



Helping Employees Make the Most of Their 401(k)/403(b) Plans

Seven Things You Need to Know about Tax Laws and Sunset Provisions Part 2

Last week we looked at the current sunset provisions in various tax laws, which are the result of legislative compromises over tax-relief measures. As currently written, they will cause some popular tax breaks to disappear in just four to six years. Here are three more we feel you should be mindful of.

4. The tax man giveth and taketh away

Watch out for income taxes on capital gains recognized after property is inherited starting in 2010. In very general terms, “basis” is usually the cost paid to acquire an asset. When you sell an asset, basis is subtracted from the proceeds to determine any taxable gains. The basis of many kinds of property acquired from a decedent is now generally its fair market value at the time of the person’s death, often referred to as a “stepped-up basis.” In contrast, property acquired by gift has a carryover basis — the receiver usually gets the same basis the giver had. This stepped-up basis on inherited property means that any appreciation from the time the decedent acquired the property until the time of death will likely not be subject to income taxes, either at the decedent’s death or at any later time.

In 2010, the year in which federal estate taxes are scheduled to temporarily disappear, the provision for stepped-up basis at death will also temporarily disappear. For basis purposes, death transfers in 2010 will be similar to transfers by gift, meaning that basis is carried over. However, “basis increases” will be available to allocate to eligible transferred property — up to \$1.3 million of basis increases for property transferred to either a spouse or non-spouse, and another \$3 million for transfers to spouses. These basis increases would not be subject to income taxes. This may affect families whose senior generations may have significant taxable estates composed of low-basis properties. If both amounts are fully allocable, \$4.3 million of gains can be erased upon the decedent’s death.

Make sure any estate plan you devise is flexible enough to cover the various potential estate tax scenarios of dying in different years.

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5. Consider the advantages of lifetime giving

Despite other changes in the tax code, each person's lifetime gift tax exemption remains the same, at \$1 million. The exemption isn't scheduled to rise, nor is the gift tax itself scheduled to go away. There also aren't any sunsets on this horizon. Even without any tax relief on this front, gifting can offer advantages for affluent families. If you give away \$1 million to your children and it doubles in value over the years, all the growth and the original million are out of your taxable estate.

Although a big-ticket gift might be a budget-buster for your family right now, after you manage to pay for college tuition and other major expenses, it may become more feasible. In the meantime, consider making smaller, yearly gifts. Every person currently is allowed to give away up to \$11,000 each year per recipient on a tax-free basis. This limit will gradually be increased for inflation, as it is tied to the Consumer Price Index.

6. Plan to create liquidity in your estate

You may or may not die during a year in which federal estate taxes are high, but odds are strong that your heirs will need access to cash or its equivalent, if only to pay probate costs, administrative fees, and any state or federal estate taxes that might be due. For married couples, an effective tool may be a "second-to-die" life insurance policy, which may provide valuable funds when they're really needed — when the estate passes to the second generation. Best of all, these policies may be more affordable than insurance that only covers one spouse's life.

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