Estate and inheritance tax laws have recently undergone substantial changes and are likely to continue to change in the near future. Accordingly, it is important to have your estate plan reviewed periodically. Aside from estate taxes, a person's death and the manner of holding title to assets may also have income tax consequences.

A full treatment of tax issues arising on the death of an individual is well beyond the scope of this pamphlet. However, some common questions are addressed below.

Estate and Inheritance Tax

Only large estates are subject to estate taxes. For all intents and purposes, inheritance tax in California has been abolished. For persons dying in 2011 and 2012, federal estate taxes only apply to estates over $5,000,000, and unless Congress acts to extend the temporary rules set to expire on January 1, 2013, persons dying after that date will pay taxes on estates over $1,000,000.

The amount of property which may be given away is called the "exemption equivalent". Amounts given that are over that amount are taxed at a 35% rate for 2011 and 2012, and a graduated rate from 41% to 60% for 2013.

Estate taxes should not be confused with probate expenses. Even if the estate is less than the exemption there may be expenses associated with probate unless a trust or other probate avoidance mechanism is used. Conversely, even if probate is avoided with a trust, there might be estate taxes if the estate is large enough.

Tax Planning For Spouses

Often, spouses make wills providing that each spouse leaves his entire estate to the other. If the other spouse has already passed away, the estate goes to their children or other persons. Prior to 2011 couples with assets above the exemption equivalent who made such wills were risking the imposition of unnecessary taxes. However, as a result of new portability rules, a spouse may leave all of their property to their surviving spouse, and upon the death of the second spouse, a combined exclusion of $10,000,000 can be utilized.

In most cases, one may give anything he wants to his spouse without gift or estate tax regardless of amount. Thus, under the scheme involving the wills described above, there will be no tax owing at the first spouse's death, and upon the second spouse's death, both exemption amounts could be used, so only amounts over $10,000,000 would be taxed.

Certain rules must be followed in order to qualify for the portability of exclusions between spouses. In order to qualify for portability, the executor of the estate must file a timely 706 and make the appropriate election. Additionally, the person claiming the portability may only carry-over the unused exclusion of the *last* deceased spouse. Furthermore, the portability does not extend to the deceased spouses Generation Skipping Transfer Tax.

Unless Congress acts, for people dying after January 1, 2013, the exemption equivalent will be set at $1,000,000 and no portability will be allowed. Thus, under the scheme involving the wills described above, there will be no tax owing at the first spouse's death, but only the second spouse's exemption equivalent would be used, so amounts over the exemption equivalent would be taxed.

For example, suppose Jim and Mary (a married couple) own $2,000,000 in community property assets, that Jim dies in early 2013, and that Mary dies later the same year. If they had the wills described above, Jim's half of the assets would go to Mary without tax. When Mary dies, $1,000,000 of the assets ($2,000,000 less the $1,000,000 exemption equivalent) will be taxed at a 41% to 60% rate.

The problem may be overcome by using what is known as an A-B trust. Under such a trust instrument, when one spouse dies, the couple's assets would be divided so that both spouses' exemption equivalent would be used.

If Jim and Mary had created such a trust, on Jim's death the trust would be divided into two trusts, often called the survivor's trust and the deceased spouse's trust. Typically, the survivor's trust would contain Mary's half of the community property, $1,000,000 (plus any separate property she owns) and would be fully revocable and amendable (meaning that she could do anything she wanted with it.) The deceased spouse's trust would contain the rest of the property up to the exemption equivalent (in our example, $1,000,000) and would be irrevocable. However, Mary would receive all of the income of the deceased spouse's trust while living, and could use the principal for emergencies or to maintain her standard of living. Both trusts would be given to the couple's children when Mary dies.

Because it is irrevocable, the deceased spouse's trust is considered to have come from Jim, even though Mary could reach it if she needed and the children do not receive it immediately. Gifts to the children *are* subject to estate tax, but since the deceased spouse's trust is only $1,000,000 in value, no tax is owing. Neither will there be any tax due when Mary dies, as the survivor's trust is also less than $1,000,000.

QTIP Trusts

A device known as a QTIP Trust can be used to delay payment of estate taxes until after both spouses have died without giving the surviving spouse the absolute right to do anything she wants with that property.

Suppose Bob and Alice married late in life and that Alice has $1,800,000 in separate property and that Bob has $200,000. If Alice died in 2013 and left her estate to her children, they would have to pay tax on $800,000. However, if she left $1,000,000 to her children and the rest in a QTIP trust, Bob could receive the income from the remaining $800,000 which would be taxed as a part of his estate when he dies, but would still go to Alice's children. Since Bob's estate will probably be less than the exemption equivalent, Alice's children would not have to pay any estate tax at all.

Joint Tenancy Versus Community Property

The majority of spouses in California probably hold some property as joint tenants. For property which has increased in value, that method of holding title can have significant tax consequences.

Capital gains tax (a type of *income* tax, not estate tax) usually must be paid when property is sold for a profit. The amount of tax is figured on the difference between the "basis" (basically cost) and sales price. The higher the basis, the less tax is owned when property is sold. (There will be less profit.) For joint tenancy property, when one owner dies, the basis is increased to the fair market value of a one-half interest plus one-half the original basis. For assets held as community property, the basis is increased as to the *entire* value of the property.

Suppose Jim and Mary purchased investment property in 1985 for $200,000 which is worth $1,000,000 in 2011 when Jim dies. Mary decides to sell the property that year. If the property were held in joint tenancy, Mary's basis would be $600,000 and she would be taxed on the difference, or $400,000. If title was held as community property, Mary's basis would be $1,000,000 and there would be no tax.

Gifts During Lifetime

Under current law, for the years 2011 and 2012 individuals may give away up to $5,000,000 during their lifetimes without having to pay gift tax. Gifts over that amount are subject to gift tax at a 35% rate. The value of gifts made up to $5,000,000 is subtracted from the amount that may be given without estate tax after the donor dies.

An exception to this principal is that a person may give up to $13,000 per person per year without any estate or gift tax consequences. There will be no particular savings unless there will be tax owing on the giver's estate when he dies. People whose estates aren't that large should make such gifts only if there are other reasons for doing so. On the other hand, tax savings resulting from such gifts can be substantial for people with large estates.

The basis in property given during one's lifetime is not stepped up, but it is for property given at his death. Thus, gifts of appreciated properties should not be made during one's lifetime since if the recipient of the gift sells it, he may have to pay increased capital gains tax.

ABOUT ESTES & ESTES, LLP

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