Estate Planning

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Purpose of Estate Planning

- Distribute your estate
  - Who
  - When
- Minimize/eliminate transfer taxes
  - Estate
  - Gift
  - Generation-skipping transfer tax

Basic Documents in an Estate Plan

- Advance directive for health care
- Power of attorney
- Distribution plan
  - Will
  - Trust

Basic Documents in an Estate Plan

- Advance Directive for Health Care (Living Will and Health Care Proxy)
  - Directions if you are terminally ill or permanently unconsciousness
  - You can also appoint a health care proxy

Basic Documents in an Estate Plan

- Power of Attorney
  - Allows a person to conduct your business affairs if you are not present or not able
  - Acts of the attorney in fact are binding on the principal
  - Can be current or "springing"
  - Terminates at the death of the principal

Basic Documents in an Estate Plan

- Will
  - Provides for the distribution of property owned by the decedent at his death
    - Decedent has no control over the assets after the probate period
  - Can be changed any time before testator's death or incompetency

Non-Probate Estate

- Non-probate estate
  - Jointly owned property
  - Retirement accounts
  - Life insurance proceeds, generally
  - Trust estate

Jointly Owned Property

- Ownership
  - Joint with right of survivorship
    - Not affected by a Will
    - Not a probate asset
  - Tenants in common
    - Can be passed according to a Will
    - Probate asset
- Potential problem

Revocable Trust Instead of a Will

- Trusts provide greater control over distributions, e.g. conditions and length of time
- Privacy concerns – wills are public documents trusts are not
- Avoid the expense and trouble of court-supervised proceedings
- Property management in case of incapacity
- Protects residual beneficiaries
- Spousal election
- Only disposes of assets in the trust

Transfer Taxes

- Gift Tax
- Estate Tax
- Generation-skipping Transfer Tax
- Excise taxes because they are imposed on the transfer of property
- Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)
  - Last major change to the transfer tax system

Are you going to be better off with a change?

- Yes, unless you planned to die in 2010 and were worth more than $7 million
- Without the change
  - $1,000,000 applicable exclusion amount
  - 55% tax rate
    - 60% for amounts between $10,000,000 and $17,184,000
- With the change
  - $3,500,000 applicable exclusion amount
  - 45% tax rate

What has been proposed

- H.R. 25 (54 sponsors) and S. 296 (4 sponsors)
  - Repeal income tax and other taxes, abolish the IRS and enact a national sales tax
- H.R. 205 and H.R. 1960
  - Repeal federal estate and gift tax
- H.R. 173 and H.R. 1328
  - Exempt certain farmland from estate tax
- Senate Amendment 873 to Senate Congressional Resolution 13—Passed 51 to 48
  - $5,000,000 applicable exclusion amount
  - 35% tax rate
  - Budget guidance only

What is likely

- Make estate, gift and GST taxes permanent
- Reunify the gift and estate tax
- $3,500,000 applicable exclusion amount
- 45% tax rate
- Increase the 2032A valuation reduction to $3,500,000
- Make unused AEA of the first spouse to die available to the second spouse
  - President Obama's guidance
  - H.R. 436 – Sponsor: Pomeroy
  - S. 722 – Sponsors: Baucus, Rockefeller, and Schumer

Gift Tax

- Payable by the donor
- Gift tax return is Form 709
- Gift taxes are generally due April 15 of the year following the gift

Estate Tax

- Payable by the executor of the estate
- Estate tax return is Form 706
- Due 9 months after the date of death
  - A 6-month extension is available

Transfer Tax Rate

- Graduated rates based on cumulative transfers during life and at death
  - Rates start at 18% and depending on the year can be as high as 60% (since 2007 the maximum rate has been 45%)

Estate Tax Credits

Year	Applicable Exclusion Amount	Applicable Credit Amount (Unified Credit)
2001	$675,000	$220,550
2002-2003	$1,000,000	$345,800
2004-2005	$1,500,000	$555,800
2006-2008	$2,000,000	$780,800
2009	$3,500,000	$1,455,800
2010	No estate tax	
2011	$1,340,000	$345,800

Gift Tax Credits

- Applicable exclusion amount remains at $1,000,000 for all years after 2001
- Use of the applicable credit amount is mandatory on taxable transfers
- Transfers in excess of the applicable amount create a current tax liability

Gross Estate

- Section 2033: Property owned by the decedent at death

Gross Estate

- Section 2042: Life insurance
  - Included in the gross estate under 2 circumstances:
    - Proceeds are payable to the insured's estate
    - Insured has incidents of ownership (rights to the economic benefits
      - Change the beneficiary, change the time or manner of receiving a beneficial interest, borrow against the policy, pledge the policy as collateral for a loan, choose whether to receive dividends or apply them to premiums, surrender the policy, determine the form in which proceeds are paid, or change the owner

Gross Estate

- Section 2039: Annuities
  - The gross estate includes the value of certain annuities or other payments that a beneficiary receives because he survives the decedent
  - Includable only to the extent purchased by the decedent
    - Contributions by the decedent's employer are considered made by the decedent
  - Actuarial value included in the estate

Gross Estate

- Section 2036. Transfers with retained life estate
  - The value of the gross estate shall include the value of all property of which the decedent made a transfer under which he retained for his life:
    - The possession, enjoyment, or the right to income
    - The right to designate the persons who shall possess or enjoy the property or income therefrom
    - The right to vote shares of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property

Gross Estate

- Section 2038. Revocable transfers
  - The value of the gross estate shall include the value of all property over which the decedent made a transfer but retained the power to alter, amend, revoke or terminate the transfer

Gross Estate

- Section 2037. Transfers taking effect at death
  - Gifted property is included in the donor's estate if:
    - The recipient must survive the donor to obtain possession or enjoyment of the property;
    - The donor retains a reversionary interest; and
    - The value of the reversionary interest just before the donor's death is over 5% of the value of the property
    - The property is included in the estate at its full value, not its actuarial value

Gross Estate

- Section 2035. Adjustments for certain gifts made within 3 years of decedent's death
  - Gifted property will be included only if the property would have been includable under Sections 2036, 2037, 2038 or 2042
  - Gift tax paid by the donor within 3 years of the donor's death is always includable in the decedent's estate, regardless of whether the gift is included

Gross Estate

- Section 2044. Certain property for which marital deduction was previously allowed
  - If a marital deduction was allowed in the deceased spouse's estate, the property will be includable in the surviving spouse's estate

Gross Estate

- Section 2040. Joint interests
  - The gross estate includes property held by the decedent and any other person as joint tenants with right of survivorship
    - Each person's share will be his proportionate share of capital contributions
    - If the decedent owned property with his spouse, then ½ of the value of the property is included in his estate no matter who originally owned the property

Gross Estate

- Section 2041. Powers of appointment
  - Property is included in the decedent's gross estate if he had the power, alone or with others, to appoint the property to himself, his estate, his creditors, or creditors of his estate

Estate Tax Deductions

- Section 2053. Expenses, indebtedness and taxes
  - Deduction are allowed from the gross estate for:
    - Funeral expenses
    - Administration expenses (including non-probate property)
    - Claims against the estate
    - Unpaid mortgages

Estate Tax Deductions

- Section 2054. Losses
  - The estate is entitled to deduct losses incurred during the settlement of the estate arising from fires, storms, or other casualties, or from theft, when such losses are not compensated for by insurance or otherwise
  - Casualties are sudden and unexpected
    - (termites eating the house don’t count)

Estate Tax Deductions

- Section 2055. Transfers for public, charitable, and religious uses.
  - A deduction is allowed qualifying transfers
  - The charitable estate tax deduction is unlimited

Estate Tax Deductions

- Section 2056. Bequests, etc. to surviving spouse
  - A deduction is allowed qualifying marital bequests
  - The marital deduction is unlimited
- Section 2057. Family-owned business interests
  - Repealed for decedents dying after 12/31/03

Estate Tax Credits

- Section 2010. Unified credit against estate tax
  - Applicable credit amount
- Section 2011. Credit for state death taxes
- Section 2013. Credit for tax on prior transfers
  - Credit for estate tax on property which was taxed in the estate of another decedent within 10 years
- Section 2014. Credit for foreign death taxes

Optimizing the Tax Attributes of Married Couples

- Tax Attributes
  - Annual exclusion amount ($13,000 per donee in 2009)
  - Applicable credit amount (unified credit)
  - GSTT exemption (same as applicable exclusion amount)

Basic Estate Plan

- Take advantage of both spouses' applicable credit amount and leave the remaining property to or for the benefit of the surviving spouse in a manner that qualifies for the unlimited marital deduction
  - No transfer tax due on the first death
  - Plan has to be funded

Transfers that Qualify for the Marital Deduction

- Outright gift or bequest
  - Principal residence
  - Personal assets
- QTIP trust
  - Trust held for benefit of surviving spouse during surviving spouse’s life and at his death to the persons chosen by the decedent (remainder beneficiaries)
- Annuity includable under sec 2039
  - Must be purchased with decedent spouse’s funds and surviving spouse must be only person eligible to receive benefits

QTIP Trust Requirements

- Surviving spouse must receive all income of the trust paid at least annually
  - Spouse must have power to require the trustee to make the trust productive of income
    - What's good for spouse isn't necessarily good for remainder beneficiaries
- No one but surviving spouse can receive distributions during her lifetime

Planning for a Taxable Estate

- The value of the estate must be reduced through a gifting program, preferably, using techniques that stretch the donor's annual exclusion and applicable exclusion amount

Tax Economics of Lifetime Gifts

- Effective gift tax rate is lower than the estate tax rate
  - Estate is tax inclusive
    - Tax base is the value of the estate
    - $1,000,000 estate minus 45% tax leaves $550,000 for the beneficiary and $450,000 for the IRS
  - Gift tax is tax exclusive
    - Tax base is the value the donee receives
    - $1,000,000 to make a gift and pay the tax. The donee receives $689,655 and the IRS gets 45% or $310,345

Tax Economics of Lifetime Gifts

- Any income and appreciation accruing from the gifted property escapes gift and estate taxation
- Valuation of transfer for gift tax purposes may be lower than the value for estate tax purposes

Basis Rules

- Sec. 1015. A donee takes the donor's basis plus the gift tax attributable to the appreciation
- Sec. 1014. If a person takes property under a decedent's will or trust he gets a "step-up" (or change) in basis to fair market value at date of death.

Tax-Free Gifts

- Specific purpose
  - Tuition and medical expenses
- Specific amount
  - Annual exclusion
    - $10,000 for 2001 and prior years
    - $11,000 in 2002 through 2005
    - $12,000 in 2006
    - $13,000 in 2009
    - Indexed for inflation in 1999, but increments of $1,000

Unlimited Gifts for Tuition and Medical Expenses

- Does not use any exclusion, applicable credit or GSTT exemption
- Payment must be made directly to a qualified educational organization or health care provider
- Tuition only—does not apply to room and board, books, fraternities/sororities, or transportation
- No gift tax return required

Annual Exclusion Gifts

- Each person may give up to $13,000 per donee per year free of gift tax without using any of his credit amount or GSTT exemption
  - Not limited to family members
- Gift must be a present interest

Split-Interest Gifts

- They are split-interest because the grantor retains an interest either for a term of years or one or more lives
- The value of the gift is determined actuarially using the term of the trust and the 7520 rate
- Choosing the technique
  - When interest rates are rising the value of an income interest increases and the value of an annuity decreases and QPRT's and CRAT's are favored
  - When interest rates are decreasing GRAT's, CLAT's and PA's are favored

Qualified Personal Residence Trust (QPRT)

- Allows a person to give away one or two personal residences at a fraction of the transfer tax cost
- The donor's taxable gift is reduced by the actuarial value of his retained right to income (the right to live in the house).
- Since the taxable gift is reduced by an income interest, a QPRT will be a better tax-minimizing device when interest rates are high

QPRT

- How it works
  - Personal residence is transferred to an irrevocable trust
  - The donor, as term holder, retains the right to live in the house for a fixed number of years
  - After the term, the property passes to other beneficiaries
  - If the donor dies during the term, the house reverts to the donor's estate
  - On the date of the gift, the donor makes a gift of the value of the remainder interest in the house

QPRT

- Calculation of the gift
  - A $400,000 house contributed to a
    - 15-year QPRT
      - 3.2% 7520 rate would create a taxable gift of $249,382 or 62% of the value
      - 5.0% 7520 rate would create a taxable gift of $192,407 or 48% of the value
    - 8-year QPRT
      - 3.2% 7520 rate would create a taxable gift of $310,902 or 78% of the value
      - 5.0% 7520 rate would create a taxable gift of $270,736 or 68% of the value

GRAT

- Grantor retained annuity trust is an estate freezing technique and can be a dramatic tax-saver in the right circumstances

How a GRAT Works

- The grantor of a GRAT transfers property to the trust and retains an annuity payable for a term of years or for the shorter of the grantor's life or a term of years
- The grantor makes a taxable gift of the value of the remainder interest
  - The amount of the gift will be determined under the actuarial tables and will depend on the length of the term, the amount of the annuity and the 7520 rate
- During the term the trust will be a grantor trust
  - Grantor is not taxed on the annuity, but taxed as if the grantor owned the trust assets

GRAT Example

- Calculation of a zero-gift GRAT
  - $1,000,000 contributed to a GRAT earning 6.0% interest
    - 15-year GRAT
      - 3.2% 7520 rate would generate an annuity of $84,983 (or $1,274,756) and a tax-free gift to your beneficiaries of $418,503
      - 7520 rate of 5.0% would generate an annuity of $96,342 (or $1,445,130) and a tax-free gift to your beneficiaries of $154,107
    - 8-year GRAT
      - 3.2% 7520 rate would generate an annuity of $143,662 (or $1,149,296) and a tax-free gift to your beneficiaries of $171,962
      - 7520 rate of 5.0% would generate an annuity of $154,722 (or $1,237,776) and a tax-free gift to your beneficiaries of $62,491

GRAT Example

- Calculation of a GRAT with a remainder interest
  - Assumptions
    - You want a $250,000 annuity for 10 years and $1,000,000 taxable gift to your children (no taxes due since that is the AEA)
  - Results
    - Invest $3,110,950
    - Tax-free to children
      - At 5.0% interest they would receive $1,922,937
      - At 6.0% interest they would receive $2,276,039
      - At 7.0% interest they would receive $2,665,598

GRAT

- Risk involved
  - If the Grantor dies during the term, part or all of the property may be includable in the grantor's estate
    - Amount needed to fund the annuity
- Reward
  - There is an opportunity to make a tax-free gift of an amount greater than the amount the actuarial tables say is being transferred
  - Assets that are expected to earn a great deal of income and/or appreciate substantially are chosen to fund the trust

Charitable Remainder Trusts

- How does it work
  - The donor transfers property to a trust
  - One or more non-charitable beneficiaries receive a specified amount each year from the trust for a term or life
  - At the end of the term the charity gets the remaining trust assets

Charitable Remainder Trusts

- Advantages
  - Income tax charitable deduction on transfer of property to the trust
  - Tax-free sale of appreciated property by the trust
  - Tax-free accumulation of income inside the trust
  - Deferral of income taxation to the individual beneficiary
- Disadvantages
  - Permanent loss of the property to the family
  - Application of certain private foundation rules

CRAT

- Assumptions
  - 7520 rate of 3.4% (can use current or past 2 months rate for CRAT)
  - Residential rental property with a FMV of $1,000,000 and a basis of $0 (fully-depreciated)
  - 60-year old grantor with a 58-year old spouse

CRAT

- Results
  - CRAT sells rental property and reinvests in asset with a 5% return – no tax paid at the time of the sale
  - Current income tax deduction of $186,617
  - $46,500 annually for their joint lives (28.07 years)
  - $1,305,255 expected payments
  - Each payment is ordinary income and the $150,000 of capital gains tax is never paid
    - Ordinary income first, then capital gain, then tax-free, then return of basis
  - Charitable remainder
    - 5% = $1,204,409

Private Annuity

- An individual sells an item of property in exchange for an annuity for the seller's life
  - Must be unsecured
  - Seller can retain no interest
  - Payment cannot be tied to income from the property
  - Payable with full recourse to the obligor's independent assets
    - Buyer should be financially able to pay the annuity even if the property is exhausted

Private Annuity

- If the value of the annuity equals the value of the property there is no gift
  - Compare the present value of the payments to the fair market value of the property to determine whether a gift has been made
- When the seller dies nothing is included in his estate
  - Unspent annuity payments will be in the estate

Private Annuity

- Benefits
  - Actuarial tables are key in deciding whether to use a private annuity
  - When assets perform better than the 7520 rate
  - When the annuitant has a shorter life expectancy than indicated in the tables
  - When the annuitant needs income
- Payments continue for life, and possibly after the property has been exhausted

Private Annuity

- Income tax consequences
  - Seller
    - Recognize income as payments are received
    - Each payment is divided into three elements: recovery of basis, gain, and interest
  - Buyer
    - Basis is the amount of payments actually made
    - No deduction for payments since they are capital expenditures

Private Annuity Example

- Assumptions
  - 7520 rate is 3.2%
  - 60 year old seller
  - $500,000 FMV with a $100,000 basis
- Results
  - Life expectancy = 21.54 years
  - Annuity is $34,227
  - Under regulations proposed in 2006 all capital gains taxes have to be paid on the date of the sale or $60,000
    - Ordinary income = $13,130
    - Tax free return of principal = $21,097
    - [under old regulation capital gain portion = 16,878 and nontaxable portion = 4,219]

Private Annuity

- At Death
  - Seller
    - Annuity terminates
    - If the investment has not been recovered the estate can take a loss on the final income tax return
  - Buyer
    - Buyer’s estate is responsible for payment of annuity
    - If the estate does not have sufficient assets then the seller may have a problem

SCIN (Self-canceling installment note)

- A SCIN is an installment sale with a bona fide provision under which all obligation to pay automatically ceases on the seller's premature death
  - Provision must be bargained for
  - Price must reflect the bargain
  - Seller can retain no interest

SCIN (Self-canceling installment note)

- Advantages
  - Estate freezing technique
  - Income and appreciation are out of the estate
- Disadvantages
  - Recognition of gain and interest income
- Price premium
  - Usual practice is to determine the present value of each payment, taking into account the interest rate charged and the probability that the seller will be alive on the date of the payment

SCIN Example

- Assumptions
  - 7520 rate is 3.2%
  - 5% note
  - 60 year old seller
  - $500,000 FMV with a $100,000 basis
- Results
  - Annuity is $40,121
    - Interest income = year 1, $25,000; year 2, $24,244; year 3, $23,450, etc.
    - Capital gain = year 1, 12,097; year 2, 12,702; year 3, 13,337, etc.
    - Tax free return of principal = year 1, $3,024; year 2, $3,175 year 3, $3,334, etc.
  - Payments cease after 20 years or the premature death of the seller

Desirable Characteristics for the Business Entity

- Maintain control while giving interests to family members (unity of management)
  - Avoiding veto power of small owners
- Preventing interests in family property from passing to outsiders as a result of death, divorce or other disposition
- Limited liability
- Creditor/asset protection
- Limited withdrawal rights
- No taxation at the entity level
- Discounted values for entity interests

Desirable Characteristics for the Business Entity

- Facilitating gifts
- Perpetual life
- Avoids the difficulties with fractional interests
- Avoids ancillary probate
- Can be used to reduce estate taxes
- Provides a succession plan
- Qualification for special tax provisions

Transfer Taxation of Interests in Partnerships

- Discounts
  - Lack of control
    - Little voice in partnership operations
    - Cannot obtain pro rata share by compelling liquidation
    - Cannot obtain the value of his interest by redeeming it
    - Cannot transfer his management rights
    - Cannot compel distributions
    - Must pay taxes on his allocable share
  - Lack of marketability
    - Few unrelated parties would be interested in a minority interest in a family partnership without a substantial discount
  - Discounts depend on the type of assets in the business