Preserving Your Family Land and Family Wealth

The Wisdom of Estate Planning

Rick De Stefano

Attorney, De Stefano & Paternoster, P.C

I'd like to thank the Land Trust for the good work they do, and it's my pleasure to be here.

Now, other speakers will address the specific issues of what's called a conservation easement; I'm not really here to talk about that. I'm here to talk more generally about estate planning and estate taxes. When we think about estate planning we think about what the client's goals or objectives are. And the client may have many goals and objectives, but typically they include first, and most obviously, disposition: What's going to happen to the assets? Will they go to the spouse or the children, the church, the charity, the cousin? The second most important objective, in my opinion, is to reduce or eliminate federal estate taxes. Most people have this motivation when they come to an estate planner. They want to reduce their federal estate taxes. I'll talk a bit about that today.

A third objective is to avoid probate, because probate can be expensive, probate can take up time, and probate can involve the public record, where you would prefer it to be private.

Another objective clients have is called asset protection, meaning, trying to keep the assets secure from creditors, from lawsuits, from mismanagement by your beneficiaries.

Another aspect is what we call special needs. Maybe some of the beneficiaries are minors. Some are disabled. Some are spendthrifts. Some are married to spendthrifts. These things are factored in.

And another objective is to reduce current or future income taxes, which I'll touch on a little later.

So, with good planning the goals of the client can be met through various estate planning tools: wills, trusts and so forth. As I said, one of the most important objectives is reducing or eliminating estate tax. Let me talk a minute about the basic rules of estate tax for those who don't know.

The privilege of dying with any wealth is taxed. Or more technically, the privilege of transferring that wealth to others is taxed. All assets, which include life insurance and other death benefits, are grossed up in what is called the "gross estate." Certain deductions are allowed, principally debts such as an unpaid balance on mortgages. There are deductions for gifts to charity. There are deductions for funeral and other expenses. After the deductions are taken away from the gross estate, there is then the "taxable estate." Now, the mechanics of the tax is that there's a tentative tax assigned to the taxable estate and then a credit is

"The privilege of dying with any wealth is taxed. Or more technically, the privilege of transferring that wealth to others is taxed...An important tool in planning is a conservation easement."

applied, called the "unified credit." I'm going to come back to that. But once the credit is applied, the net amount after that can be a very large number. The net estate tax can be a large amount, and it's due nine months after death. So it can be very disruptive to the family to have to liquidate assets if the estate does not consist of cash or securities or large life insurance benefits, but rather the estate consists of land or a small business. The family must make some arrangement to borrow money or liquidate the assets.

The single biggest loophole --I often call it a loophole; it's not really a loophole, it's an important legal deduction--is called the marital deduction. Anything going to your spouse is tax-free. So that's a very important deduction. The exception to that is if the spouse is not a citizen of the United States, and those rules get a little tricky. But for the most part, the gifts to a spouse, either during life or at death, are not taxed. There's also effectively an unlimited charitable deduction at death, so gifts to charity or church or whatever are deducted from the gross estate, and they're not taxed. To illustrate very simply the marital deduction, if a decedent dies with a $10 million estate and gives $1 million to charity and $9 million to the spouse--no tax. Doesn't matter if it's $50 million--no tax. The problem is, when the second spouse dies, that same $9 million that hypothetically that same spouse got in my last remark, if that was going to be passed down to the children, we'd be looking at a tax in the zone of $4 million. Ouch. Yes, these taxes are very high.

Now aside from the marital deduction, the next most important thing to know about estate tax is what's called the lifetime exclusion. A certain amount is excluded from tax, even if it does not go to your spouse. So for example, gifts to the children--a certain amount of that is not taxed. Now, ancient history, that is to say, before I went to law school, up to just about when I got out of law school (so it seemed like for all time) the exclusion was $60,000. I remember in 1953 when I was a little boy my parents bought a house for $7,800. So $60,000 was a lot of money and it was in fact intended to exempt most regular people from the estate tax. But by the mid-'70s, when we'd had a couple of Middle Eastern wars and one major oil shock and gasoline lines, and a round of inflation, Congress raised that $60,000 up to $600,000. I remember, I was just about out of law school when I was looking at a house for $50,000. So $600,000 was a lot of money, and it was intended of course to make it so almost everyone would not have to pay estate tax--only the rich.

But a few more oil shocks later, and Iranian revolutionaries, and inflation--pretty soon even $600,000 was not really keeping regular folks out of the estate tax. In 1996, they passed a new rule affecting this exclusion to walk it up to $1 million in the year 2006. It got up to $675,000 in the year 2001, when more and different laws were passed by the current administration, so the effect is that this year, the exclusion is $1.5 million for the estate tax, and $1 million for the gift tax. That $1.5 million is going to walk up a little more, and in the year 2010, the entire estate tax will be repealed. In the year 2011, the estate tax will be reinstated. Is everyone clear on that? Okay. In the year 2011, and thereafter, the exclusion that I've been talking about falls back down to $1 million. Meanwhile, for the whole time, the gift tax exclusion stays at $1 million. So, to slightly oversimplify, figure a million bucks unless you're pretty sure you're going to pass away before the year 2011.

I like to say that in my opinion there will always be an estate tax, although people may argue with that. There's a lot of political support for eliminating it. In my opinion, it'll stick around, so it makes sense to plan based on the current rules. That is, the current law as it will apply to the years 2011 and out. So plan on a million-dollar exclusion.

Let me talk a minute about the rates. At the old rates, until the newest law came into effect,

basically the lowest bracket was 34 percent, because by the time you applied your $600,000 exclusion, the next dollar was taxed at 34 percent. The old top rate was 55 percent. Ouch. Now the new top rate is going to walk down to 45 percent. So when planning, figure 45 percent of your family's wealth will eventually go to Washington, D.C. Now, this is where the rise in land values starts to make us all very nervous. Reportedly, acreage in El Salto is worth well over $100,000 an acre now. In Des Montes, I keep hearing the number $90,000 lately. A real expert in value, Mr. Nichols, will be talking a little later. But I know a little bit about it, just from what I've heard. By the way, Mr. Nichols, I'd like to talk about Weimer, where I live. Don't listen to this--but a friend of mine, who's a spec builder, just finished a house there. A year ago he bought the lot, and it was over $80,000--one acre. And I hear from this same friend that he's now shopping for another lot, and they're asking over $90,000 in Weimer--for an acre.

In the late '80s, a relative of mine bought some land in Des Montes for $8,000 an acre. $8,000! I hear that in the '70s, it was only $1,000. So, let me illustrate a little with a hypothetical case but using some real numbers. Imagine a husband and wife with a combined gross estate of $2.7 million. Included in that is $2.7 million is 15 acres that Dad had inherited that's now worth $800,000, and 25 acres that Mom had inherited, now worth $600,000 an acre. That's $1.5 million worth of land. So that's how we reach this hypothetical $2.7 million. If there's no planning, there will be a $1.5 million exclusion at the second death. $1.2 million will be taxable. The tax on that $1.2 million will be $540,000, due in nine months. That means you'd have to write a check, or rather your children will have to write a check in that situation, for $540,000. The objective of basic estate planning is to make sure that both spouses get their $1.5 million exclusion. So, in other words, we don't want to waste the first decedent's $1.5 million by transferring everything to the spouse, since the spouse gets an unlimited marital deduction. We like to use up that million by putting it in a trust, or giving it directly to the children, or whatever. That's basic estate planning. In that case, in the same estate, the gross estate at the second death--remember there's no tax on the first death--the gross estate at the second death would only be $1.7 million, instead of $2.7 million. Now we'd exclude another million from that, leaving only $700,000 taxable. The tax on that: $315,000. Still an awfully high number, but a savings of $450,000.

That's an illustration of what I call basic planning. Advanced planning asks, can we save even more? Are there other things we can do to save a little more money? Yes, there are various things that can be done, and the one that's interesting in the context of estates that have a lot of land--agricultural land or open space land--is the conservation easement that Ernie will be speaking about next. A quick example of how that might work is, a conservation easement, in simple terms of course, is simply a restriction that you yourself put on the land. And you surrender certain development rights, which has the effect of lowering the land's value for estate tax purposes and other purposes. So imagine that we had a $700,000 piece of land, and the value after granting the easement was $300,000, let's say. In that hypothetical situation, we'd have a $400,000 easement, which would have two terrific effects. One, we'd have an income-tax deduction in the year that the easement was given, because it's a charitable donation. And two, the estate would be reduced by that $400,000, even though you still own the land. So the additional tax savings under that trick, under my assumed facts, would be another $180,000 saved, lowering the bill for this hypothetical family down to $135,000 from $765,000.

Using some estate-planning techniques can save some real money for your family. A quick note, because my time is rapidly ending here. Some of this

planning can be done at death or even after death, but it's much better, for many reasons, to do it while you're alive, while you can control what's going to happen. So I do recommend that if you're in a situation where you have a lot of wealth tied up in land, that you give serious thought to these issues, for the sake of your children and/or other family members.

If you leave your family a lot of land, and if they can't come up with the cash to pay the estate taxes, they're going to have to sell the land, or possibly do some borrowing. But pretty much you've got to liquidate the land and write that check for hundreds of thousands of dollars to the IRS. The issue of how to allocate taxes among several beneficiaries is a planning issue. There are rules about that, but the rules may not be what you want, and you may want to put a clause in your will or trust to allocate taxes among the beneficiaries whichever way you decide you want to do it. There's also the whole issue of state death taxes, which I didn't even mention. In New Mexico, don't worry about it. New Mexico takes only the tax that the federal government credits you for state death taxes. Most states do this. We call it the "pickup tax," and it allows us to not have to think about it. The truth is, though, that of those big numbers I was quoting you earlier, you give a little bit to New Mexico and the rest to the Feds, because the Feds would give you credit for what you paid to the state. Some states--and I think Massachusetts is one of them--have additional death taxes, which estate planners must factor in as well, but New Mexico is not one of them.

Let me just sum up. The objectives that a client has in estate planning can usually be addressed by some thought and some planning. Particularly, correct disposition, saving taxes and managing the assets--preserving the assets. Because of inflation in the value of land, which is projected to keep going, these numbers will be incredibly high if you don't do the planning. And the tax numbers also will be incredibly high. Put another way, planning can save your family hundreds of thousands of dollars. An important tool in planning is a conservation easement. Our next speaker will address some of the specifics of that option.