Estate Planning Insights

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Estate Planning Insights

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HOW MUCH SHOULD YOU GIVE AWAY AND HOW SHOULD YOU GIVE IT?

This may seem like an odd topic, given the recent crisis in the financial markets and decline in market values of many assets; however, this may also be an opportune time to make some gifts to avoid future estate taxes. Simply stated, the purpose of this newsletter is to provide some ideas regarding non-charitable lifetime giving.

How Much Should You Keep? Before deciding how much to give away while you are living, a preliminary question is how much of your own "estate" you should keep. Issues to consider are (i) your health and life expectancy (in this regard, consider how long your parents and grandparents lived), (ii) your standard of living and cash flow, (iii) anticipated changes in the value of your assets over time, and (iv) the effect of inflation. We are not financial planners, but we work with some of the best in the industry. A good financial planner can help you determine how much you should keep and how much, if any, you should give away while you are living. Some financial analysts refer to what you should keep as your "core capital". Usually, core capital is calculated to give you a very high probability (even as much as 95%) of always having enough money for yourself. Once you have identified this figure, the rest is "excess" (money you will never need or use).

As far as how much you *can* keep and not have your estate pay any estate taxes when you die, very soon--on January 1, 2009--the estate tax exemption amount will be $3.5 million. This means that a person who dies in 2009 can pass on to his non-charitable beneficiaries up to $3.5 million worth of assets, free of estate taxes (assuming he has not used any of his $1 million lifetime gift tax exemption during life). For married couples *who do not waste the exemption of the first spouse to die*, a total of $7 million worth of community property assets can be transferred without estate taxes in 2009 (typically, the best way to avoid wasting the first spouse's exemption is to include a provision in a Will or Living Trust for the creation of a Bypass Trust on the first spouse's death). As of this writing, both presidential candidates have indicated that they want Congress to keep the estate tax exemption amount at $3.5 million (at least) once it reaches that level next year. If Congress does not change current law, however, then the estate tax exemption amount will decline to $1 million for 2011 and thereafter (under current law, there is no estate tax imposed on the estates of persons who die in 2010, regardless of the size of their estates, but then the existing estate tax scheme "sunsets" after that). Most likely, sometime during 2009, Congress will change the estate tax laws (we will keep you informed). Assuming our next president and Congress keep the estate tax exemption amount at $3.5 million (or higher), there will be many, many people who no longer *need* to make gifts during their lifetimes to reduce their estates for federal estate tax purposes. Of course, this does not mean that people with nontaxable estates will not want to make gifts during their lifetimes for other reasons.

The Transfer Tax System. As a reminder, both the estate tax and the gift tax (both sometimes referred to as "transfer taxes") are excise taxes imposed on the transfer of wealth. The estate tax (sometimes called the "death tax") applies to transfers effective at death, while the gift tax applies to transfers (i.e., gifts) made during life. The current estate tax rate is 45% (this is something that may also be changed by Congress next year; however, if Congress does not change it, the top rate will go back up to 55% in 2011). It is the person making the transfer (and not the recipient of the gift or inheritance) who incurs the transfer tax. In other words, the decedent's estate bears the estate tax and the maker of a gift (called the "donor") bears the gift tax.

Why Make Lifetime Gifts? The transfer of assets during lifetime, by gift or otherwise, is generally more efficient from a transfer tax standpoint than a transfer at death. This is because removing assets from the donor's estate during life helps to reduce or eliminate future estate taxes by removing the *growth and appreciation* of those assets from the donor's estate at death. In addition, *income* produced by the gifted assets is also removed from the donor's estate. Further, despite the use of the same tax rate schedule for calculating both the gift tax and the estate tax, the method of computing the tax results in a lower effective tax rate for lifetime gifts than for transfers at death. Thus, a common goal in estate planning is to utilize reduced cost lifetime transfer techniques to reduce future estate tax liabilities.

The Gift Tax Annual Exclusion. Qualified gifts having a value at the time of gift less than the annual gift tax exclusion amount are "tax-free" gifts. The 2008 gift tax exclusion amount is $12,000. This figure is rising to $13,000 for 2009. Gifts made directly to individuals will qualify for the annual exclusion from the federal gift tax. Thus, a gift in 2008 to an individual (the recipient of a gift is called a "donee") of any type of asset (cash, stocks, bonds, mutual funds, real property, etc.) that has a fair market value of $12,000 or less will be a "tax-free" gift. A married couple has two annual exclusion amounts per each donee. Thus, a married couple can give each of their children up to $24,000 total in 2008 without making a taxable gift.

If a donor makes a gift to a donee in a particular year that is larger than the gift tax annual exclusion amount, she is making a "taxable gift" and, therefore, must file a United States Gift Tax Return (Form 709) with the Internal Revenue Service ("IRS") to report the gift. (Not filing a Gift Tax Return to report a *taxable* gift is fraud.) For example, if a widow gives her daughter $20,000 in cash or other assets in 2008, the first $12,000 would be a tax-free gift, but the remaining $8,000 is *taxable*. This does not mean that the widow will have to write a check to the IRS to pay gift tax. Everyone also has a $1 million lifetime gift tax exemption amount. Thus, no gift tax is payable until a person makes taxable gifts during her lifetime exceeding, in the aggregate, $1 million. However, taxable gifts affect a person's estate tax exemption at death and that is why they must be reported.

Gifts to trusts do not automatically qualify as tax-free gifts even if the amount is within the annual gift tax exclusion. In order for a gift to a trust to qualify for the annual gift tax exclusion, the beneficiaries of the trust must be given some type of withdrawal right (usually referred to as a "Crummey" power, after a particular tax case) that makes the gift to the trust virtually the same as a gift made directly to an individual. Usually, the beneficiaries of the trust must be given written notice of their withdrawal right in order for the gift made to the trust to qualify as a tax-free gift for the donor. Of course, the donor hopes that none of the trust beneficiaries will actually exercise his/her withdrawal power because the donor placed the funds in the trust to accomplish some long-range planning goals.

Do You Have Excess Wealth You Should Give Away Now? If you determine that you have "excess wealth" that you will never need and you do not plan to leave all of this excess wealth to charity when you die, then, if you do not make lifetime gifts, you are basically retaining this excess wealth for the benefit of the government, which will obtain 45% (or more) of it upon your death. If you decide a lifetime gift is warranted, what type of gift should you make? Obviously, charitable gifts make sense for those who have charitable intent. In most cases, a donor will obtain both income tax and estate tax benefits by making charitable gifts during life. This newsletter is not focused on charitable gifts, however, for a simple reason: you can always avoid all estate taxes at death by leaving your entire estate (or your entire estate above the estate tax exclusion amount) to charity. If that is not your plan, however, and you have "excess wealth", you should very seriously consider making some gifts to individuals (or trusts for individuals) now.

The Simplest Approach: Make Annual Exclusion Gifts. Experts who study the effectiveness of various types of lifetime giving programs have determined that one of the simplest forms of gift is often overlooked but very effective: the annual exclusion gift. If everyone with a taxable estate were to make direct gifts to children and grandchildren (or other loved ones) of the annual exclusion amount each year, significant wealth would be transferred to the next generation, completely free of both estate tax and gift tax.

For example, assume a widower has two children and four grandchildren (6 donees). The widower could give each of them $12,000 in 2008, gift tax-free. That would be $72,000 (6 x $12,000) removed from the widower's estate for federal estate tax purposes. Of course, if any of the grandchildren are minors, the widower would have to make the gift either to a custodial account under the Uniform Transfers to Minors Act or to a 529 plan (because minors cannot legally own assets). The widower could also make gifts to the spouses of his children, which would remove another $24,000 from his estate in 2008. Further, the donees do not have to be related to the donor. For example, if he desires, the widower could make a tax-free gift to his long-time housekeeper also. If the widower were to make annual exclusion gifts again next year, he will be able to transfer even more wealth than he did in 2008 since the new tax-free amount for 2009 will be $13,000 per donee.

Thus, the power of making annual exclusion gifts to reduce one's estate should not be ignored. Even making gifts to individuals of amounts less than the maximum is an effective (and simple) way to avoid the estate tax at death (and provide benefits to loved ones now).

Another Approach: Create an Irrevocable "Grantor Trust" for Children and Grandchildren. Sometimes people want to make gifts to reduce the size of their estate but they do not want their beneficiaries to have direct or immediate control of the amounts given. The solution is making a gift to an irrevocable trust (the trust must be irrevocable to remove the assets from the donor's estate). As noted earlier, however, if the donor wants her gifts to the trust to qualify for the annual gift tax exclusion, the beneficiaries of the trust must be given a withdrawal right over the gifts for at least some period of time. Assuming the trust beneficiaries understand that it would be a mistake to exercise their withdrawal right over the funds placed in the trust, the funds will remain in the trust and provide future benefits to the beneficiaries per the terms of the trust. There are many types of irrevocable trusts with various trust terms; however, most trusts allow distributions to be made to or for the benefit of the beneficiaries for their health, support, maintenance and education.

One of the most significant features that should be included in nearly all irrevocable trusts created today is called a "grantor trust" power. A grantor trust power is something that is either retained by the grantor (the creator of the trust) when she creates the trust or is given to another person upon creation of the trust. A grantor trust power makes the person who possesses the power responsible for paying the income taxes on the income earned by the assets in the trust. OUCH! Why would anyone want to do this–pay someone else's income taxes? In the case of the grantor, the grantor's estate will be further depleted by the income taxes she pays on behalf of the trust and yet these income tax payments are not treated as additional gifts to the trust. Thus, in this way, more wealth is moved from the grantor to the beneficiaries of the trust, free of estate and gift taxes.

The grantor trust power can be used in other ways, too. Suppose a very wealthy donor has already used completely his $1 million lifetime gift tax exemption but needs to transfer additional wealth out of his estate. Suppose also that he owns a very valuable asset that is likely to appreciate greatly in value or to produce a large amount of income sometime soon. He does not want to make a taxable gift and pay a gift tax. If he tries to transfer the asset making annual exclusion gifts (e.g., transfers pieces of the asset worth $12,000 per donee per year), he will not be able to get the asset out of his estate fast enough. On the other hand, if he has previously set up an irrevocable grantor trust for the benefit of his descendants and the trust has sufficient assets in it, instead of making a taxable gift to the trust, he can sell the valuable asset to the trust. The trust will give him a down payment on the sale and also a promissory note for the balance of the purchase price, payable to him over time. Since the valuable asset is now owned by the trust, the trust will experience the appreciation in value (or large amounts of income), not the grantor. This is one type of "estate freeze" technique. Because the trust is a grantor trust for federal income tax purposes, the grantor does not report a taxable sale (a person cannot sell something to himself). However, it is still important for the asset to be sold at fair market value and for the trust to sign a note to the grantor that is "commercially reasonable" under the circumstances. In the best cases, the valuable asset will appreciate at a higher rate than the interest rate the trust is paying the grantor on the note (in this regard, the interest rate that must be used on the note will be lower than the interest rate required for a GRAT--discussed below--making it somewhat easier to "jump the hurdle"). Further, as noted earlier, the grantor will pay the income taxes on the trust's income each year as long as he retains the grantor trust power (if he gets tired of paying income taxes on the trust's income, he can release the power). Thus, in this way, significant wealth will have been transferred out of the grantor's estate *at no gift tax cost* (reducing future estate taxes payable on his death).

Yet Another Technique: Create a GRAT. *Now* may be a great time to contribute stock to a Grantor Retained Annuity Trust ("GRAT"). This is a technique in which the grantor places assets in an irrevocable trust for a term of years and retains an annuity payable to him by the trust. At the end of the trust term, the assets remaining in the trust (if any) pass to the persons designated by the grantor in the trust instrument (called the "remainder beneficiaries"). Both the term of the GRAT and the size of the annuity affect the value of the gift the grantor is making to the remainder beneficiaries. The higher the annuity rate, the higher the value of the grantor's retained interest and the lower the value of the gift being made to the remainder beneficiaries. Further, the longer the term of the trust, the lower the gift. The term of the trust should not be so long that the grantor might die before the trust terminates, however, because if the grantor actually dies during the trust term, all of the trust assets will still be included in his estate for federal estate tax purposes (and that means the GRAT did not work).

The value of the gift being made to the remainder beneficiaries of the trust is calculated using applicable IRS rules. (In fact, everything about a GRAT is prescribed, making it less risky than some other wealth transfer techniques.) Since the grantor will be paid an annuity from the GRAT during its term, the grantor is not making a gift to anyone of that portion of the trust's value. The gift that is being made is the present value of the interest in the trust passing to the remainder beneficiaries when the trust terminates. This "future value" of the gift is presumed based on IRS rates in effect today.

A GRAT should have at least a two-year term. Although there is no maximum term, it should not be too long (due to the mortality risk). Short-term "rolling" GRATs, containing only one type of asset, seem to provide the best chance for transferring wealth to the next generation at little or no gift tax cost. Wealth transfer is maximized if the remainder beneficiary of the GRAT is a grantor trust (discussed above). Married couples should partition community property and create two GRATs (to increase the odds of being successful). It is possible to "zero out" a GRAT by using a short term and a very high annuity rate, which makes the value of the gift to the remainder beneficiaries essentially zero. With all GRATs, the hope is that the assets placed in the GRAT will appreciate more rapidly than the assumed rate of return provided by the IRS, which, for GRATs, is the "Section 7520 rate". For November 2008, this rate is 3.6%, which is a very low "hurdle rate". Thus, if stocks with a low current value are placed in a two- or three-year zeroed-out GRAT, for example, and if the stock actually increases in value by more than 3.6% over the GRAT term, the excess appreciation will pass to the remainder beneficiaries at no gift tax cost. As a result of the recent market decline, there is a reasonable chance that many stocks will appreciate in value over the next few years. The trick is figuring out which ones those are!

Technically, you really cannot lose with a GRAT from an estate and gift tax standpoint. If the GRAT does not work (because the trust assets did not perform better than the 7520 rate over the term), then the grantor receives all of the trust assets back and he is no worse off. Further, if the grantor dies during the GRAT term, he is no worse off than had he done nothing. On the other hand, sometimes people "hit a home run" with a GRAT, transferring significant wealth gift tax-free. Thus, a GRAT is something more people should try!

Contact Us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown below.

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