

## HOW TO FORECAST ESTATE SETTLEMENT COSTS (334-1)

### Obj 1. 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 will cause higher than minimum transfer taxes.**

### Obj 2. 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.

### The three types of estate settlement costs:

1. **Decedent's final costs**--include unpaid debts, unpaid property taxes, unpaid income taxes, final medical expenses, and funeral costs.
2. **Probate costs**--were discussed above.
3. **Death taxes**--are imposed on transferring the decedent's wealth.
  - a. **Federal estate taxes**--are, for most wealthy people, the largest cost in transferring wealth. **The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001** repeals the federal estate (but *not* the gift) tax, effective in 2010. However, procedural rules caused the law to contain a sunset provision, so the repeal is currently effective *only* for the year 2010, at which time taxes will return to their 2001 levels. Some policymakers are now considering removing that sunset provision, to make the repeal permanent. Throughout this course, the text and we will assume the federal estate tax will continue indefinitely.
  - b. **Federal generation-skipping transfer tax (GSTT)**--is imposed on gifts or bequests to grandchildren at the maximum federal gift and estate tax rate once transfers exceed exemptions. The GSTT is scheduled for repeal in 2010, subject to the EGTRAA one-year sunset.
  - c. **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 Obj 3.*].]

### Obj 3. 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**--was a type of state death tax system that imposed a tax equal to the maximum allowable credit against the federal estate tax for state death taxes paid by the estate. EGTRRA eliminated the state death tax credit after 2004.  
Sixteen states continue to impose a credit estate tax and have frozen their credit estate taxes at pre-EGTRRA levels to avoid the loss of tax revenues.  
Any state death taxes paid are deductible against the gross estate.

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

Obj. 4 **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 **ISSUES WHEN FORECASTING ESTATE SETTLEMENT COSTS:**

1. **The importance of proper values**--Accurately forecasting costs depends on accurately estimating the correct value for each estate asset. Don't just take client's word, especially 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 be 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 **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,
5. creditor claims and other claims against the estate, *and*
6. uninsured casualty losses that occur during the estate settlement period.

**The taxable estate** equals the adjusted gross estate minus the marital deduction, the charitable deduction, and the state death tax deduction.

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 **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 four applicable credits to determine the *net* federal estate tax.

**The four federal estate tax credits:**

1. **The applicable credit amount**--is \$780,800 for 2008 and \$1,455,800 for 2009. [See Table 1-4.]
2. **The foreign death tax credit**--for foreign death taxes paid by US citizens or residents on property also included in the gross estate for federal estate taxes.
3. **Credit for gift taxes paid on pre-1977 gifts**--before the estate and gift tax systems were unified.
4. **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 **HOW TO CALCULATE THE FEDERAL ESTATE TAX:** Art Agent died in 2008 with a taxable estate of \$3.5 million. He had no lifetime adjusted taxable gifts.

Use pages 1.21 and 1.22 of the Study Guide to calculate the **net federal estate tax** due.

**Calculation:**

Taxable estate	\$3,500,000.
Tentative tax base	3,500,000.
Tentative federal estate tax	1,455,800.
Applicable credit amount	780,800.
Net federal estate tax due	\$675,000.

**Steps in calculation:**

1. **Determine the tentative tax**--Use the unified rate schedule on page 1.21. The tentative tax on \$1.5 million (\$555,800) plus 45% (maximum rate for 2007 to 2009) of the \$2 million excess (\$900,000) equals \$1,455,800.
2. **Subtract the applicable credit amount**--\$780,800 for 2008.
3. **Figure the net federal estate tax due**--\$675,000 (\$1,455,800 minus the credit of \$780,800).

Obj. 10 **CASH NEEDS OF THE ESTATE INCLUDED IN THE FINAL SETTLEMENT COSTS:**

1. Federal estate taxes.
2. State death taxes.
3. Income taxes on items of IRD.
4. Built-in capital gains tax liability.
5. Funeral and administrative expenses.
6. Unpaid property and income taxes.
7. Creditor claims.

## **HOW TO FORECAST THE ESTATE SETTLEMENT COSTS OF 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.

### ***[Other estate-planning consequences of EGTRRA:***

1. ***New modified carryover basis rules for 2010***--EGTRRA eliminated the income tax basis adjustment at the property owner's death (aka ***step-up***).  
*The step-up will be repealed only for 2010 due to EGTRRA's sunset provision and will return to normal in 2011.*
2. ***Increases in the applicable credit amount***--The applicable estate tax exclusion amount is scheduled for three increases prior to 2010, while the gift tax exclusion amount is scheduled to remain at \$1 million.
3. ***Changes to the maximum federal estate and GSTT tax rate***--EGTRRA reduced the maximum rate incrementally from 50% (in 2002) to 49% (in 2003), 48% (in 2004), 47% (in 2005), 46% (in 2006), and 45% (from 2007 to 2009).  
*The tax is scheduled to be repealed in 2010 and then to be reinstated at 55% in 2011.]*