HOW TO FORECAST ESTATE SETTLEMENT COSTS (334-1)

Obj 1. **IDENTIFY THE COSTS ASSOCIATED WITH LIFETIME GIFTS:**

1. **Professional fees**--for preparation of instruments of transfer of property such as real estate.
2. **Realty transfer tax**--imposed by some local jurisdictions on real estate transactions.
3. **Complex gift costs**--for intensive legal advice for transfers such as gifts to trusts.
4. **Gift taxes--*Federal*** gift taxes may be currently payable ***if*** gifts exceed various exemptions, exclusions, deductions, and tax credits. Only a ***minority*** of states imposes a gift tax.

Despite those costs, there are many estate planning advantages of lifetime gifts. **The primary goal is always to distribute the client's wealth according to his personal goals *even if*** that plan causes higher than minimum transfer taxes.

Obj 2. **IDENTIFY THE TWO TYPES OF PROBATE COSTS:**

1. **Court costs**--are standard published court fees imposed by counties for settling estates. Costs are higher for more complex estates, which must be kept open longer.
2. **Professional fees--The highest costs are the fees for professionals who settle the estate:**
   a. **Executor's commission**--is the fee, generally set by local practice, paid to a professional individual or corporate executor. Such fees, which vary from jurisdiction to jurisdiction, are usually based on the size of the probate estate, with the commission percentage declining as the estate size increases.
   b. **Legal fees**--are for the attorney retained to advise the executor on legal issues. Many jurisdictions now prefer hourly charges over percentage rates.
   c. **Tax preparer's fees**--are paid to the attorney or accountant for preparing the decedent's final income tax return, estate income tax return, Form 706 estate tax return, and state estate or inheritance tax return.
   d. **Appraisal fees**--are for professional valuations of hard-to-value estate assets such as personal property, artwork, collectibles, real estate, and closely held business interests.
   e. **Federal estate taxes**--are, for most wealthy individuals, the largest cost in transferring wealth.
   f. **Federal generation-skipping transfer tax**--is imposed on gifts or bequests to grandchildren at the maximum federal gift and estate tax rate once transfers exceed exemptions.
   g. **State death taxes**--all 50 states and the District of Columbia impose some type of death tax: an inheritance, estate, or credit estate tax *[See below.]*.

Obj 3. **UNDERSTAND THE THREE TYPES OF STATE DEATH TAXES:**

1. **Inheritance tax**--is the tax imposed by some states on property ***received*** at death based on a set of tax rates that vary according to the relationship of the beneficiary to the decedent. More distant relations pay higher rates.
2. **Estate tax**--is a state estate tax similar to the federal estate tax, but with separate rates.
3. **Credit estate tax or sponge tax**--is based on a tax table in the federal estate tax return and is set to equal the maximum allowable credit against the federal estate tax for state death taxes paid by the estate. ***All*** states and the District of Columbia impose a credit estate tax. ***Some*** states use it as their ***only*** death tax; others as a ***minimum*** tax, then add other state death taxes.

Be sure to consider state death taxes when forecasting estate settlement costs, since they can be substantial.

Obj. 4 **IDENTIFY THE ITEMS INCLUDED IN GROSS ESTATE: The gross estate equals the total of these eight items:**

1. property owned outright;
2. certain interests gifted within 3 years of death;
3. property transferred during life ***if*** the decedent retained certain rights;

4. benefits from qualified retirement plans, IRAs, and nonqualified annuity products payable to the decedent's chosen survivor;
5. property jointly held with the decedent's survivor;
6. general powers of appointment held during life and/or at death;
7. life insurance payable to the executor, or in which the decedent held incidents of ownership (or gifted incidents of ownership within 3 years of death); and
8. life interest held by the decedent ***if*** a QTIP election was made to require inclusion in the estate.

Note: Items included in the ***probate*** estate are those owned outright at death, ***not,*** generally, jointly held property, life insurance, or retirement plan assets. The probate estate is a subset of the gross estate.

Obj. 5 **CONSIDER THE EFFECT OF INFLATION WHEN FORECASTING ESTATE SETTLEMENT COSTS:**

1. **The importance of proper values**--Accurately forecasting costs depends on accurately estimating the appropriate value for each estate asset. Don't just take client's word, particularly on complex items. The fact-finding questionnaire is very important.
2. **Administration expenses**--Typically, administration expenses are estimated at a fixed percentage (3 to 5 percent) of the estate.
3. **The impact of inflation**--is significant in forecasting settlement costs.
   a. Mortality assumptions of single and married clients must be considered with inflation. The time frame should the foreseeable future, such as 10 or 15 years. Estimates are less reliable over longer periods.
   b. Probate expenses, federal estate taxes, and state death taxes all increase as the size of the estate increases.
   c. Using a separate inflation rate for each asset is the most accurate method, but is less realistic in the long term due to changes in the composition of assets.
   d. Your client's income needs, both before and after retirement, will affect growth of assets, especially the value of his retirement plans.
   e. The expected inflation rate of the overall economy significantly affects the expected inflation rate of every specific item.

Obj. 6 **IDENTIFY THE ITEMS DEDUCTIBLE FROM THE GROSS ESTATE:** Certain items reduce the gross estate to arrive at the adjusted gross estate. Those items are important in the settlement cost forecast since they represent cash needs. And, they are deductible, so they reduce estate taxes. **Items deductible from the gross estate:**

1. funeral expenses,
2. unpaid taxes,
3. administrative expenses,
4. recourse debts, and
5. creditor claims or other claims against the estate.

Obj. 7 **LIFETIME TAXABLE GIFTS MADE AFTER 1976** (when the estate and the gift tax systems were unified) **ARE ADDED TO THE ESTATE TAX BASE TO** determine the ***tentative tax base*** for federal estate tax purposes.

1. Since gift tax returns are filed annually during life, the donor must pay gift taxes on taxable transfers in excess of the applicable credit amount.
2. To preserve the theory of estate and gift tax unification, all lifetime taxable gifts are added to the decedent's taxable estate.
3. The decedent pays taxes at the highest federal estate tax bracket based on ***total taxable transfers,*** during life ***and*** at death.
4. After the tentative estate tax is computed, deduct the gift taxes actually paid during life.

Obj. 8 **KNOW THE FIVE CREDITS AVAILABLE AGAINST THE FEDERAL ESTATE TAX:** After the tentative tax has been reduced by gift taxes paid, the federal estate tax payable is further reduced by these five applicable credits to determine the ***net*** federal estate tax. **The five federal estate tax credits:**

1. **The applicable credit amount**--is $220,550 for 2001. See Table 1-3 on page 18 of your text.
2. **The credit for state death taxes paid**--is limited to the ***larger*** of the tax actually paid ***or*** the maximum state death tax credit. See Table 1-5 on page 20 of your text.
3. **The foreign death tax credit**--allows for death taxes paid by the estate to a foreign country.
4. **Credit for gift taxes paid on pre-1977 gifts**--before the estate and gift tax systems were unified.
5. **The credit for tax on prior transfers**--provides relief if property included in the gross estate was inherited from someone who died less than 10 years before the decedent.

Obj. 9 **CALCULATE A SAMPLE FEDERAL ESTATE TAX:** Art Agent had a taxable estate of $3.5 million. His assets are in a state that imposes an estate tax of 15 percent of the federal taxable estate. Art's state also imposes a credit estate tax if its base estate tax is less than the allowable federal death tax credit. Use pages 1.21 and 1.22 of the study guide to calculate the **net federal estate tax** due if Art died in 2001.

Calculation:

Taxable estate	$3,500,000.
Tentative tax base	3,500,000.
Tentative tax	1,565,800.
Adjusted taxable estate (for determining maximum state death tax credit)	3,440,000.
Applicable credit amount	220,550.
Net federal estate tax due	$1,116,050.

Steps in calculation:

1. **Determine the tentative tax**--use the unified rate schedule on page 1.21. The tentative tax on $3 million ($1,290,800) plus 55% of the $500,00 excess ($275,000) equals $1,565,800.
2. **Subtracted the applicable credit amount**--$220,550 for 2001.
3. **Determine the maximum state death tax credit**--The base is the adjusted taxable estate (the taxable estate minus $60,000). Using the table on page 1-22, the maximum credit on $3,440,00 is $229,200. Even though the actual state death tax was $525,000 (15 percent of $3,500,000), the credit is limited to the ***lesser*** of the maximum credit or the tax actually paid.
4. **Figure the net federal estate tax due**--$1,116,050 ($1,565,800 minus the credits of $220,550 and $229,200).

Obj. 10 **FORECAST THE ESTATE SETTLEMENT COSTS OF YOUR CLIENTS:**

1. **Single clients**--Both current and future costs should be estimated.
   a. **Current costs**--The cash needs must be determined assuming a current date of death. Funding for such a premature death can be provided with life insurance, which will be available for future needs if a premature death does not occur.
   b. **Forecasting future costs**--Such forecasts should consider the effect of several years of inflation, assuming death in the foreseeable future (10 or 15 years).
2. **Married clients**--This involves forecasting two estates and combining the results into one summary of family estate settlement costs.
   a. **Author's preference**--Assume one death in the current year and the other death in 10 to 15 years. Then reverse the mortality assumptions and do the forecast.
   b. **Effects of inflation**--Assume the assets grow between deaths (eg, at 5%). Assuming estate taxes are sheltered at the first death due to the unlimited marital deduction, all estate taxes will be paid at the second death. Administrative expenses are charged at ***both*** deaths.
   c. **Problems exposed by forecast**--Perhaps a large combined settlement cost burden has ***not*** been minimized. Also, the current asset ownership may ***not*** be optimal. ***Example:*** The less wealthy spouse may ***not*** have enough assets to fund a credit shelter trust if he dies first.