The Estate Tax is in Flux, So Concentrate on What you Can Control –

Check Your Beneficiary Designations Today

By Jim Coleman

As we embarked on a new decade, headlines like "On Your Mark, Get Set, Die!" greeted readers of personal finance pages. Because Congress failed to pass a new estate tax law before the 2009 sunset of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), 2010 began without an estate tax.

How did this happen in a nation where Ben Franklin famously quipped there are two guarantees – death and taxes? Although the House of Representatives passed an extension of the current 2009 estate tax rate, which taxed individual estates worth $3.5 million or more and couples' estates worth $7 million or more at 45 percent., the Senate, where a majority of Democrats favor raising the rate and Republicans favor its elimination, failed to act. Congressional leaders have, however, pledged to enact a retroactive fix early this year.

If Congress doesn't act, estate taxes will be reinstated in 2011 at a rate of 55 percent for estates valued at more than $1 million. There are many proposals, some of which would change the income tax aspects on inherited monies. The law eliminating the estate tax in 2010 also replaced the step-up in basis at death with a modified carryover basis on appreciated assets inherited from a decedent in 2010. In years prior to and following 2010, most assets included in an individual's estate receive an unlimited 100% step-up in basis. That is, individuals inherited assets with a basis equal to their value at the date of the death of the decedent. If the heir subsequently sold the inherited asset for its value as of the date of death, capital gain tax was not imposed.

In contrast, after December 31, 2009 the basis of property acquired from a decedent is equal to the lesser of the decedent's adjusted basis and the fair market value of the property on the decedent's death. In addition, the executor is permitted to allocate a limited basis step-up of $1.3 million of property passing to all beneficiaries and an additional $3.0 million of property passing to a spouse in a qualified manner (giving the spouse a potential step-up of $4.3 million.) This means that those inheriting estates will have to pay capital gains taxes on any assets sold based on the original price paid for the asset, after an exemption for the first $1.3 million in capital gains (plus $3 million for assets transferred to a surviving spouse).

According to estimates from the chief tax counsel for the House Ways and Means Committee, while last year's estate tax laws would have impacted about 6,000 estates, 71,400 estates could now face these new capital gains taxes. Further, the Center on Budget and Policy Priorities estimates that at least 62,500 of these are estates would not have owed any estate tax if the 2009 tax laws had remained in affect. Because family farms and businesses constitute a disproportionately large share of this group, they continue to lobby strongly for estate tax reform.

SOURCE: http://www.elderlawanswers.com/resources/article.asp?id=8002&Section=4&state=

When Congress acts, we may see the re-emergence of 2009's $3.5 million ($7 million for couples) exemption, thereby preserving all the carefully crafted estate plans. Notably, however, if nothing happens on Capital Hill this year, come 2011, the pre-2001 exclusion of $1 million ($2 million for couples)

returns, and the top rate for assets above that amount would revert back to the 55% level set before EGTRRA.

Having federal estate tax laws in flux is obviously difficult from a planning perspective. The fact that more than 20 states already have decoupled from the federal estate tax system also presents challenges. (These states generally chose to remain at the $1 million exemption that was effective before EGTRRA. And if you die in a state that has decoupled, your estate could be subject to state estate tax.)

Concentrate on What you Can Control – Beneficiary Designations

Rather than spend our time second guessing Congress and bemoaning the continued lack of clarity from Washington, I urge clients to focus on an estate planning issue that potentially can have a greater impact on their heirs than whether the estate tax exemption increases by $500,000 or $1 million – Beneficiary designations.

While you may view your will as the cornerstone of your estate plan, it's important to remember that there are assets that pass outside of the will directly to your named beneficiaries. Proceeds from life insurance, investments in Individual Retirement Accounts (IRAs), annuities, and qualified retirement plans (such as 401(k)s, 403(b)s, and SEPs), as well as trust property pass directly to your named beneficiary, bypassing probate. (Jointly owned property – your home, car, bank and investment accounts also automatically pass to the surviving co-owner, avoiding probate.)

Often overlooked in estate planning is the fact that the beneficiaries you name for assets such as IRAs and 401(k)s take priority over instructions in your will. That is, the beneficiary you named for your retirement account twenty years ago will inherit those assets even if you later specify in your will that someone else will inherit everything you own. I've seen instances where a 50 year-old woman with a husband and family still has her father listed on the beneficiary account of the 401(k) from her first job. Obviously, if her father is dead when she passes away, the 401(k) would be directed to her father's heirs, not her family.

Again, because named beneficiaries take priority over the instructions in your will, it is possible that the majority of your net worth could pass outside your will through your IRAs or 401(k)s to beneficiaries you forget naming. Accordingly, it's crucial that you review your beneficiary forms – all of them – on a regular basis. The following tips can help you ensure that you have properly designated your beneficiaries:

- **Do not list "my estate" as your beneficiary**. IRA beneficiaries should be named people. Specifying "my estate" is a mistake because estates and other legal entities don't have life expectancies. Accordingly, when you leave your IRA to a trust, the entity must draw down and pay taxes on the entire IRA account within five years or according to your original distribution plan if you have already begun taking distributions.

- **Name your beneficiary carefully.** Who should you name as your beneficiary? From a tax standpoint, your spouse is usually the best choice. A spousal beneficiary has the greatest flexibility for delaying IRA distributions that are subject to income tax. In addition to rolling over your IRA into his or her IRA, a surviving spouse can decide to treat your IRA as his or her own IRA. This can provide greater flexibility for long-term tax planning. However, while naming a surviving spouse can be the best move from an income tax standpoint, a possible downside could be increasing the size of your spouse's estate beyond any applicable future exclusion amount.

If you name a non-spousal beneficiary, your child, for example, he or she will not be permitted to co-mingle the inherited IRA with another account without taking a complete distribution and triggering taxes. However, as a designated beneficiary, a non-spouse beneficiary can stretch out distributions over his or her own life expectancy. Since today's tax regulations default to the stretch IRA for a designated beneficiary, most IRA custodial agreements do the same. However, there is no guarantee. Some financial institutions still restrict beneficiary options in their IRA custodial agreements or annuity contracts and might not allow the stretch IRA, so it's wise to check on those details.

- **If you name a minor as a beneficiary, name a guardian for them.** Because the courts' view is that money left to a minor should be put in a savings account until that person is age 18, there could be a situation where, for an extended period of time, a half a million dollars sits in the bank earning next to nothing. To afford your beneficiary better investment options, name a guardian who can invest the money on their behalf.

- **Attend to the per stirpes designation.** You may want to ensure that your assets go to your blood family — that is to your children or grandchildren rather than your children's spouses. However, when you explain this to a mutual fund company, many often will send a standard change of beneficiary form that may not have the essential per stirpes designation listed as an option. Many fund companies have a completely separate form for the per stirpes designation, so ask for it by name.

- **Request and review your beneficiary forms every few years**. If you had an IRA before you got married, it is likely you will want to change your beneficiary from your parents or siblings to your spouse. Similarly, if you have old 410(k) plans scattered around the country from jobs you held decades ago, you need to update those beneficiary forms as your personal circumstances change. Finally, with today's high level of mergers and acquisitions, beneficiary forms could get lost. So even if you do not have any changes in your own life, it is a good idea to request copies of your beneficiary forms from your former employers and mutual fund companies every few years.

- **Review your plan in light of the recession.** Market downturn presents both challenges and opportunities for estate planning. A quick to-do list should include reviewing your will and beneficiary forms to ensure that losses in asset values of your real estate holdings or investment accounts have not resulted in an unintended, disproportionate distribution to your heirs. Also, if gifting is part of your estate planning strategy, now could be a good time to gift assets whose values have plummeted to minimize transfer taxes.

With the multitude of political and economic arguments surrounding the federal estate tax, it's unlikely any resolution will come swiftly or last for very long. Accordingly, in summary, in addition to listing death and taxes among life's certainties, I would include debate over death taxes.

While Congress continues to wrestle with the future of the federal estate tax, once you've completed a careful analysis of your beneficiary forms, be sure to let your executor know where to find them – along with your will, your living will and power of attorney documents, and passwords to computer accounts. Securities America's Personal Document Locator is a handy resource in that regard. Mark Kaizerman's *Beneficiary Directory* also offers a valuable step-by-step guide for organizing documents for your heirs. Finally, there are also a number of providers of virtual vaults for estate planning documents, including emoney (www.emoney.com) and Executor's Resource (www.executorsresource.com) that can help you to efficiently manage your estate plan.

About Jim Coleman

Jim Coleman has been in the financial services industry for over 20 years. He founded Coleman Financial Advisory Group, voted "The Best Financial Advisor of Greater Waterbury for 2008 and 2009". Coleman specializes in providing comprehensive financial planning, asset management and estate planning services. He holds a degree from Northeastern University, in Boston, with a double major in finance and marketing. He is a member of the Financial Planning Association and is the President of the Connecticut Chapter of the Society for Financial Awareness.

Coleman's passion is finding solutions to financial problems and further educating his clients and the community. Listeners in Connecticut rely on Coleman to deliver sound, accurate financial advice as host of *All About Money,* a radio talk program. He writes a financial planning column for a local newspaper, the *Prospect Pages*, and recently authored a book titled *Educated Investing: Your Guide to Surviving and Thriving in the Fast-Paced Global Markets of the 21st Century.* Visit www.ColemanAdvisoryGroup.com to learn more.

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