

Understanding the Federal Estate Tax

One of your estate planning goals may be to ensure your family's financial security by providing a generous legacy. But estate, gift, and generation-skipping transfer (GST) taxes can significantly reduce the value of an estate. Without careful planning, these taxes could claim a large portion of the assets you intended to leave to your loved ones.

The purpose of this overview is to give you a better understanding of federal transfer taxes and their potential impact on your estate. Knowing when and how these taxes come into play is the first step in designing and implementing an effective planning strategy.

Your Gross Estate

Basically, your *gross* estate is the value of all the property in which you hold an interest at your death. The value of certain assets may be included in your estate even though someone else holds legal title to the property. Here's a partial list of property that would be included as part of your gross estate.

- Your personal possessions
- Amounts you have on deposit in checking and savings accounts
- Stocks, bonds, and other securities you own
- Real estate you own
- Your partnership and business interests
- The proceeds of insurance policies on your life if you possess any "incidents of ownership" in them at your death
- The value of insurance policies you own on the life of someone else
- Debts owed to you
- Your interest in retirement plans and individual retirement accounts
- The value of any annuity you own that will continue to be paid to another beneficiary after your death
- The value of jointly held property, except for any part contributed by the survivor (An exception: One half the value of property owned by you and your spouse is includable in your estate, regardless of who provided the consideration for the property.)
- The value of property over which you possess a "general power of appointment" (usually in conjunction with a trust)

Valuing Your Gross Estate

The value of property for estate-tax purposes is its *fair market value* at the time of your death (or at the "alternate valuation date," generally six months later). Fair market value is the price at which property would exchange hands between a willing buyer and a willing seller, both with reasonable knowledge of relevant facts. The tax law contains "special" valuation provisions for certain types of property, such as farm property and real estate used in closely held businesses.

Your Taxable Estate

Once the value of your gross estate has been determined, certain items are subtracted from the total to arrive at your *taxable* estate. Deductible items include:

- Administration and funeral expenses
- Claims against your estate, such as your mortgage, valid debts you owe, and unpaid property or income taxes
- Any loss resulting from a fire or other casualty that occurs during the estate administration period if the loss isn't reimbursed (for example, by insurance)

Your estate may be entitled to other important deductions as well.

The Unlimited Marital Deduction

Generally, your estate may deduct the value of all property passing from you to your surviving spouse in a qualified manner. The practical effect of the marital deduction is that you're generally

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allowed to pass an unlimited amount of assets to your surviving spouse free of estate tax. However, leaving all property outright to your spouse may not be the best estate planning approach, especially if the value of your combined estates is greater than the unified credit exclusion amount (discussed later). Although your assets will pass tax free to your surviving spouse, when your spouse dies, the assets that remain will be included in his or her estate for tax purposes, potentially reducing the amount your children or other heirs eventually inherit.

The Charitable Deduction

Your estate may be entitled to a charitable deduction for the value of any property you give to a qualified charitable organization. The estate-tax charitable deduction isn't subject to percentage limitations, so your executor or personal representative may claim a charitable deduction for the full value of the gift.

Computing the Federal Estate Tax

The accompanying table summarizes the federal estate-tax computation. As you can see, the value of any lifetime gifts you made that gave rise to a gift tax must be added to your taxable estate. The estate-tax rate is applied against this total. Once this tentative tax is determined, any gift taxes you paid are subtracted.

Every estate is allowed a unified credit that permits a certain amount of assets to pass to beneficiaries free of estate and gift tax. Generally, no estate tax will be due if your total taxable estate and taxable lifetime gifts are less than or equal to the applicable credit exclusion amount — \$5.12 million in 2012. In 2013, the exclusion amount is scheduled to revert to \$1 million and the top estate-tax rate jumps from 35% to 55%.

Under a special "portability" provision, any exclusion amount that remains unused by the estate of a spouse who dies in 2012 (or died in 2011) generally may be added to his or her surviving spouse's exclusion amount. As a result, it may be possible for the surviving spouse's estate to avoid estate tax on more than \$5.12 million of assets. However, certain restrictions apply, and this provision is only temporary under current law.

	Gross Estate
-	Allowable Deductions
=	Taxable Estate
+	Taxable Lifetime Gifts
=	Total
	Tentative Tax from Estate-tax Table
-	Gift Tax Paid on Lifetime Gifts
=	Estate Tax Before Credits
-	Unified Credit
=	Estate Tax Owed

The Generation-skipping Transfer Tax

You may want to arrange for some of your assets to benefit a grandchild or someone else much younger than you are. But be aware that the tax law limits the value of the assets you can pass tax free to individuals who are more than one generation below yours. The *generation-skipping transfer tax* is designed to prevent families from avoiding a generation's worth of estate taxes by transferring assets to grandchildren rather than to children. The GST-tax rate is equal to the highest federal estate-tax rate and must be paid *in addition* to estate and gift taxes.

But there is some good news. A cumulative GST-tax *exemption* allows you to transfer up to \$5.12 million (in 2012) to grandchildren and others free of the GST tax (\$10,240,000 if you and your spouse agree to split the gift). Also, the GST tax generally won't apply to transfers made to a grandchild whose parent is deceased.

Although minimizing taxes is a worthy objective, preparing for your loved ones' financial security is an equally important goal of estate planning. Strategies are available to help you both reduce your tax liability and preserve more of your assets for the benefit of those you love and the charitable causes you support.

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