

Understanding estate and inheritance taxes

By the numbers

- **Two for one:** With thoughtful estate planning you can reduce your beneficiaries' tax bill and gain peace of mind.
- **\$1.5 million** is the tax-free applicable credit amount in 2004.
- **45% to 48%** is the range of the taxable estate rate in 2004 (on the portion of the estate in excess of \$1.5 million).

It is very important to develop a plan for disposition of property throughout your lifetime and after death. One advantage of thoughtful estate planning is you may minimize your or your beneficiaries' tax bills, including estate, inheritance, and generation-skipping transfer taxes.

Estate tax

The federal estate tax is a transfer tax imposed on the value of property you own at the time of death. An estate tax return must be filed within nine months after death for each decedent whose gross estate exceeds the applicable credit amount. This credit amount will increase as follows:*

Estate and gift taxes

Year	Top estate tax rate	Exemption
2004	48%	\$1.5 million
2005	47%	\$1.5 million
2006	46%	\$2 million
2007	45%	\$2 million
2008	45%	\$2 million
2009	45%	\$3.5 million
2010	repealed	N/A
2011	55%	\$1 million

Inheritance tax

Some states impose an inheritance tax on the amount of assets inherited by each heir. In general, these taxes are based on the amount inherited, but the relationship of the heir to the deceased may also affect the tax rate imposed. Spouses, children, and grandchildren may be taxed at a lower rate than other heirs. A friend, for example, may have to pay taxes of 20% of the amount inherited, while a grandchild's tax rate may be only 2%. It is important to make sure that your estate has sufficient liquid assets to enable your heirs to pay off inheritance taxes. You should also be aware of the inheritance-tax exemptions your state may offer and take full advantage of them.

*These amounts were set by the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and are scheduled to expire after December 31, 2010. Unless legislatively extended, these provisions will revert back to tax laws in effect prior to passage of EGTRRA.

Key points

continued

How can you take control of, and possibly eliminate, estate taxes? First and foremost, start planning with your investment professional as soon as possible. He or she will help you fully understand estate and inheritance taxes —

and take full advantage of any planning opportunities. A comprehensive estate plan will help you

- reduce your tax bill
- manage your beneficiaries' inheritance taxes

- ensure that your wealth is transferred according to your wishes

Generation-skipping transfer (GST) tax

The GST is applied to property that is transferred to a beneficiary who is at least two generations younger than the property owner. This tax is designed to ensure that property does not skip a generation without a transfer tax being assessed. The beneficiary is known as the skip person, and the tax rate applicable to generation-skipping distributions is 50%. Each transferor can shelter up to \$1.5 million in 2004 from the GST (this amount may be adjusted annually for inflation).

A generation-skipping transfer takes one of three forms:

- **direct skip:** a transfer to a skip person that is also subject to estate or gift tax
- **taxable termination:** trust property that is held for or distributed to a skip person after interest in the trust property has been terminated
- **taxable distribution:** any distribution from a trust that is not a taxable termination or direct skip

Transfers that are not subject to gift tax because of the \$11,000 annual exclusion and the unlimited exclusions for direct payment of medical and tuition expenses are not subject to GST tax.

How estate taxes are assessed

Step One: Determining Gross Estate Value

The first step in computing the estate tax is to figure out what is included in a gross estate. The gross estate may include

- all property that you owned at the

time of death (If you owned a partial interest in property, the value of that interest is included.)

- the value of an annuity receivable by any beneficiary as your survivor
- the full value of all property held in joint tenancy (with rights of survivorship and not as tenants in common), except to the extent that the surviving co-tenant can be shown to have contributed to the acquisition or improvement of the property and except for certain joint interests between spouses
- the value of all property to which you had a general power of appointment at the time of death
- the value of life insurance proceeds if receivable by your estate's executor under policies on your life, or receivable by any other beneficiaries under a policy on your life if you possessed any incident of ownership at death
- the value of (if occurring within three years before death)
 - transfers of life insurance by the insured
 - releases or exercises of general powers of appointment
 - releases of certain powers in property interests retained from previously created powers of appointment inter vivos (*i.e.*, during lifetime) transfers

Keep in mind that 529 prepaid tuition and college savings plan assets are generally not considered part of the donor's estate. The only exception occurs if you are spreading a gift over five years for gift tax purposes. If you die within that five-year period, the

gifts for the years up to and including the year of your death are removed from your estate and the subsequent year gifts are included in your estate.

In addition, the value of your estate is the value of all property as of the time of death. However, if the executor elects, the property may be valued on an alternate valuation date that is usually six months after death. If the alternate valuation date is elected, that will be the date for valuation of all property. The alternate valuation procedure cannot be used by selecting values on an asset-by-asset basis but must be used on an all-or-nothing basis. The property in an estate must be valued at its fair market value. For this purpose, fair market value is that price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts.

Step Two: Determine Taxable Estate Value

Once the gross estate has been determined, the next step is to compute the taxable estate using the following formula.

Gross estate value	
– estate administration expenses	
– losses	
– indebtedness	
– bequests to surviving spouse	
– charitable bequests	
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= the taxable estate	

continued

Step Three: Determine Actual Estate Tax

Once the taxable estate is computed, the estate tax is figured using graduated tax rates, which ranges from 45% to 48% in 2004. The applicable credit amount is then subtracted from the total tax to get to the actual estate tax due.

When a person dies, his or her estate plan — for good or bad — is fixed, and the chance is gone, obviously, to put the most worthwhile estate plans into place. Therefore, it is very important for you to plan ahead as to what you want to happen to your estate. In order to do this, you will need to be familiar with and consider not only taxes but state and federal laws regarding wills, trusts, property ownership (including community property rules), asset transfers, and probate administration. Contact your investment professional and estate attorney for assistance informing your estate plan.

Resources

Condon, Gerald M., *Beyond the Grave revised edition : The Right Way and the Wrong Way of Leaving Money To Your Children (and Others)*, Harper Business, 2001, 480 p., \$17.95

Esperti, Robert A., Peterson, Renno L., *Protect Your Estate: Definitive Strategies for Estate and Wealth Planning from the Leading Experts*, McGraw-Hill Trade, 1999, 329 p., \$16.95

Apolinsky, Harold, Welch, Stewart H., Welch III, Stewart H Apolinsky, Harold, *J.K. Lasser's New Rules for Estate and Tax Planning*, John Wiley & Sons, Inc.; First edition 2002, 304 p., \$18.95

Association of American Retired Persons (AARP)
www.aarp.org/estate_planning/

Nolo Self-Help Law Center
www.nolo.com

Contact your investment professional for more information.

The above is a brief discussion of general federal estate, inheritance, and generation-skipping transfer taxes. MFS® does not provide legal or tax advice. Individuals should contact a qualified attorney or investment professional before finalizing any estate plans.

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.



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