

info sheet Using estate planning to minimize taxes

Why you need estate planning

Thoughtful estate planning is crucial so that your property is transferred according to your wishes. But in addition, a comprehensive estate plan will help you manage both your tax bill and that of your beneficiaries.

Gifts can help reduce your tax exposure

Gifts are a good way to transfer your wealth tax-free, while at the same time lessen the size of your estate thereby reducing estate taxes down the road. Gift taxes are based on all property transferred throughout your lifetime. In general, a taxable gift occurs when you give an amount in excess of \$11,000 to anyone in a single calendar year. While a gift tax return is required to be filed annually whenever taxable gifts are made, you will not pay any gift tax until your lifetime total taxable gifts exceeds the applicable credit amount (\$1,000,000 in 2002). The exclusion that allows a taxpayer to give up to \$11,000 annually to each of any number of persons without incurring any gift tax liability is an important planning technique. Additionally, all gifts to a spouse or to a charity generally are not taxable.

Tax year Tax-free (applicable credit) amount

2002	\$1,000,000
2003	1,000,000
2004	1,500,000
2005	1,500,000
2006	2,000,000
2007	2,000,000
2008	2,000,000
2009	3,500,000
2010	repealed

Subject to the applicable credit discussed above, there is generally no limit as to how many people to whom you can give annual gifts. In addition, there is a split-gift provision that enables a married couple to elect to give jointly — and free of gift tax — up to \$22,000 per recipient, thereby taking advantage of each of the spouse's \$11,000 annual exclusion.

Any amounts you pay on behalf of someone directly to a qualified educational institution for tuition and/or to a medical care provider for medical expenses are also not subject to gift taxes. The gift tax exclusion for tuition and medical expenses is in addition to the \$11,000 gift tax annual exclusion and is permitted without regard to the relationship between the donor and the donee.

Making the marital deduction work for you

An unlimited deduction for transfers between spouses is allowed for both gift and estate tax purposes. With this unlimited marital deduction, all estate tax upon the death of the first spouse can be avoided merely by leaving all of the estate to the surviving spouse. There is, however, a potential drawback to this technique. When the first person dies, his or her applicable credit goes unused since all of the property passes to the spouse. Assuming that the spouse dies still owning some of that property, it will then be included in his or her estate and only one applicable credit amount will have been used. The applicable credit in the first estate would be wasted. This is particularly important in larger estates where up to \$2 million (in 2002) can be sheltered from tax with the use of two applicable credit exemptions.

Additionally, if all assets are held by a husband and wife as joint tenants with right of survivorship (JTWROS), no matter what the will says, all of the assets will pass by law to the surviving spouse. To effectively use each spouse's applicable credit along with the unlimited marital deduction, it is essential that at least enough property to utilize each spouse's credit be *individually* owned.

Estate equalization and the marital deduction

Equalization can be an effective tool when married couples have property that they want to leave to their heirs, but which is valued above the deduction limits and would engender higher estate taxes. Many individuals use the combination of their applicable credit and their unlimited marital deduction to transfer some assets to their heirs (equal to the applicable credit amount) and 100% of their remaining assets to their surviving spouse (under the unlimited marital deduction), thereby avoiding paying any estate taxes on the death of the first spouse. Depending on the size of the estate, however, the estate taxes might be higher upon the death of the second spouse.

One possible planning technique is to leave more assets to the non-spouse heirs and pay some estate taxes on that property when the first spouse dies. In some cases, this can result in a lower total estate tax (when you add the tax liabilities of both spouses' estates) because both spouses' estates get the benefit of the lower estate tax brackets. Equalization can shift more assets to future generations and ultimately pass more money on to the heirs. However, in some cases, it may not be worthwhile to pay any estate taxes at the death of the first spouse because the tax savings are not significant. You should ask your investment professional whether this strategy would be appropriate for you, your financial portfolio, and your estate plans.

The tax advantage of giving money to charity

Generally speaking, gifts to charities are not subject to gift taxes. Lifetime charitable donations have two advantages. The donation is eligible for an income tax deduction, and the property donated is removed from the donor's estate thereby reducing the ultimate estate tax exposure. Charitable bequests made upon death via a will or a specially designed trust will also generate estate tax savings. For example, consider the case of Joe and Sheila, each of whom has \$1,000,000 in separately owned property. They have no children and wish to leave as much money as possible to their favorite charities. When Joe dies, he could give all of his property to the charities, and there will be no federal estate tax due upon his death. Sheila could continue to use her own assets for her support and then leave the remainder to the charities, again avoiding any estate taxes. Alternatively, Joe could leave everything to Sheila and have no estate taxes because of the marital deduction. When Sheila dies, she could leave all of the property to charity, and her estate would get the full deduction.

Planning options existing after death

While the best estate planning is done during your lifetime, there are some steps your heirs and executor may be able to take in order to save some estate taxes. Various income tax elections and other federal income tax planning options can be used after your death so as to produce overall tax savings for your family. For example, some medical expenses can be deducted either on the decedent's final income tax return or on the estate tax return. The decision of where to deduct them will be based on the tax rates applicable to each return.

Some expenses incurred in the administration of the estate can be deducted either on the estate tax return or on the income tax return for the estate. Again, an analysis of the effective tax rates will be necessary to determine the best course of action.

Another post-mortem estate planning device is a disclaimer. A disclaimer occurs when a beneficiary refuses to accept assets passing to him or her from the deceased. The disclaimer will qualify for estate tax purposes if it is made within nine months of the decedent's death and if the beneficiary has not accepted any benefits from the disclaimed property. This can be an effective way of maximizing the use of the applicable credit or of getting around state intestacy rules when proper planning was not done before death.

Trusts can help you save on estate taxes

Properly structured irrevocable trusts can be extremely valuable estate planning tools and generate substantial estate tax savings. Trusts designed to hold life insurance policies are a good way of keeping the proceeds from the policies out of your estate. Other types of trusts can accomplish different objectives such as facilitating charitable giving and effectively using the applicable credit and unlimited marital deduction. (Refer to the MFS Heritage Planning infosheet "Using trusts as part of your estate planning" for more information.)

Estate planning is not only important to help ensure that your wishes are carried out — this type of thought and strategizing may also help you to lower your tax bill during your lifetime. And implementing strategies to help manage estate taxes can help you make sure that as much of your estate as possible goes to the heirs you've chosen rather than Uncle Sam. Ask your investment professional and/or attorney for assistance in constructing your estate plan.

The above is a brief discussion of general estate and gift tax management strategies. MFS does not provide legal or tax advice. Individuals should contact a qualified attorney or investment professional before finalizing any estate plans.

For further information

Croke, Frank J. and Croke, William F.

Family Trust : How to Avoid Probate, Save Taxes, Protect Your assets, Provide For Your Family, Capital Management Press, 1999, 307 p., \$26.95.

Kraemer, Sandy F. *60 Minute Estate Planner,* Prentice Hall, 1999, 304 p., \$39.95

Randolph, Mary and Clifford, Denis. *9 Ways to Avoid Estate Taxes,* Nolo Press, 2001, 240 p., \$29.95.

Welch, Stewart H. *J.K. Lasser's New Rules for Estate Planning and Tax,* John Wiley & Sons, 2001, 304 p., \$16.95.

Contact your investment professional for more information or to construct a personalized Heritage PlanningSM Profile to help your parents, your children, or yourself.

This material is not intended to replace the advice of a qualified attorney, tax adviser, investment professional, or insurance agent. Before making any financial commitment regarding the issues discussed here, consult with the appropriate professional.

