Don't Waste Your Federal Credit

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People are sometimes surprised to learn that the government not only taxes the income earned while working, but it also can tax the accumulated estate built from those earnings. What can you do to minimize the sting of federal estate and gift taxes and protect your family's inheritance? Start by looking at your will and beneficiary designations.

Many married couples arrange their affairs so that all of their property will pass to their surviving spouse. This arrangement may seem like a good plan. It's simple and — thanks to an unlimited federal gift- and estate-tax marital deduction — generally allows you to leave all your property to your spouse *tax-free*. But it may not be the best plan. Why not? Because it doesn't take advantage of your federal credit. Ultimately, the property your surviving spouse receives from you could be taxed as part of his or her estate.

What Is the Federal Credit?

The credit lets you pass a certain amount of assets to anyone you choose, free of estate and gift tax. This amount – the credit equivalent – is $1.5 million in 2004. Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the estate tax credit equivalent is scheduled to increase gradually, reaching $3.5 million in 2009. The estate tax will be repealed in 2010, but returns in 2011, with a credit equivalent of $1 million. Unlike the estate tax credit equivalent, the gift tax credit equivalent is not scheduled to increase to above $1 million.

Coordinating Your Credits

Married couples who coordinate the use of their credits can leave twice as much property to their families without incurring federal estate taxes. One way to take advantage of both your and your spouse's credits is to create a family trust in your will and fund it with property equal in value to the credit equivalent. With a trust strategy, your surviving spouse can receive income for life with the remaining property passing to your children at your spouse's death. Your credit will offset estate taxes on the trust property, and the property won't be included in your spouse's estate. Your spouse's credit will be available to offset some or all estate tax on any other property your spouse owns at the time of his or her death.

To ensure the beneficial use of both your and your spouse's credits, you may have to re-title some of your property. Let's say you and your spouse own most of your property jointly with right of survivorship. Generally, property held jointly by married couples automatically passes to the surviving spouse with no federal estate tax consequences, due to the marital deduction. So, one spouse's credit may be wasted. Dividing your property so that you and your spouse each own enough property separately to take advantage of the credit can remedy the problem and allow you to effectively use planning techniques such as family trusts.

Family trusts and re-titling strategies are sophisticated planning techniques that may or may not be appropriate for you. Before implementing either technique, consult your professional financial planner.

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CRN #0211-7971