS TO TAKE IN PLANNING YOUR ESTATE

I. Make a complete inventory of assets and liabilities.
   1. Check titles to all property
   2. Use current market values (later, project values for 5 and 10 years into the future)
   3. Note any expected inheritance
   4. List each party's contribution to jointly-owned property

II. Analyze your present position
   1. Obtain copies of current wills
   2. Inventory all life and health insurance policies and have them available
   3. Note special situations such as handicapped children, parental support, etc.
   4. List employer benefit plans
   5. Check on probable Social Security benefits

III. Decide on objectives
   1. Family income need
      a. In case of disability
      b. In case of premature death
      c. At retirement
   2. Do you want your business to continue or terminate at retirement or death?
      a. Which assets will be retained?
      b. Which assets will be sold?
   3. Investments
      a. Who will manage them?
      b. Who will dispose of them?
   4. Minor children
      a. Will a guardian of the person be needed?
      b. Consider a trust to manage their property
      c. At what age will funds be distributed?
   5. Amounts to be passed to charities and other special interests

IV. Consult the estate planning team
   1. Qualified life underwriter (CLU or other agent)
      a. Analyzes present insurance
      b. Examines need for liquidity
      c. Lists problems regarding liquidity, transfer costs and income
   2. Trust officer
      a. Makes recommendations regarding trusts and executors
      b. May make investment recommendations
      c. Can offer management of assets
      d. Source of information on estate planning

3. Accountant
   a. Computes tax consequences of various transfers
   b. Provides advice on valuing assets
   c. May help provide for business continuation or sale
   d. May provide property management assistance

4. Lawyer
   a. Pulls together all ideas into a well-integrated plan
   b. Draws all legal documents
   c. Assists in making final decisions on best methods of transfer
   d. May do hypothetical probate to test the plan

NOTE: The insurance agent and trust officer are both available without fee to help you correlate your plans. You may wish to confer with them early in the estate planning process.

You should give some thought to your objectives and options in order to be in a better position to ask the right questions of your legal advisor.

V. Decide on a plan
   1. Provide liquidity—this is especially important if the business is to continue after death.
      a. Savings accounts
      b. U.S. Bonds and corporate bonds, including "flower bonds"
      c. Life insurance
   2. Make changes in ownership of assets—deeds, stock certificates, etc.
   3. Make gifts if desired
   4. Execute wills and trust documents

VI. Test the plan under all levels of concern
   1. Disability
   2. Premature death
   3. Retirement
   4. Husband dies first
   5. Wife dies first
   6. Both husband and wife die
   7. Husband, wife and children die

VII. Review your plan regularly
   1. Keep a current list of assets
   2. Keep your will current
   3. Advise appropriate members of your estate planning team of any major changes in your situation

Major Estate And Gift Tax Provisions of the 1976 Tax Refore Act

A unified rate schedule for estate and gift taxes.--Under the old law, estate and gift taxes were levied separately; each had its own tax rate schedule. Since the gift tax was lower than the estate tax, an individual could substantially reduce Federal taxation of intergenerational transfers by giving part of his property away during his lifetime instead of transferring all of it in a bequest. The new law eliminates this separation, and treats all transfers--whether given during one's lifetime or at death--substantially the same.

In the previous law, there was a $60,000 exemption for the estate tax and two different kinds ofexemptions for the gift tax--a once-only exemption of $30,000 and an annual exemption of $3,000 for each separate donee. The $3,000 annual gift exemption is retained in its present form; an individual may still give up to $3,000 each to other individuals every year without such gifts entering the tax base. However, the two once-only exemptions have been eliminated and replaced with a single tax credit.

For decedents dying in --	Unified credit	Equivalent Exemption 1/
1977	$30,000	$120,667
1978	34,000	134,000
1979	38,000	147,333
1980	42,500	161,563
1981 and thereafter	47,000	175,625

The tax schedule itself will be progressive, increasing from a marginal rate of 30 percent (32 percent after 1980) on taxable transfers to 70 percent for cumulative taxable transfers of more than $5 million. Page five of this paper includes the entire rate schedule, as well as an example of its use.

Marital deduction.--The previous marital deduction was half of the adjusted gross estate. This has been increased to the larger of $250,000 or half of the decedent's adjusted gross estate. This is, of course, in addition to the usual tax credit available to all estates, but it is limited to the amount the spouse actually receives if the marital deduction is larger than the bequest. There is also a special marital deduction for gifts--a complete deduction for the first $100,000 in lifetime transfers, no deduction for the next $100,000 and a 50 percent deduction for all subsequent gifts.

Valuation.--Under this new provision, real property in an estate that is devoted to farming or other closely held businesses may be valued for estate tax purposes on the basis of its use in that capacity rather than on the basis of its fair market value. However, this special valuation cannot reduce the decedent's gross estate by more than $500,000. To qualify for this special valuation, these factors must be met:

(1) The value of the farm or other closely held business assets (both real and personal property) must comprise at least 50 percent of the decedent's adjusted gross estate.

(2) At least 25 percent of the adjusted value of the gross estate must be qualified farm or other closely held business real property.

1/ These equivalent exemptions are not comparable with the $60,000 exemption under the previous estate tax provisions because of the different tax rate structure which prevailed.

Federal Estate Tax Rate Schedule
(Effective on January 1, 1977)

If taxable estate value is at least 2/--	Tax liability is--	Plus--	Of excess value over 3/--
Dollars	Dollars	Percent	Dollars
0	0	18	0
10,000	1,800	20	10,000
20,000	3,800	22	20,000
40,000	8,200	24	40,000
60,000	13,000	26	60,000
80,000	18,200	28	80,000
100,000	23,800	30	100,000
150,000	33,800	32	150,000
250,000	70,800	34	250,000
500,000	155,800	37	500,000
750,000	248,300	39	750,000
1,000,000	345,800	41	1,000,000
1,250,000	448,300	43	1,250,000
1,500,000	555,800	45	1,500,000
2,000,000	780,800	49	2,000,000
2,500,000	1,025,800	53	2,500,000
3,000,000	1,290,800	57	3,000,000
3,500,000	1,575,800	61	3,500,000
4,000,000	1,880,800	65	4,000,000
4,500,000	2,205,800	69	4,500,000
5,000,000	2,550,800	70	5,000,000

2/ The taxable estate is defined as the gross value of the estate less the total exemptions and deductions allowed by the Internal Revenue Code of 1954, as amended.

3/ The following example is a calculation of Federal estate tax liabilities made by using this schedule: Suppose a man dies in 1977 and leaves an estate of $400,000 (after all debts and estate administration fees are paid) to his wife. The estate is entitled to use the marital deduction, which is now $250,000. Thus, the estate has a tax liability on $150,000. Looking at the schedule, the tax is $33,800. But if the man made no prior use of the new tax credit, the full $30,000 credit may be deducted, leaving a tax liability of $3,800. Of course, the amount which can be deducted also depends on what gifts have been previously granted and on the year the estate is probated. (Under provisions of the old law, the tax liability for this estate would have been $32,700.)

(3) The property must pass to a qualified heir (a member of the decedent's family).

(4) The real property must have been owned by the decedent and been in its present use for 5 of the last 8 years preceding the decedent's death.

(5) The decedent or a member of his family must have materially participated in the operation of the farm or other closely held business for 5 of the last 8 years immediately preceeding the decedent's death.

In addition, a recapture rule affects the tax benefits provided by this special assessment if the heir subsequently sells the property to individuals outside the family or converts the use of the property from farming or other qualifying business purposes within 15 years of the decedent's death (unless the sale occurs because of the heir's death). If the sale takes place within 10 years of the decedent's death, all the tax benefits are recaptured; the amount subject to recapture is phased out during the remaining 5 years. The potential recapture is enforced by a special lien placed on the real property which heirs elect to have valued by the special valuation procedure.

The special valuation is determined by dividing the average yearly gross cash rental of comparable land, less State and local real estate taxes, by an average of the annual effective interest rates for all new Federal Land Bank Loans. (This represents a commonly accepted means of capitalizing an infinite stream of returns.) These averages are computed on the basis of the most recent calendar years preceding the decedent's death. But several alternative valuation rules can be used at the discretion of the estate executor when it is established that comparable gross rental values are not available.

<u>Extension of time for payment of the estate tax.</u>--Section 6166 in the Internal Revenue Code previously allowed a 10-year extension of estate tax payments for estates that were largely attributable to farms and other closely held businesses (35 percent of the gross estate and 50 percent of the taxable estate in the closely held business). The new act retains this treatment, and provides more liberal treatment of certain cases. The time period for tax payments was extended to 15 years for an estate in which the value of the closely held businesses makes up at least 65 percent of the adjusted gross estate. This kind of estate also qualifies for a special 4-percent interest rate on the tax liability from the first $1 million of farm or other closely held business property in the estate. The interest on the rest of the estate's tax liability will be calculated at the regular rate.

Further, the new law substitutes a "reasonable cause" test for the "undue hardship" test of the old law with respect to obtaining extensions of time to pay the tax. Under this third type of extension payment plan, any estate may qualify for a 10-year tax payment extension plan if "reasonable cause" for such an extension is demonstrated.

The legislation also provides for a special lien to secure the unpaid estate tax liability attributable to a farm or other closely held business. The lien will apply to real and other property which can be expected to survive the tax payment period. When this procedure is followed and when a party is designated to make tax payments and receive and send IRS notices, the executor will be discharged from personal liability. Previously this was a major deterrent to the use of the installment payment provision.

Carryover basis.--Capital gains that are unrealized during an individual's lifetime have not been taxed under prior estate tax provisions. The present act will change this practice somewhat in the future.

Under the old law, the tax basis of inherited property was "stepped up" to its fair market value at the time of the decedent's death. Later, when an individual sold this inherited property, taxes were paid on the difference between the selling price and the "stepped up" value of the property. But any appreciation before the time of the inheritance was never taxed as income.

Under the new provisions, the tax basis for marketable bonds and securities will be either the original purchase price or the appraised fair market value on December 31, 1976, whichever is greater. Farmland and other assets will be considered separately. Their appreciation will be prorated by a straight-line apportionment method based on the relative amount of time the property was owned before January 1, 1977. The less time this type of asset was owned before this provision takes effect, the greater the percentage of the appreciation will be taxable. The rule is as follows:

$$\text{Appreciation subject to tax} = \frac{\text{Amount of time asset held after December 31, 1976}}{\text{Total amount of time asset held before sale}} \times \text{Total appreciation}$$

So, no appreciation attributable to an asset before January 1, 1977, will be subject to the new carryover basis rules. Executors may elect to exclude as much as $10,000 of assets which were household or personal effects of the decedent. In addition, the basis of an estate can be stepped up to $60,000. Thus, the new provision is not intended to apply to beneficiaries of smaller estates.

Generation-skipping transfers.--Some transfers, as organized under trusts or other similar arrangement, have in the past avoided estate taxation on the generations being skipped. In the future, these transfers will be taxed when the trust assets are distributed to a generation-skipping heir or when an intervening interest in the trust is ended. An exception is provided which permits one generation to be skipped if the transfer is to a grandchild, but it is limited to a transfer of $250,000 or less.

The tax will be substantially equivalent to the estate tax which would have been imposed if the property had been transferred outright to each successive generation. In general, these provisions apply only to generation-skipping transfers that take place after April 30, 1976. But they will not apply to any transfer under a trust which was irrevocable on April 30, 1976, or to revocable trusts and wills if the grantor dies before January 1, 1982, and the trust instrument or will is not revised after April 30, 1976.