

Strategies for Reducing Wealth and Transfer Taxes

By,

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A. Lifetime Gifts

The current gift tax program permits a person to transfer up to \$12,000 worth of gifts of a present interest per year to however many beneficiaries he desires. In addition, the spouse of the donor may elect to “split the gift” thus permitting the donor to gift up to \$24,000 worth of assets per person per year. For individuals who otherwise are facing an estate tax burden, annual gifting is an invaluable resource. Through annual gifting, it is possible to transfer thousands, tens of thousands, even hundreds of thousands of dollars worth of assets out of the donor’s estate over his or her lifetime. Annual gifting also ensures that any future appreciation in the assets that are gifted is taxed to the beneficiary rather than to the donor. (Presumably the beneficiaries are children or grandchildren who are at lower tax brackets than the donor.)

Of course balanced against the desire to avoid estate taxes is the desire to ensure that the donor has sufficient assets to provide for his future needs. A fear of being dependent on others is one of the major concerns that donors have with respect to gifting. For this reason many donors do not gift the maximum amount that they otherwise would be able to.

Lifetime gifts may take many forms. These may be gifts of cash, gifts of business interests, gifts of specific property, forgiveness of indebtedness and gifts in trust.

Gifts of cash are the simplest form of gifts. In this situation the donor simply writes a check or gives cash to the beneficiary or beneficiaries. The beneficiaries are then free to do what they would like with the cash. The gift is easy to value because gifts of cash are always valued at the face amount of the cash. In other words a gift of \$10,000 in cash is valued for gift tax purposes at \$10,000.

Often times, however, there are situations where the beneficiary of a gift may need more than the annual exclusion amount at a given time. For instance, the beneficiary may be buying a new home or starting a new business. In this situation it is common to see the donor make a loan to the beneficiary of the full amount needed and then, on an annual basis, forgive the loan in the maximum amount allowed. The paperwork required in such a strategy would be in a form of a promissory note to represent the amount loaned to the beneficiary and then annual debt forgiveness letters to evidence the amount of debt that has been forgiven. It is important to remember in this type of scenario that the debt must be subject regular annual interest accrual otherwise the IRS deems an assumed interest rate and that interest rate will also be part of the gift from the donor to the beneficiary. To the unwary donor, this deemed interest rate gift may result in the donor exceeding the annual exclusion amount when the debt forgiveness is combined with the assumed interest gift. The IRS, on a monthly basis, states what the minimum interest rate must be to avoid this deemed interest gift computation. This interest rate varies from month to month and also varies on the term of the loan, whether it is short-term, mid-term or

long-term. It is important to note that the interest rate for deemed gift purposes is determined at the time the loan is made. Thus, if after the loan is made there are subsequent adjustments to the interest rate provided by the IRS, the interest rate of the loan does not need to change.

Many donors are understandably reluctant to give outright gifts of cash to the beneficiaries. They may have concern that the beneficiary will not use the cash in the manner that the donor would desire. For this reason, a common gifting vehicle is in the form of a trust. In order for a gift to be eligible for the annual gift tax exclusion that gift must be a gift of a present interest. Gifts in trusts however, are typically gifts of future interests, meaning that the beneficiary does not have the right to the assets until some future time. In order to ensure that gifts made in trust qualify for the annual gift tax exclusion, the beneficiary is given the unrestricted right to demand the distribution of the assets that were made in trust for a specific period of time, commonly 30 or 45 days. If the beneficiary does not elect to have the assets distributed outright within that time period, the right lapses and the gift stays in the trust and is distributed pursuant to the terms of the trust. Gifts in trust in this manner are done through the use of "Crummey" notices. Crummey notices are so named because of that was the name of the first person who utilized this method. It is not a reflection on the type of gift! Crummey notices are formal letters to the beneficiary (or if the beneficiary is a minor, to the beneficiary's legal guardian) which advises the beneficiary of this right to withdraw assets. While the beneficiary does have the right to withdraw these assets the beneficiary also knows that if it does so the donor is less likely to make future gifts to that beneficiary. For this reason Crummey rights of withdrawal are rarely invoked by the beneficiary. Crummey letters need to be issued each time assets are transferred to the trust. In the past people attempted to have a single Crummey notice which covered future contributions to the trust, however that was found to be ineffective in the IRS's eyes.

One type of trust that does not require the use of these Crummey notices is a 2503(c) trust, so named because of the location in the Internal Revenue Code where the governing provisions are found. A 2503(c) trust provides that the trust assets must be distributed to the beneficiary, i.e. to the child, when the child reaches the age of 21. Because of this distribution requirement 2503(c) trusts are not used as often as standard Crummey trusts.

The value of the gift to a beneficiary when made in trust manner is that beneficiary's respective share of the value of the property transferred to the trust. For instance, if there are 4 beneficiaries in a particular Crummey trust, each of which receives a Crummey withdrawal letter entitling it to withdrawal one fourth of the assets contributed, the value of the gift is one fourth of the value of the contributed assets. For example, if \$80,000 were transferred to the trust, each of the four beneficiaries would have a gift in the amount of \$20,000.

Gifts may also be made of non cash assets such as stocks, real estate or personal property. The method of formalizing the transfer depends on the type of property. For real estate, the transfer would be evidenced by a deed. For certain types of personal property, the transfer would be evidenced by certificates of title. In other types of personal property, the transfer would be evidenced by a simple form of assignment letter. The value of the property transferred would be its then current fair market value. Determining the fair market value may be simple or may be difficult depending on the asset transferred. Valuation experts are available to determine the value of virtually any type of property.

Another form of transfer is the transfer of ownership interest in a company. This transfer is evidenced by an assignment of company interests. It is important to remember that if the assignment is being made to a beneficiary who is a minor that the assignment must be made to an adult as custodian for the minor, typically under the Utah Uniform Transfers to Minors Act.

B. Valuation Discounting

The valuation of the transfer of a minority interest in a company is a little more complicated but has additional advantages. This is because a one (1%) percent ownership in a company having a total value of \$1,000,000 is less valuable to someone than an outright gift of \$10,000 cash. With an outright gift of cash, the beneficiary can dispose of the money as he or she sees fit; however, with a fractional interest in a company, the beneficiary has little control over how the asset or assets of the company are spent. Accordingly, gifts of entity interests and other fractional interests are subject to valuation discounts which enables a donor to transfer assets with gross value greater than the annual exclusion amount to beneficiaries. For example, if the appropriate discount for a particular transfer is 25%, then the donor effectively gift \$12,500 worth of assets while only using \$9,375 worth of annual exclusion.

The amount of discount taken varies depending on the lack of marketability of the asset and the lack of control. Lack of marketability means whether there is a public market available for the business interest, in other words, whether the business interest being transferred is publicly traded. In addition, the lack of marketability discount takes into account the assets and operations which comprise the underlying business. An entity which owns an undivided interest in real estate is entitled to a greater discount than entity which only owns readily marketable securities. The discount for lack of control varies depending on the rights that the owner of the transferred business interest have in the operation of the entity. The smaller the percentage ownership transferred, the less control the owner of that interest has and thus the greater the discount allowable.

Determining the amount of discount taken is very subjective. The IRS routinely accepts discounts of 25-30 percent for lack of marketability and lack of control. If a higher discount rate is desired, then adequate proof of the amount of discounting needs to be obtained. This can be done in the form of independent business valuations from a properly trained valuation advisor or other forms of proof of the discount reasonableness. The more aggressive the discount, the more comprehensive the proof of discounting should be. In addition, the more aggressive the discounting, the more heightened the scrutiny will be from the IRS.

C. Marital Deduction Planning

Gifts to a spouse are not subject to gift tax or estate tax. Thus, transfers between spouses both during life and at death can be effective wealth tax reduction tools. If one spouse has substantially more assets more than the other spouse transfers may be made during life to “equalize the estates”. In addition, at death strategic gifts may be made to the spouse to defer and or reduce the amount of estate tax.

A common scenario is on the death of the first spouse the maximum amount that can pass free from estate tax is set aside for the benefit of the spouse and decedents and the remainder is

either distributed outright to the surviving spouse or held in a marital trust for the surviving spouse. This means that no estate tax is due on the first spouse's death. On the second spouse's death only the amount that is not covered by that spouse's unified credit would be subject to estate tax. By then the surviving spouse may have gifted sufficient interests or used up sufficient assets so that on the second spouse's death, no estate taxes are due at all.

Gifts between spouses are also used for asset protection purposes in addition to tax planning purposes. Where one spouse is at higher risk for lawsuits or judgments, it is common to have the other spouse own the home and other family assets. Gifting may be used to facilitate this asset allocation.

D. Life Insurance Planning

In determining ways to reduce the estate tax burden, life insurance is a common component of an estate. While it is true that life insurance proceeds are tax free to the beneficiaries, that is only half the story. If the person insured by the insurance also has any incidents of ownership in that insurance, the insurance payout amount is included in the decedent's estate for estate tax purposes. This can have an undesired impact on the overall estate tax planning. To combat the undesired taxes, irrevocable life insurance trusts are commonly formed to own the life insurance policies so that the policies are not included in the decedent's estate for estate tax purposes.

The way that an irrevocable life insurance trust works is that the donor contributes an existing life insurance policy or funds the trust so that the trust can purchase a life insurance policy. The donor then provides the beneficiaries with Crummey withdrawal letters thereby making the contribution of the insurance and/ or the cash a gift of a present interest. Then when the insured dies, all of the insurance proceeds are available by way of the trust for the beneficiaries and none is needed to pay estate tax on the life insurance. If the insured dies sooner than actuarial anticipated there is the added advantage that the amount of the premiums paid is substantially less than the amount of the death benefit paid.

In addition, the irrevocable life insurance trust can be structured as a generation skipping trust and generation skipping tax exemptions may be allocated to the trust as gifts are made thereby enabling the full death benefits to be free of generation skipping tax as well. The funds in the life insurance trust may be used for a variety of purposes including paying estate tax on other assets in the decedent's estate.

E. Charitable Giving

Gifts to qualified charities are also free from estate and gift taxes. There are a number of charitable giving vehicles available that provide both charitable giving methods and also provide estate and gift tax benefits as well.

One common vehicle is the charitable remainder trust. This trust provides that the trust is funded with certain assets and then the income or a stated amount of the trust is paid out over a period of time, such as a period of years or an individual's life. The remainder is given to one or more qualified charities. The use of such a trust has certain estate gift and income tax benefits. First, the amount of the charitable deduction and the value of the income interests are determined

at the time the gift is funded based on projected growth rates and projected life expectancies. This provides for potential advantages in the event that the assets grow at a higher than anticipated rate or the persons receiving the income interests live longer than statistically expected. In addition, the charitable remainder trust has the advantage that it can sell its assets free of income tax and capital gain taxes. Thus charitable remainder trusts are attractive vehicles for individuals who own assets that have substantial current value but that the individual's basis in the assets is very low. If the individual were to sell the asset outright, that individual would be subject to significant capital gains. Instead, if the individual contributes that asset to the charitable remainder trust and the charitable remainder trust subsequently sells that asset, no capital gain is recognized upon the sale of the asset. (Rather, the capital gain tax is paid by the non-charitable beneficiary when the distributions are made.)

In addition, the individual's estate is substantially reduced when the transfer is made. If the donor is not a beneficiary of the trust, the entire value of the trust may be removed from the donor's estate for estate tax purposes.

The rules surrounding the formation, funding and distribution of charitable remainder trusts are very complex and as such I will only provide a brief summary of those rules here. Charitable remainder trusts can be in existence for the life of one or more individuals or for a term of years not to exceed twenty. The payout must be greater than 5% of the trust assets per year. The income beneficiaries may not be substituted. The grantor must not retain rights to change the amount that the income beneficiary receives. In addition, amounts paid to the income beneficiary of the trust are required to retain the income tax character the income had when earned by the trust. The grantor of the trust may serve as a co-trustee or sole trustee of the CRT. However, if the CRT owns closely held stock, real estate or other assets which do not have an objective and ascertainable market value, an independent trustee must be the sole party responsible for making the annual determination of value.

Here is a simple example: John (age 54) and Jane Smith (age 50) own stock in the ABC Corporation. They purchased the stock for \$20,000. The corporation was sold to XYZ Corporation and the value of their stock is now \$1,000,000. John and Jane want to sell the stock but are concerned with the approximately \$275,000 of capital gains tax which will be due and owing at the time of the sale. John and Jane are charitably inclined. How can they sell the stock, diversify their investments, avoid the capital gains tax, keep income for life and make gifts to charity? Establishing a charitable remainder trust may solve all of these issues.

If John and Jane transfer the stock to a CRT and retain a 7% "unitrust" interest for their joint lives, a \$132,209 charitable income tax deduction (equal to the current value of the charity's remainder interest in the CRT) will be available to them (which at a 39.6% federal income tax rate would save them \$52,387 of income tax). They would receive 7% of the fair market value in income yearly, or \$70,000 in the first year. In addition, since the CRT is tax exempt, the \$275,000 capital gains tax John and Jane would otherwise pay on a sale of the stock individually would not be recognized upon the sale of the stock if the CRT is the seller. Rather, as distributions from the CRT are made, the donor pays taxes based on the type of income being distributed to him. The donor first is taxes on any ordinary income, then on capital gains.

There are also other popular methods of charitable giving which can have tax advantages as well. A donor may establish a private foundation or supporting organization. Both private foundations and supporting organizations are trusts wherein all of the assets are irrevocably dedicated to charitable purposes but the grantors remain involved in the charitable giving process.