

Holding Title: Life, Death and Taxes (Part Two)

By Jim Nations, Esq.

Understanding Cost Basis and Capital Gains Tax: Cost basis is one of the numbers used to determine capital gains. For many land owners, the cost basis is the price they paid for their property, plus any capital improvements that have been made. The cost basis is subtracted from the selling price to determine the capital gains. When a married couple owns an appreciated asset as community property, the surviving spouse will get a step-up in the cost basis to the fair market value at the date of death of the other spouse. In other words, if the surviving spouse has to sell the residence, he or she is unlikely to have to pay any capital gains. But if the residence is held in joint tenancy, it is more likely that some capital gains tax may be due. The federal tax reform bill passed in 1997 allows the each spouse a capital gains exclusion of \$250,000, but for some California residents, even this amount may not be enough to prevent payment of capital gains tax when a residence is sold. Any gains in excess of the exclusion will usually be taxed at 15% federal and 9.3% California rates.

An Additional Tax Concern at Death - Inheritance Tax

The 2001 Tax Relief Act substantially increases the amount of tax exemption, while reducing the maximum tax rates through 2009, with no tax in 2010, and a sunset reinstatement of the 2000 rates in 2011.

Each estate has an exemption from the tax that will increase each year until 2009, when it will be \$3,500,000. The exemption amounts are as follows:

Year of Death	Exemption Amount
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2010	Repealed
2011	\$1,000,000

After the exemption, however, the tax rates take a BIG BITE! The maximum rates for the federal estate tax are as follows:

Year of Death	Maximum Tax Rate
2004	48 %

2005	47 %
2006	46 %
2007	45 %
2008	45 %
2009	45 %
2010	0%
2011	55%

The marital deduction: Assets that are transferred from one spouse to the other spouse at death are not taxed. This is called the "marital deduction," and there is no limit on how much can be transferred.

The disadvantages of using the marital deduction: Although the marital deduction protects the surviving spouse from federal estate taxes, it may subject the surviving spouse's estate to higher taxes at a later date. Using the marital deduction to transfer all of a spouse's assets to the surviving spouse means that the first spouse to die will not have taken advantage of his or her exclusion amount, and that benefit is no longer available to the couple's estate.

TRUST ME!

How title is vested can have significant probate implications and estate tax results upon death. The only way you can avoid probate (other than holding title as Joint Tenants with rights of survivorship or Community Property with rights of survivorship) is to put your property into one of a variety of trusts. Why? Because the trust names the chain of ownership of a property going forward.

Here are some less common ways to hold title to property:

1. Living Trust

A revocable living trust is one way to pass assets from one generation to another and avoid probate. However, they aren't designed to help you minimize estate taxes. (For that you need an irrevocable trust.) You set up the living trust, and then transfer assets, such as your home or stocks, into the trust. You may name beneficiaries and leave a list of instructions for the trustee who will administer the trust. For many people, trusts take the place of wills. Also, living trusts aren't public documents, so the element of privacy is appealing.

For most people, (with estate values less than \$2,000,000 in 2006) a simple living trust is a no-brainer. It allows you to easily and quickly avoid probate:

The fees listed below are the California statutory fees used to compensate attorneys and executors in probate cases for various sizes of estates. ***If both the attorney and the executor receive a fee, the amount paid will be double that shown below.***

SIZE OF ESTATE	STATUTORY FEE
\$100,000	\$4,000
\$200,000	\$7,000
\$300,000	\$9,000
\$400,000	\$11,000
\$500,000	\$13,000
\$600,000	\$15,000
\$700,000	\$17,000
\$800,000	\$19,000
\$900,000	\$21,000
\$1,000,000	\$23,000
\$2,000,000	\$33,000

On a \$2 million estate, a simple inexpensive living trust could save your estate more than \$66,000! Probate fees are based on the gross value of your estate. If your estate consisted of a \$1 million home with a \$900,000 mortgage balance, it is valued at \$1 million for probate fee purposes. The fees could be \$46,0000 - i.e. 46% of you equity!

While this seems like one of the best ways to save money and assure a smooth and quick disbursement of your estate to your loved ones, a quick and dirty sampling of Alameda County records indicate that fewer than 27% of real property owners take advantage of this simple, cost effective opportunity. **IF YOU OWN CALIFORNIA REAL ESTATE, AT A MINIMUM, GET A LIVING TRUST!**

2. Irrevocable Trusts

Various irrevocable trusts may be created to protect your assts from future creditors, achieve charitable goals, provide for special needs and minimize taxes :

a. Exemption Trust

An exemption trust is known by many names, including bypass trust, credit shelter trust, or B trust. Regardless of the name of the trust, its purpose is to reduce or eliminate federal estate taxes for a married couple's estate. This type of estate plan sets up an irrevocable trust that will hold the assets of the first spouse to die. The amount transferred to the irrevocable trust will not be taxed for federal estate tax purposes when the second spouse dies. For couples with substantial assets, the savings for their estate can be more than \$300,000.

b. Life Insurance Trust

The purpose of a life insurance trust is to avoid federal estate taxes on life insurance proceeds owned or controlled by the decedent. Anyone who buys their own life insurance, or has it provided by their employer, will usually have the face value of the insurance included in their estate for federal estate tax purposes. By setting up an irrevocable life insurance trust that buys the insurance and pays the premiums for the insurance, the benefits of the insurance, upon death, do not inflate the value of the estate and thereby avoids estate taxes.

c. Charitable Remainder Trust

A charitable remainder trust allows you to make a donation to your favorite charity, and retain the income from the donated assets for your personal use during your lifetime.

d. Special Needs Trust

The primary purpose of a special needs trust is to preserve government benefits for disabled beneficiaries. Usually the benefits involved are from programs that have limits on the beneficiary's assets and income. Receipt of an inheritance will disqualify the beneficiary for future government benefits. Two of the programs that are based on financial need are Supplemental Security Income (SSI) and Medi-Cal, which is California's version of Medicaid.

Qualified Personal Residence Trust

This is an estate-planning move that allows you to discount the future value of a home and save gift taxes if you give the property away while you're alive or estate taxes if you leave it to your heirs. You set the term of the trust and you place your home into it. You're allowed to live in the home for the term of the trust. The beneficiaries of the trust (your heirs) will receive the home when the term of the trust expires.

The benefit of a QPRT is that the IRS allows you to discount the future value of the house according to a preset schedule, and pay less in gift and estate taxes. But if you die before the QPRT term expires, the property reverts back to you.

Family Limited Partnerships

By creating a partnership, parents can pass along pieces of their property to their children (or anyone else) by making them small limited partners of a partnership that owns the property. Limited partners don't manage the property or have an active role in it and that can discount the value of their share of ownership, lowering estate or gift taxes when the property is transferred.

In Summary

Consideration of how you hold your real property and doing a bit of estate planning offers many benefits, including making sure your property goes where you want, saving taxes, saving money for your heirs, letting your estate be transferred faster, and helping you plan in case you become disabled. Certain tools are part of most estate plans, including: a will; a living (or other) trust; life, health and disability insurances; retirement plans; a power of attorney; a health care power of attorney; and a living will.

While Ben Franklin's old adage "But in this world nothing is certain but death and taxes," is still largely true, with the help of a good attorney you can avoid the latter, and who knows, perhaps with the right geneticist, some day, you may be able to avoid the former as well!

Live long and prosper.

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