

SPECIAL REPORT

“What Do We Mean When We Say... Tax Planning?”
by Francis Burton Doyle, Esq., *WealthPLAN*



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Invariably in the process of working with clients on their wealth plans, the subject of tax planning arises. Clients have no problem clearly enunciating their desire for “tax planning.” However, what most clients don't realize is that the objective of “tax planning” needs to be further dissected into five distinct areas:

- Income Tax Planning (*both on a state and federal level*)
- Federal Gift Tax Planning
- Federal Estate Tax Planning
- Federal Generation Skipping Tax Planning
- California Real Property Tax Planning

Each one of these areas has its own unique set of rules and consequences, and the objectives of effective planning in one area may be at odds with the planning objectives in another area. For example, from an income tax perspective it is desirable to achieve a stepped up in basis at a decedent's death. With a step up in basis, it generally means that all of the capital gains inherent in a decedent's appreciated assets will be eliminated. However, in order to achieve a step up bsi, the asset must be included in the gross estate for the decedent. Being included in the gross estate of the decedent means that the assets will be subject to federal estate tax.

Income Tax Planning

For the average client there are two paramount areas of income tax planning. First is to achieve and maximize the step up in basis available on the death of a decedent. Under Section 1014 of the IRC the income tax basis of a person's assets is adjusted upwards to their date of death value. For the average person, with assets of less than the 2 million dollar federal estate tax exemption, achieving the full benefit of the step up in basis is the single most important tax-planning objective they can have.

For example, a mother owns a house in Santa Clara, CA worth \$400,000 at her date of death, which she purchased for \$70,000 in 1975. With the step up in basis, the family can sell the property for an amount equal to its date of death value without any capital gains consequence. This is an inordinate benefit which can be lost if the house is gifted to the children during the mother's lifetime. In that event, the mother's low \$70,000 basis would carry over to the children and when they sold the property they would incur a substantial capital gain for income tax purposes.

The advantage of the step up in basis is magnified with regard to community property. Under Section 1014, if one spouse dies not only does his/her one half of the community property receive step up, the surviving spouse's one half of the community property also receives a step up. In order to get this advantage, the property must be categorized as community property as opposed to joint tenancy or tenancy in common. Thus, in the planning process, it is critical to characterize the property of a husband and wife as community property.

The second objective is to structure the payment of IRA's, 401k and tax deferred annuity payments over a period of time, which will negate their income tax impact on the recipient of those payments. In general, payments from 401 retirement plans are ordinary income to the recipient. In contrast, the general rule is that distributions from the estate are generally not taxable. Thus in most situations it is most desirable to “string out payment from a retirement plan.”

Gift Tax Planning

There are two cardinal rules of gift tax planning. First, maximize the use of the \$12,000 annual exclusion and only use the \$1,000,000 lifetime federal gift tax exemption on a leveraged basis.

The annual exclusion is probably the most powerful planning tool, as well as the most overlooked. The \$12,000 is available per donee and in that sense it is unlimited. Although measured in terms of a dollar amount, other assets can be used to fund annual exclusion gifts. The “per donee” aspect makes it a huge factor. For example, a married couple who has 3 married children and 8 grandchildren could together gift \$336,000 per year to their children and their children's spouses and

their grandchildren, free of any gift tax or reduction in the lifetime federal gift tax exclusion. Thus over a couple of years almost one million could be given under the exclusion.

The \$1,000,000 exemption is precious and should only be used on a leveraged basis. This leverage can be best obtained through the use of discount entity planning where valuation adjustments range from 20% to 55%.

Estate Tax Planning

The first step in estate tax planning is awareness. Clients often have a misunderstanding that the only assets in their probate estate are includable in their gross estate for federal estate tax purposes. They often believe that the life insurance, retirement plan benefits and assets in a revocable trust are excluded. Once you explain to them that all of these items are specifically included, then they can appreciate why estate tax planning is important. For the average person living in California, with the inclusion of these assets, their estates will approach the 2 million federal estate tax exemption and some planning will be required. Think about it: a house, a \$500,000 life insurance policy and their retirement plan will normally put the client at the 2 million threshold.

From an estate tax planning perspective, structuring the estate plan so that in a marital situation the 2 million exemption is utilized will go a long way in protecting the estate from the federal death tax. Thus, it is still advisable for married couples to plan for both exemptions to be utilized.

Beyond this basic structure, life insurance should be removed from an insured's gross estate for federal estate tax purposes. This can easily be achieved in most cases by utilizing an irrevocable life insurance trust. Secondly, the ownership of assets can be fractionalized in some fashion so that valuation discounts can be used in their valuation. These discounts range from 15% to 45%.

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Estate Planning, Probate and Trusts involve complex areas of law. Individual circumstances must be considered before any advice can be given. The general information above is not to be construed as legal advice, which can only be given after consideration of the unique facts of each matter. Please seek the advice or counsel of your attorney, financial advisor or CPA, as it may be appropriate.

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About the Author...

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- Member, *State Bar of California*
- *California State Bar Certified Legal Specialist, Taxation Law and Probate, Estate Planning and Trust Law*
- Founder, *WealthPLAN*, 30 years of experience in Tax, Estate-Planning Probate, Trust Administration and Litigation
- Instructor, *California Continuing Education of the Bar (CEB)*, *Lorman Education* and *National Business Institute (NBI)*
- Professor; *Lincoln Law School of San Jose, Wills & Trusts and Real Property*
- President, *Santa Clara County Estate Planning Council*
- Chair, Planning Committee, *Annual Jerry A. Kasner Estate Planning Symposium, Santa Clara University, School of Law*
- JD, *University of San Francisco Law School, MS, Taxation, Golden Gate University, BA Santa Clara University*

A Note from Frank Doyle:

I have been working in this area of law for over thirty years.... I am a member of the *State Bar of California* and certified by the *Cal Bar* as a legal specialist in Taxation Law and Probate, Estate Planning and Trust Administration. I am also an educator and I enjoy teaching and sharing the stories of the challenging legal conundrums that I have solved in my practice over the years. I remember it well; I walked in the door and told my wife, "I quit my job today". She looked at me (holding our 6-week old son) and said, "What are we going to do?" It was at that point that I decided to break out on my own and start my estate planning practice. I hit the road and began to set up the alliances, a network of associates and the expertise to build a thriving international estate planning practice.

Over the years, I have continued to teach law school and present *MCLE* courses nationwide. I was frustrated with the fact that I have never found the information that would allow an attorney to capture the basics of developing and expanding a thriving estate planning practice, so I have created them for you now. I am the founder of *WealthPLAN* and bring over 30 years of experience in tax, estate planning, litigation, probate and trust administration. I have taken all of my experiences and legal expertise to create the *Advanced Legal Training Institute*, foundation course entitled, *Integrated Estate Planning Seminar Series (I-IV)*. This set of 17-AudioCDs include over 30 hours of legal information that will give you a jump start to get yourself into this lucrative and growing legal niche. I have taken the best ideas from all of my presentations, case studies and professional experience to provide you with a step-by-step program to support our aging population. I am now working with some of the children and grandchildren of my original clients. The *Advanced Legal Training Institute* tapes and workbooks offer checklists, templates, forms and articles to provide an in-depth educational experience for attorneys and other estate planning professionals. P.S. My 6-week old son, John, is now grown and a practicing attorney himself.

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