<u>Passing your Wealth</u>

<u>By: Randall A. Denha, Esq.</u>

Although Republicans have tried to do away with the estate tax and it will disappear for one year in 2010, the next year (2011) our unified transfer tax system will be back completely.

This year and next, the estate tax credit covers assets of $2 million per person and $4 million per married couple. In 2009 this amount is $3.5 million per person; and in 2010 there is no estate tax. 2011 returns us to the $1 million per person credit equivalent, with the estate and gift tax system integrated as it was prior to 2003.

In order to reduce their estate tax burden, a few taxpayers have become involved in exotic schemes developed by aggressive law and accounting firms and a few slick life insurance outfits. Some of these methods are legitimate, but they can also be disguised tax-avoidance scams that leave taxpayers vulnerable to Internal Revenue Service scrutiny that can lead to substantial penalties. A sure and safe method for reducing transfer taxes is gifting.

Gifting should be done only if estate owners have sufficient income and assets after gifting to provide for their desired lifestyle and financial security. However, when income and asset values allow for gifting, four methods can be considered:

Annual Exclusion Gifts--Gifts of $12,000 per spouse can be made annually to children (or anyone else for that matter) without any gift taxes or reductions in the estate and gift tax credits. Therefore, if a couple has two children they could gift $48,000 annually, double that amount if the spouses of their children also receive gifts, and $12,000 per grandchild. Annual exclusion gifts can be given directly to children, or commonly they are made to irrevocable trusts (using so-called Crummey powers) for the payment of life insurance premiums. Annual exclusion gifts remove both the amount gifted and any earnings from the estate value.

Gift Tax Credits--Estate and gift credits become equal in 2011 when married couples' credits are equivalent to $2 million of asset value (or $1 million individually). What is often not very well understood about credit gifting is that the actual value of the gift isn't removed from the estate value because it is integrated with the estate tax in a unified system. What is removed from estate value is the growth of the asset gifted. A credit gift of $2 million incurs no gift taxes. Upon death the $2 million gift is brought back into the estate, and the unified tax credits are applied.

It is the growth on this $2 million that provides the savings, compared with having retained this asset in the estate. That is, a $2 million credit gift that has a value of $6 million when the estate owners die has effectively removed $4 million from estate value with corresponding estate tax savings, compared with not making this credit gift. Because of this, gifts equal to the credit should be made as soon as possible so the maximum amount of growth potential is realized outside of the estate. However, many clients I work with who should have used their gift tax credits long ago are holding on to them because their advisers are either unaware or ignorant.

Paying Gift Taxes--Gifts that exceed annual exclusion amounts and exceed estate and gift tax credits on a cumulative basis are subject to the payment of gift taxes. Making gifts and paying current gift taxes, instead of retaining the same amount within the estate and paying the estate tax at death, is great planning (as long as death doesn't occur at a time when the estate tax isn't levied). Paying current gift taxes is valuable because the gift tax isn't included in the amount of the gift, whereas the estate tax is included.

For example, Mr. and Mrs. Rich, with assets valued at $12 million, including $10 million of marketable securities and cash equivalents, have used their estate and gift tax credits ($2 million) in previous years. They have also made annual exclusion gifts each year. In 2011, they make a $2 million gift and pay a gift tax of $1 million (rounded off), for a total cash outlay of $3 million. In 2021 Mrs. Rich dies, having survived Mr. Rich. The $2 million gifted to their children in 2011 has been invested in tax-exempt bonds and is worth $2.89 million in 2021, which represents their net value.

Alternatively, the $3 million is retained in the estate, also invested in tax-exempt bonds and has a gross value of $4.34 million in 2021 when the estate tax is paid. This $4.34 million generates a $2.17 million tax, leaving the children with $2.17 million, which is $720,000 less than if the taxable gift is made in 2011. This is a robust difference of 33%. Most estate planning attorneys avoid even discussing this approach with clients.

Generation Skipping Transfers (GST) --These are asset transfers that skip the next generation. Since estate and gift taxes are imposed every time assets are transferred, the ability to transfer assets to grandchildren and beyond saves a great deal of estate taxes. Indeed, transferring asset principal beyond the next generation is such a good deal that the amount is limited under complex GST rules. The current GST amount is $2 million per spouse but returns to $1 million in 2011. This is planning the very wealthy use, usually with the guidance of some of the finest estate planning attorneys, so there is no need for this column to go into further explanation.

Types Of Assets Gifted

Selecting the type of asset to be gifted is very important. It is imperative that assets gifted go up in value; otherwise transfer taxes will be higher than need be because it is the value at the time of the gift that is brought back into the estate for calculating the estate tax. If closely held business stock has a gift value of $2 million but declines in value to $500,000 by the second death, taxes will be based on its $2 million value at the time of the gift, not the current $500,000 value.

For this reason, the prudent course is to gift cash that can either be used immediately by heirs or, if gifted to an irrevocable trust, should be invested conservatively so there is no chance that it will decline in value. Investing in participating whole life insurance with increasing death benefits from stellar companies like New York Life, Northwestern Mutual, AIG and Guardian is a very good choice, because the death benefits are not subject to income taxes and the yields are very likely to be higher than tax-exempt bonds.

A gift's cost basis needs to be taken into account. When securities or real estate are gifted, the persons receiving the gift (donee) retain the cost basis of the person who makes the gift (donor). Possible capital gain tax exposure is relevant because assets retained by the donor receive a step-up in basis at death. If real estate with a fair market value of $1 million and a cost basis of $100,000 is gifted and the donee sells the gifted real estate for $2 million, there is a capital gain of $1.9 million.

However, if the donor had retained the real estate and died with a fair market value of $2 million, the real estate has a new cost basis of $2 million, and there are no capital gain taxes due. Balancing potential estate and gift tax savings with possible capital gain tax exposure should be considered when selecting assets to be gifted.

Individuals who have accumulated considerable wealth can use various gifting techniques to substantially reduce their estate taxes without necessarily resorting to other exotic methods that may have misunderstood and nasty surprises.

Making annual exclusion gifts is a common technique. Using gift tax credits as soon as possible to enhance their growth, resulting in the actual estate tax savings, is often overlooked. And gifts that require the payment of gift taxes are almost always avoided even though they provide a sure method for reducing estate taxes associated with the gifts by 33% (as long as the estate tax isn't repealed). Care needs to be taken to limit the possibility that gifted assets don't go down in value. Finally, gifts of assets with a low cost basis should be avoided.

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In addition to the estate and succession planning areas of law that Randy practices on a daily basis, he also specializes in an area commonly referred to as Asset Protection Planning (APP). As an APP attorney Randy is frequently encountering those clients that are fearful of creditor claims that lack merit and for no other reason are brought

because the client has "deep pockets". Typical clients in this area are physicians, builders and real estate developers..