

CHAPTER 6

ESTATE AND GIFT TAX PLANNING

Introduction

An important part of any proper estate plan is to consider the application of estate taxes and the efficacy of making lifetime gifts to minimize the estate tax obligation. As outlined in Chapter 5, estate taxes apply not only to assets owned at death but also to certain assets controlled by the decedent at the time of his or her death.

Many people do not need to include tax-planning provisions in their estate plan due to the exemptions that are available to offset the estate tax that would otherwise be due. However, your estate planning attorney should analyze your individual situation to ascertain whether estate taxes may be applicable.

There are many techniques available to reduce estate taxes. Some are as simple as establishing one or more trusts during lifetime or following death. Other strategies involve the transfer of assets to legal entities, such as a limited liability company, to structure the ownership of assets in a manner that will reduce the value of the entity and its assets for the purpose of calculating estate tax. Several of the more common techniques are discussed in this chapter and in Chapters 7 and 8.

Basic estate tax planning for the married couple

As discussed in Chapter 5, each individual has an estate tax exemption that is the equivalent of a credit against estate taxes that would otherwise be payable. For much of the 1980s and 1990s, this exemption was \$600,000. Under the 2001 Tax Act, the exemption was increased to \$1 million with further increases throughout the decade. The exemption will return to \$1 million in 2011 unless Congress acts to change the law.

Recall from Chapter 5 that the entire amount that passes to a surviving spouse is exempt from estate taxes. However, if the surviving spouse owns the entire



estate and the value of that estate exceeds the exemption that is in effect at the time of death, estate taxes will be payable. If the assets of a married couple will exceed the exemption amount, it is important that provisions be included in their estate plan to utilize both spouses' exemptions.

For example, if a husband and wife equally own assets worth \$2 million and the entire estate passes to the surviving spouse following the death of one of them, the estate tax would be \$435,000 on the surviving spouse's death (assuming the surviving spouse dies after 2010). If the exemption available in the first spouse's estate can be utilized, all \$2 million worth of assets will pass to the couple's heirs (such as their children) without estate tax.

One approach for utilizing both spouses' exemption amounts is to have the estate plan provide that the children (and not the surviving spouse) receive the estate of the first spouse to die. Using this technique in the example above, \$1 million will be distributed to the couple's children on the death of one of the parents. While this will eliminate the estate tax in the above example, it may not be consistent with the couple's non-tax goals. Most couples anticipate that the surviving spouse may need all of their accumulated assets during his or her lifetime and are not prepared to dispose of a substantial portion of their estate following the death of one of the spouses.

As an alternative, the couple may include provisions for a testamentary trust in their wills or revocable living trust. This trust is commonly referred to as a Credit Shelter Trust. Other names, such as Bypass Trust, Exemption Trust, or Family Trust, are also used.

Typically, the Credit Shelter Trust provides that all of the income of the trust (such as interest on bank accounts and bonds, rent payments on rental property, and dividends on stock) will be distributed on a periodic basis to the surviving spouse. The trust can be drafted to provide for distribution of income to other family members as well (called a "sprinkling power").

In addition to all of the income, the surviving spouse may also have access to the principal of the Credit Shelter Trust. For example, if the surviving spouse incurred a major expense that exceeded the income of the trust, assets of the trust could be distributed from the trust to the surviving spouse to provide the means with which to pay the expense.

The surviving spouse may serve as the trustee of the trust and may be given the authority to appoint his or her own co-trustee or successor trustee. However, if the surviving spouse is going to serve as the sole trustee, he or she may not withdraw the principal of the trust except for his or her health care needs, education, maintenance and support. If principal is distributed to the surviving spouse for other items, the tax savings benefits of the Credit Shelter Trust will be lost. In addition, if the surviving spouse is appointed as the sole trustee, sprinkling powers over income (as described above) should not be used without careful consideration of the income tax consequences.

Since the Credit Shelter Trust does not come into existence until one spouse dies, the couple does not need to dedicate any particular assets to the trust during life. Funding of the Credit Shelter Trust is part of the probate of the will of

the first spouse to die or, if a living trust is used, it is part of the administration of the trust.

There are many other provisions that can be included in the Credit Shelter Trust. For example, the surviving spouse may have the power to change the manner in which the assets of the trust are distributed at his or her death (called a “special power of appointment”). Thus, even though the Credit Shelter Trust is irrevocable at the death of the first spouse, the survivor may, if authorized, modify the distribution provisions that will take effect at the survivor’s death. This kind of flexibility makes the irrevocable nature of the Credit Shelter Trust more acceptable.

As discussed in Chapter 3, a person may own assets that are subject to estate tax but will not be subject to the terms of the will or living trust and as a result, to the tax-planning provisions included in those documents. Therefore, an important part of the estate planning process is to coordinate the beneficiary designations that will take effect upon death of assets such as retirement accounts, life insurance policies, and annuities so that estate taxes may be minimized following the death of the surviving spouse.

Finally, it is important to remember that the assets of many types of trusts are free from the claims of creditors. Thus, if the surviving spouse incurred a substantial obligation (such as a lawsuit judgment), assets within a properly drafted Credit Shelter Trust may not be subject to the claims of the surviving spouse’s creditors.

If the value of the estate owned by the first spouse to die exceeds his or her estate tax exemption amount, the remaining assets—after funding the Credit Shelter Trust—will be distributed outright to the surviving spouse or to one of several types of trusts that will qualify for the marital deduction. Thus, no estate tax will be payable on the first spouse’s death regardless of the size of the estate.

Introduction to other estate tax planning techniques

For the unmarried person, or for married couples with assets exceeding two exemption amounts, there are many other strategies available that will reduce or eliminate estate taxes. Many of these are outlined below.

Charitable gifts

There are many charitable giving strategies that can be used to reduce a person’s estate tax liability. Some of the approaches involve gifts that are made during lifetime that will remove assets from the donor’s estate for estate tax purposes while allowing the donor to benefit from the donated assets during his or her lifetime (and during the lifetime of his or her spouse). Many of these techniques are discussed in detail in Chapter 7.

Gifts to individuals

Gifts to individuals can take many different forms, including an outright gift or a gift to a trust for the benefit of another person. In each case, the gift involves a transfer of assets from one person (the donor) to another person (the donee). The donor must not retain any interest in or right to benefit from the assets gifted to the donee or the gift will not be effective for gift tax purposes.

Certain gifts are not subject to gift tax. These gifts include those that qualify as annual exclusion gifts and gifts for the purpose of paying medical or educational expenses.

ANNUAL EXCLUSION GIFTS

Annual exclusion gifts (currently \$12,000 per donee per year) are not subject to gift tax. There is no limit on the number of annual gifts that a donor may make but no donee may receive more than \$12,000 worth of assets per calendar year from a single donor. Thus, a married couple with three children and five grandchildren can give a total of \$192,000 per year without any gift tax.

If the prospective donee is a minor or is otherwise unable to properly manage the assets to be gifted, several different approaches can be used to provide for the effective management of the assets. These include: 1) gifts to a trust that will terminate when the minor reaches age 21; 2) gifts to a trust that extend beyond the age of 21 and include certain withdrawal provisions (often called a “Crummey Trust” named after the court case that authorized the strategy); 3) gifts to a state-sponsored tuition plan (often called a “529 Plan”); and 4) gifts to a Uniform Transfers to Minors Act account. In each case, however, the donor should not be designated as the trustee (in the case of a trust) or custodian of the funds. Making a gift to such a trust or account while retaining the right to control the distributions may result in the gifted assets being included in the donor’s estate when he or she dies.

GIFTS FOR MEDICAL EXPENSES AND EDUCATION

Gifts that are for the donee’s health care or education are also not subject to gift tax. However, the donor must pay the health care provider or educational institution directly. If the gift is made to the donee who then pays the health care or educational expense, it is a gift and will be subject to gift tax if it exceeds the annual gift tax exclusion amount.

TAXABLE GIFTS

Gifts that exceed the annual gift tax exclusion amount or do not qualify for the exclusion for health care and educational expenses are “taxable gifts.” However, this term can be misleading. The mere fact that the gift exceeds \$12,000 per year, for example, does not mean the donor must pay gift tax.

The donor may use (in fact, is required to use) his or her applicable credit amount to offset the tax that would otherwise be owed on a taxable gift. This amount is limited to \$1 million under current law.

For example, if the donor makes a gift to his children of assets with a value of \$1 million and assuming that the donor has already made annual exclusion gifts in that year, the gift tax is \$345,800. This tax is offset by the donor's gift tax applicable credit of \$345,800. Thus, no gift tax is payable.

However, if the donor in the above example has used all of his gift tax applicable credit amount for his lifetime, no further gifts may be made (other than annual exclusion gifts and gifts for medical and educational expenses) without paying gift tax.

The donor must report all taxable gifts (and the use of his applicable credit amount) on a U.S. Gift and Generation Skipping Tax Return (IRS Form 709). This tax return is due on April 15 of the year following the year of the gift unless an extension to file is granted. This can be very important (even if no tax is payable) where the gifts are made to a trust and there is a possibility that the trust will terminate causing a generation-skipping transfer tax.

ESTATE FREEZE GIFTS

Some gifts are made, usually in a trust, that are subject to rigid restrictions regarding the use and enjoyment of the assets by the donor. These gifts, often referred to as estate freeze gifts, have the effect of reducing (or "discounting") the value of the transferred assets for gift tax purposes. These techniques allow the donor to retain the benefit of the assets transferred for a period of years. At the end of the term, the assets are distributed to the trust beneficiaries, often the donor's children.

The primary advantage of these strategies is that the value of the taxable gift is less than the full value of the transferred assets because the donor retains the use of the assets for the term of the trust. The value of the gift is calculated by using a published interest rate to determine the present value of the asset to be transferred to the donee in the future when the trust terminates. The donor must survive the trust term in order to achieve the full benefit of the strategies available.

Grantor Retained Annuity Trust

A common form of estate freeze gift is the grantor retained annuity trust or GRAT. This strategy involves the transfer of assets to a trust in which the donor retains the right to receive a set sum (usually in the form of a percentage of the initial value of the assets contributed) from the GRAT on an annual or more frequent basis. However, at the end of the trust term, the donor's children (or other intended beneficiaries) receive the remaining assets.

For example, if the donor transfers \$1 million to a ten-year GRAT and retains the right to receive a five percent (5%) annuity, the donor would receive a \$50,000 payment per year (distributed at least annually). The transfer to the trust is a completed gift for gift tax purposes. However, the value of the gift to the trust will be reduced by the present value of the donor's right to receive the annuity for a ten-year period. Assuming that a 65-year-old person establishes the above GRAT when the applicable interest rate is four percent (4%), the value of the gift to the trust would be reduced to approximately \$635,400. Therefore, by retaining the right to receive the annuity, the donor may not only benefit from the transferred assets but the value of the gift is reduced as well.



Furthermore, assuming that the value of the assets appreciate in excess of the federal interest rate applicable at the time of the transfer (4% in the above example) the children will receive substantially more than the value of the assets for gift tax purposes at the time of the trust termination. For example, using the same facts as outlined above and assuming that the assets appreciate at an average of seven percent (7%), the value of the GRAT assets would exceed \$1.2 million at the end of ten years even though the donor had received \$50,000 from the trust each year.

Personal Residence Trust

Another popular estate tax freeze technique is the personal residence trust (the PRT). This strategy involves the transfer of a residence that is used by the donor as a personal residence. Both primary and secondary residences qualify, including vacation residences.

Under the terms of the PRT the donor retains the right to use the residence for a term of years. Like the GRAT described above, the donor's retained use is valued for gift tax purposes and serves to reduce the value of the gift to the donor's children or other intended beneficiaries.

For example, if a 68-year-old donor transfers a residence valued at \$1 million to a PRT and retains the right to live in the home for a period of ten years, the value of the retained benefit derived by the donor is approximately \$525,000 which, in turn, means that the taxable gift is worth approximately \$475,000. Assuming seven percent

(7%) annual appreciation in the value of the property, the donor's children (or other intended beneficiaries) will receive the residence worth nearly \$2 million after ten years. Of course, as with the GRAT, the donor must survive the ten-year term to receive the estate tax savings benefits.

The use of a PRT is a very attractive estate planning tool for people who desire to transfer their residences at a substantially reduced gift tax cost, especially where one of the non-tax objectives is to retain the residence into the next generation.

FAMILY BUSINESS ENTITIES

Another popular strategy for making lifetime gifts and reducing the probable estate tax payable at the donor's death is the use of a family business entity (FBE). Most commonly, a limited liability company or family limited partnership will be used for this purpose.

The objectives of the FBE will depend on the circumstances. Common objectives include:

- Providing an efficient means of assuming the management of the family business assets;
- Designating appropriate family or non-family members to manage the FBE;
- Allowing the senior generation to transfer the FBE assets to junior generations while retaining the necessary control over the FBE; and
- Reducing the gift and estate tax consequences of transferring the FBE assets to the junior generations.

The ownership of the FBE is represented by units, similar to the shares of stock in a corporation. In most FBEs the units are divided into two basic types: management units and equity units. Typically, the management units carry the right to vote on most matters pertaining to the operation of the FBE. The equity units carry no right to vote except under extraordinary circumstances (such as the sale of substantially all of the business enterprise held in the FBE or dissolution of the FBE).

Most FBEs are owned only by members of a single family. As such, the equity units and, perhaps, the management units are subject to certain transfer restrictions. This is to prevent the owner of the units from selling his or her units to a non-family member without the consent of the other owners of the FBE. Thus, unlike stock in public corporations or units of public partnerships, the units of a FBE are not traded on any open market and are not generally available to non-family members.

In most cases, the FBE is established by one or more members of the senior generation (parents) contributing certain assets to the FBE. However, it is also common for members of the junior generations

(children, grandchildren, etc.) to also make contributions to the FBE. The members making contributions to the FBE receive management and/or equity units in exchange for their contributions.

Once the FBE is established, equity units (and, perhaps, management units) are transferred by gift to members of the junior generations. The value of the gift is based on the “fair market value” of the units that are transferred. Fair market value for gift tax purposes is based on what a willing buyer would pay to a willing seller, both in possession of all the facts surrounding the circumstances of the sale and both under no obligation to engage in the transaction.

The recipient of an equity unit of an FBE cannot sell his or her units and cannot vote or otherwise control the actions of members of the FBE who own the management units. Consequently, the value of an equity unit is likely to be substantially less than a proportionate share of the underlying assets that were contributed to the FBE.

Determining the fair market value of the equity and management units must be ascertained by appraisal. The appraiser will review the agreement that creates the FBE (the limited liability company or family limited partnership documents); evaluate the underlying assets of the FBE (the business that was contributed to the FBE); consider such issues as liquidity and potential for income generation by the business; restrictions imposed on the unit owners (such as the restriction on the right to manage and sell units); and many other factors. The result of this highly technical process is the fair market value of the units.

The use of an FBE can be illustrated by the following simple example:

Bob and Linda Smith own several rental properties worth \$1 million. They want to transfer a portion of the ownership of the rentals to their children; however, they want to retain management control with regard to the properties. If they simply transfer fractional interests in the rentals to their children, the Smiths lose the ability to control the rentals because, once owners, the children must consent to the actions that are taken with regard to the rentals.

Instead, Bob and Linda establish the Smith Family Business Entity (likely to be a limited liability company). They contribute the rentals to the FBE and receive both management and equity units in exchange for their contribution.

Some months later the Smiths decide to give most of the equity units (representing 90% of all of the units) to their children. Bob and Linda retain the management units. Although a majority of the units are now owned by their children, Bob and Linda continue to have the management powers by virtue of their ownership of all of the management units.

Following the year in which the gifts of the equity units are made, Bob and Linda must file a federal gift tax return (Form 709) reporting the gifts. The Smiths hire an appraiser who reviews the FBE and reports that the fair market value of the gift of 90% of the FBE is \$540,000; that is, 90% of \$1 million, reduced by a 40% discount to reflect the fact that the equity unit owners (the children) have no management powers (the lack of control discount) and cannot sell their units to anyone outside the family (the lack of marketability discount).

Thus, Bob and Linda have transferred nearly all of the equity of the FBE to their children at a substantially reduced value for tax purposes. Note that if Bob and Linda had kept the rentals until death, the full value of the rentals (\$1 million plus appreciation until the date of their deaths) would be subject to estate tax.

While FBEs are appealing for many reasons, they also have disadvantages and are not for every estate plan. For example, the income of the business (the rental income in the above example) is allocable to the owners of the FBE units in proportion to ownership. In the above example, the children will receive 90% of the income which may, or may not, be acceptable. Bob and Linda can be compensated for their services to the FBE, but cannot ignore the FBE and retain the income as though the FBE did not exist. Furthermore, Bob and Linda, as owners of the management units, are fiduciaries and owe duties to the other owners of the FBE (their children). No one should enter into an FBE without a full understanding of the consequences and a willingness to accept the additional complications associated with using a business entity.

Conclusion

Proper planning to reduce estate taxes involves the use of trusts and other entities and may include gifts to individuals and charitable organizations. While some of the strategies may add some complication to your life, they can substantially reduce—even eliminate—the estate taxes owed at your death.