TRANSFER TAXES: AN OVERVIEW

Transfer taxes are taxes which are imposed when property is transferred to another person. The transfer can be during life (a gift) or on death (a bequest). The transfer taxes with which most of us are familiar are the gift tax and the estate tax. The gift tax is a tax which is imposed when we give another person property during our lifetime. The estate tax is a tax which is imposed when we give (bequeath) a person property upon our death. Another type of transfer tax is the generation skipping tax. The generation skipping tax is a tax which is imposed when we make a transfer to a person who is more than one generation below us, e.g. our grandchildren. The generation skipping tax is imposed on transfers during life or upon our death. The generation skipping tax is a tax in addition to any gift or estate tax imposed on the transfer. A gift (or bequest) to a person two or more generations below us is subject to a double transfer tax, either the gift or estate tax and the generation skipping tax.

Structure of Estate Tax Repeal

I said that the estate tax would not be repealed unless we had a Republican President and an overwhelmingly Republican Congress, but we have come much closer than I would have anticipated with the current political mix. Under the current law, estate taxes are repealed for 2010 and reinstated in 2011. This result is very strange, and it is very likely that some change will occur before 2010, either to continue the repeal of the estate tax in 2011 and thereafter, or to pass a revision to the current law which will remain in effect in 2010 and thereafter.

As will be discussed later in this chapter, the exemption from tax is scheduled to increase from the 2003 level of $1 million to $3.5 million in 2009. At present about 2-3% of the estates are subject to the estate tax. When the exemption is fully phased in, less than 1/4 of 1% will be subject to estate tax. The proponents of repeal will face a public relations challenge in their push to have the repeal effective beyond 2010.

Pre-repeal Structure of Transfer Taxes - Now Through 2009 and Beginning Again in 2011

Gift and Estate Taxes

Like income taxes, gift and estate tax rates are progressive; that is, the more you transfer, the higher the tax rate. In determining the rate of tax, all prior taxable gifts are added to the present transfer (either a gift or a transfer on death) to determine the rate of tax to be applied to the gift. The gift and estate taxes are a "unified tax" in that the rate of tax is the same, and all prior transfers are added to the present transfer to determine your tax.

The tax rates for gifts and transfers at death are as follows:

Amount with respect to which tentative tax is to be computed	Tentative tax
Not over $10,000	18% of such amount
Over $10,000 but not over $20,000	$1,800 plus 20% of the excess of such amount over $10,000
Over $20,000 but not over $40,000	$3,800 plus 22% of the excess of such amount over $20,000
Over $40,000 but not over $60,000	$8,200 plus 24% of the excess of such amount over $40,000
Over $60,000 but not over $80,000	$13,000 plus 26% of the excess of such amount over $60,000
Over $80,000 but not over $100,000	$18,200 plus 28% of the excess of such amount over $80,000
Over $100,000 but not over $150,000	$23,800 plus 30% of the excess of such amount over $100,000
Over $150,000 but not over $250,000	$38,800 plus 32% of the excess of such amount over $150,000
Over $250,000 but not over $500,000	$70,800 plus $34% of the excess of such amount over $250,000
Over $500,000 but not over $750,000	$155,800 plus 37% of the excess of such amount over $500,000
Over $750,000 but not over $1,000,000	$248,300 plus 39% of the excess of such amount over $750,000
Over $1,000,000 but not over $1,250,000	$345,800 plus 41% of the excess of such amount over $1,000,000
Over $1,250,000 but not over $1,500,000	$448,300 plus 43% of the excess of such amount over $1,250,000
Over $1,500,000 but not over $2,000,000	$555,800 plus 45% of the excess of such amount over $1,500,000
Over $2,000,000 but not over $2,500,000	$780,800 plus 49% of the excess of such amount over $2,000,000
Over $2,500,000 but not over $3,000,000	$1,025,800 plus 53% of the excess of such amount over $2,500,000
Over $3,000,000 but not over $3,500,000	$1,290,800 plus 55% of the excess of such amount over $3,000,000

The top rate drops to 50% in 2002, 49% in 2003, 48% in 2004, 47% in 2005, 46% in 2006 and 45% in 2007. The top rate remains at 45% until 2010, when there is no estate tax and increases back to 55% in 2011.

You are may be thinking, wait a minute I thought I could give up to $1 million tax free. You can. However, the way the law is written, there is actually not a $1 million exemption from tax, but there is a tax credit of $345,800 which works like a $1 million exemption. Conceptually, it is easier to think of the equivalent amount which would be exempt using the tax credit. The credit is increasing; thus the exemption equivalent is increasing. However, the portion of the credit which may be applied to lifetime gifts is capped at $345,800.

Unified Credit - Exemption Equivalent

As stated above, each person has a credit against the above tax. The credit for 2003 is $345,800, which is the equivalent of having the first $1 million exempt from tax. Under the "pre repeal" law, the exemption from gift tax was identical to the exemption from estate tax. The credit could be used during your lifetime or upon your death. Beginning in 2004, the estate tax exemption and the gift tax exemption will be different. Both exemptions are $1 million in 2003, but the amount of credit which may be used during lifetime does not increase thereafter. The amount of the credit which can be used at death continues to increase until 2009, the estate tax is eliminated in 2010 and in 2011 returns to its current level. The credit increases in an amount equivalent to the following exemptions:

In the case of estate of decedents dying during	The application exclusion amount is
2001	$ 675,000
2002	$1,000,000
2004	$1,500,000
2006	$2,000,000
2009	$3,500,000
2010	No Estate Tax
2011	$1,000,000

Exclusions from tax

Two types of gifts are excluded from gift tax. The most commonly used exclusion is the $11,000 annual exclusion. Each person can give up to $11,000 annually to any person. There is no limit to the number of people to whom $11,000 annual exclusion gifts may be given. There is no limit to the number of years in which $11,000 annual exclusion gifts can be given. For example, if you have three children and seven grandchildren, you can give $11,000 to each of these individuals each year, for a total tax free gift of $110,000 per year. These gifts will not be subject to gift tax. You can continue this each year. In twenty years you will have given away $2.2 million tax free.

In order to qualify for the annual exclusion from gift tax, the individual must have a "present interest" in the property. For example, if I give my son $11,000 per year but state that he cannot touch the property for five years, my son does not have the present right to use the money and the gift will not qualify for the annual exclusion from gift tax. Generally, trusts do impose restrictions on the use of property transferred to the trust. In order to have a gift to a trust qualify for the annual exclusion from gift tax, frequently the beneficiary is given the right to withdraw the amount of the contribution from the trust for a period of time, usually 30 days. After the 30 day period, the beneficiary's right to withdraw the property from the trust lapses and the property cannot be withdrawn after that time. A trust with these withdrawal powers was created by an individual for the benefit of his minor children. The IRS challenged the availability of the annual exclusion for gifts in trust to minor children. The IRS lost this case. The name of the individual who created the trusts that the IRS challenged was Crummey, and thus these trusts are frequently referred to as "Crummey Trusts".

Beginning in 1999 the annual exclusion was indexed for inflation occurring after January 1, 1998. No adjustment is made until the inflation adjustment results in an increase in the exclusion of $1,000. The annual exclusion will be rounded to the next lower $1,000. The first adjustment occurred in 2002 to increase the annual exclusion to $11,000.

A lesser known exclusion is an exclusion for payments made for tuition and medical expenses. Each person can give an *unlimited* amount for tuition and medical expenses. In order to qualify for this exclusion the payment must be made directly to the educational institution or directly to the medical provider.

Neither making annual exclusion gifts nor making direct gifts for tuition and medical expenses reduces the exemption from tax (lifetime limit of $1 million) discussed above.

Deductions in Computing Tax

To Spouse

If your spouse is a U.S. citizen, you can give your spouse an unlimited amount tax free. A gift to your spouse is deductible in determining the tax you owe on a gift or on a bequest. This deduction is called the marital deduction. Any outright gift or transfer to a spouse qualifies for the marital deduction. The property will be included in your spouse's taxable estate and will be subject to tax when your spouse dies.

If the gift is made in a trust, the trust must meet certain requirements in order to qualify for the marital deduction. One of the requirements is that the trust must be included in your spouse's taxable estate upon his/her death. The most common type of trust is one from which all of the income is distributed to your spouse each year for his/her lifetime. You cannot place any conditions on the receipt of this income. For example, you cannot include a provision that the income is not distributed to your spouse in the event that he/she remarries.

There are two types of marital income trusts. If you give your spouse the power to give the trust property to anyone he/she wants on his/her death, the trust is a power of appointment trust. If you want to designate who receives the property on your spouse's death, the trust is a qualified terminable interest property (QTIP) trust. If you give property to your spouse during your lifetime, you are not required to file a gift tax return, unless the property is given to your spouse in a QTIP trust. If you give your spouse property in a QTIP trust, you must elect that this trust be treated as a QTIP trust. If the election is not made, the transfer is a taxable gift now, but is not included in your spouse's estate.

To Charity

Gifts to qualified charities also are deductible in determining the transfer tax which is owed. There is no restriction on the deductibility of gifts to qualified charities for transfer tax purposes as there are for income tax purposes.

To Qualified Heir of a Closely Held Business

This "deduction" was created in the 1997 Tax Act. The deduction was originally an additional exemption from estate tax, but has been revised in a technical corrections bill as a deduction from the estate tax. The deduction is of limited usefulness due to the restrictions in qualifying for the deduction. In general, the deduction is an amount equal to $1.3 million less the exemption from tax in the year of death. In 2003 the deduction is equal to $300,000 and is eliminated in 2004.

Generation Skipping Tax

The generation skipping tax is a tax which is imposed on transfers to individuals two or more generations below the transferor. The tax is in addition to the estate tax and the gift tax. The generation skipping tax is a flat tax at the highest estate tax level, 49% in 2003 decreasing to 45% by 2007. This tax was designed to prevent wealthy individuals from avoiding the imposition of the estate tax at each generational level by the use of trusts.

Using a simplified example of the technique used by wealthy families

illustrates the structure and purpose of the tax. Let's assume an individual had accumulated an estate of $100 million, a 50% estate tax rate and no appreciation in the property. If he left his entire estate to his children, his children would inherit $50 million. When the children left the property to their children, the grandchildren of the wealthy individual, the grandchildren would inherit $25 million. When the grandchildren left the property to their children (the great grandchildren of the wealthy individual) the great grandchildren would inherit $12.5 million. This family lost $87.5 million to the estate taxes imposed on the transfer to the successive generations.

In order to avoid the repeated imposition and payment of the estate tax, the wealthy individual frequently would leave all of his property in a trust. The estate tax of $50 million would be imposed when the property was transferred to the trust, leaving $50 million in trust. The trust would then provide that the income and the principal from the trust could be distributed to his children, grandchildren and great grandchildren. The tax which would have been owed when the child and the grandchildren died would be entirely avoided. This type of trust is frequently referred to as a “Dynasty Trust.”

To prevent the use of this type of trust to avoid the imposition of the estate tax at each generational level, Congress passed the generation skipping tax. The tax is imposed whenever a transfer is made to a person two or more generations below the transferor (a "skip person"). The tax is imposed when the transfer is made outright to the skip person or when a distribution is made from a trust to a skip person. For example, let's assume an individual in the top estate tax bracket with no exemptions or exclusions available made a bequest of $1 million to his/her grandchild. An estate tax of 50% would be owed, leaving a bequest of $500,000. Then the generation skipping tax of 50% would be owed, leaving a net bequest of $333,333 to the grandchild. The generation skipping tax is lower on a transfer directly to a grandchild since there is no tax imposed on the tax (i.e. on the estate tax, the tax is imposed on the full $1 million, but the generation skipping tax is only imposed on what the grandchild actually receives which is $333,333).

If a wealthy individual left property in a trust as discussed above, each time a distribution is made to a grandchild or great grandchild, the tax is imposed. For example, if a distribution is made to a grandchild of $11,000, $5,000 would be paid in payment of the generation skipping tax.

Exemptions

Each person has a $1,120,000 exemption from this tax. The generation skipping exemption increases with the estate tax exemption, so that the generation skipping exemption is $1.5 million in 2004, $2 million in 2006 and $3.5 million in 2009. The generation skipping tax exemption is eliminated in 2010 and is reinstated to its current level in 2011 with adjustments for inflation from 2003 to 2011.

If the exemption is allocated to a trust which has assets in excess of the available generation skipping tax exemption, then the trust will be partially

exempt and partially non-exempt. Each distribution from the trust to a skip person will be subject to the generation skipping tax in that proportion. Let's assume that the trust has $2,240,000 in assets. The grantor allocates his full $1,120,000 generation skipping exemption to the trust. If the trust was held as a single trust then one-half of each ditribution would be subject to a 24.5% tax (1/2 of 49%). In using one’s exemption, it is desirable from a planning standpoint to have a wholly exempt trust or a wholly non-exempt trust. The 2001 Tax Act included a provision allowing generation skipping trusts with an exclusion ratio other than zero or one to be divided into two trusts; one with an exclusion ratio of one and one with an exclusion ratio of zero. In the above example, the trust would be divided into two equal trusts; each with $1,120,000. One trust would be wholly exempt and one trust would be wholly non-exempt.

Exclusions

Most transfers which are excluded from the gift tax are excluded from the generation skipping tax. Outright gifts of up to $11,000 per year to a grandchild (or other skip person) are excluded from the generation skipping tax.

Direct payments for tuition and medical expenses for a grandchild (or other skip person) are also excluded from the generation skipping tax.

Gifts in certain types of trusts for the benefit of a grandchild (or other skip person) are excluded from the generation skipping tax. The grandchild must be the only beneficiary of the trust and the trust must be included in the estate of the grandchild.

The type of gift which does not qualify as an exclusion from the generation skipping tax is a trust which is for the benefit of several individuals which qualifies for the gift tax annual exclusion by giving the individual beneficiaries the right to withdraw his/her share of the contribution from the trust each year. As discussed above, this type of trust is known as a "Crummey Trust".

2010 The Law in the Year of Repeal

Estate Tax

In 2010 the estate tax is repealed. Persons dying in 2010 will not owe any estate tax regardless of the size of their estate.

Gift Tax

In 2010 the gift tax imposed on transfers over the $1 million exempt amount will be a flat tax at the highest *income* tax rate in the year of the gift.

Limits on Step-Up in Basis

Under current law, the basis for each asset of a decedent is adjusted so that the basis is equal to the value of the asset as of the date of the decedent’s death. This adjustment is frequently referred to as a “step-up” in basis. Step-up in basis may reduce or eliminate taxable gain from subsequent sale of an asset received from a decedent. In 2010 the basis of a decedent’s assets may be adjusted up to the fair market value of the asset for a maximum adjustment of $1.3 million. For example, let’s assume an individual

purchased property with a cumulative basis of $500,000 and at the time of his death the property was valued at $2 million. There would be no estate tax. The decedent's estate would be entitled to adjust the basis of those assets by $1.3 million, so that the cumulative basis in all of those assets would be $1.8 million. If the individual is married and gives his spouse property, he can adjust the basis of the property given to his spouse by up to an additional $3 million.

If the property is community property of the decedent and his spouse, then the adjustment can be applied to the spouse's share of the community as well. For example, let's assume that the couple has $6 million in community property. The assets have a basis of $2 million. The basis adjustment can be applied to all of the couple's property to adjust the basis by $4 million to bring the basis in the assets up to their current value of $6 million.

ESTATE TAX REDUCTION

Overview of Concepts

With the new tax law in effect, we may feel that all we have to do is sit back and live to 2010. Unfortunately unless there is a change in the law, we must also die in 2010 since the 2001 law is reinstated in 2011. Assuming that we will always have an estate tax, how realistic is it to eliminate all estate taxes through estate planning actions we take. I heard that Will Rogers said that "estate taxes are discretionary". When I first heard that quote, it irritated me. First, how did Will Rogers get to be so quotable? Actually, it probably wasn't Will Rogers. Seriously, that statement sounds like eliminating taxes is a simple task and a simple process. It is neither. However, given three conditions, it can be accomplished. Simply stated, it takes time, a willingness to let go of control and some charitable intent. Simple, maybe. Common, no.

Most estate tax reduction takes time. Assets are transferred over time. The younger you are when you start making these transfers, the more property which can be transferred. Most people help their children if they need help, but fall short of making the full amount of the non-taxable transfers possible. And the transfers which are made do not provide long-term benefits to the children. First, the money is generally given only if needed. If the money is needed, then it is spent upon receipt, rather than invested. Or the motivation for giving may be to alleviate a hardship, such as the costs of an illness or an education, or to provide children with some of the extras in life, be they household help, a bigger house, or vacations.

Most estate tax reduction takes time.

An effective plan to reduce estate taxes requires regular transfers over a period of time. While these transfers can be made directly to children, from an estate planning perspective it is better to have the funds accumulate in a trust for the benefit of the children. If the funds are in a trust, they can be invested and grow, thanks to compounding, while funds given directly to the children are often spent, rather than invested. Funds which have accumulated in a trust can be used to purchase assets from the parents on favorable terms. For more reasons why trusts are the preferred method of making transfers to children, see the chapter entitled, “Generation-Skipping Trust.”

In addition to time, any plan entails making transfers. A transfer means that

In addition to time, any plan entails making transfers. A transfer means that you do not own the property any longer.

you do not own the property any longer. Even if you retain management control and/or distribution control, you are committing that the funds are no longer available to you, and that they will be available to someone else, if not now, then at some point in the future. If you later decide you don't want that person to inherit anything, you're out of luck.

The charitable intent requirement actually depends on the size of the estate and the standard of living desired. You can transfer all of your assets down to the amount you need to maintain your standard of living, but then all of those assets over the tax exempt amount will be taxed on your death unless you give them to charity.

> Charitable intent...depends on the size of the estate and the standard of living desired.

With these basic parameters, what are the fundamental concepts used in transferring wealth? Wealth transfers all use one of the following techniques:

< Fully utilizing all tax free transfers

< Reducing the value of assets currently owned.

< Leveraging the amount given either through discounts (the prior technique) or through some other means such as an intervening interest.

< Transferring appreciation in assets.

Let's examine each of these concepts in more detail.

***Tax Free Transfers*.**

There are three main tax free transfers and one additional one which is a little more obscure.

> Three main tax free transfers:
> 1) $11,000 Annual Exclusion;
> 2) Exemption;
> 3) Tuition and Medical Payments

***$11,000 Annual Exclusion*.** The main tax free transfer is the $11,000 annual exclusion from gift tax. The exclusion is indexed for inflation and adjusted upward by $1,000 whenever the inflation adjustment exceeds $1,000. No adjustments are made until inflation has increased by at least $1,000. If a person has three children and seven grandchildren, he can give $110,000 per year to these family members. If he is married, his wife can give the same amount, thus the couple can give $220,000 per year. Make gifts like that for a few years and the results are dramatic. Make gifts for 20 years, and if you assume that the funds are invested at 12% (the long term stock market average return), the amount transferred to this couple's children and grandchildren is $17.7 million. Assuming a 50% estate tax bracket, transferring this amount at death at the end of the 20 year period would require over $35 million to net the children and grandchildren $17.7 million. The method of making these gifts must be structured so that the gifts to the grandchildren qualify for the annual

exclusion from the generation skipping tax as well as the gift tax. If the gifts do not qualify for the annual exclusion from the generation skipping tax the gifts are limited. See the discussion in “Transfer Taxes - An Overview”.

Exemption. Each person has an exemption of $1 million in 2003, increasing to $1.5 million in 2004, $2 million in 2006 and $3.5 million in 2009. There is no estate tax in 2010 and we drop back to a $1 million exemption in 2011. Assuming a $1 million exemption, a couple can give a $2 million on their deaths to their children free of tax. The exemption is in addition to the annual exclusion from gift tax. The purpose of the most basic estate planning technique, the Bypass Trust, is designed to fully utilize the exemption of each spouse. The first spouse to die leaves the exemption amount in a trust for the benefit of the survivor, so that this amount of property is not taxed when the survivor dies. The exemption can also be used during one's lifetime. By giving the exemption amount to one's children during one's lifetime, the value of the exemption is compounded. For example, if $1 million is invested at 12%, the amount held at the end of 10 years is $3.1 million and at the end of 20 years is over $9.6 million.

Tuition and Medical Payments. Amounts paid for tuition and medical expenses are not taxable gifts if the amounts are paid directly to the institution or provider of medical care or services. Considering the cost of an education and the cost of medical care, the payment of these amounts for grandchildren (and children) can be substantial.

Taxes. I know this item sounds strange. In creating trusts for the benefit of one's children and grandchildren, it is beneficial to structure the trust so that the income is taxed to the person creating the trust. See the discussion entitled Defective Grantor Trust.

REDUCING THE VALUE OF ASSETS CURRENTLY OWNED.

By reducing the value of an asset from $2 million to $1.5 million, you have saved $250,000 in estate taxes if you are in the 50% estate tax bracket.

A reduction in the value of assets which are currently owned generally is accomplished by shifting the control of those assets. For example, if I have $1,000 in stocks which I can sell at any time, the value of the stock is $1,000. However, if I cannot sell the stock or can only sell it if another person agrees to sell it, then the value of the stock is less than $1,000. For example, if I own $2,000 of stock equally with another person, but we agreed that neither of us could sell without the other's consent, then we have reduced the value of each of our one-half interests in the $2,000 of stock. The reduction in value which is caused by the form of the ownership of the asset is the main tax advantage of using a family limited partnership. The value of a 25% interest in a family limited partnership owning assets valued at $1 million is not $250,000. The limited partner cannot

By reducing the value of an asset from $2 million to $1.5 million, you have saved $250,000 in estate taxes if you are in the 50% estate tax bracket.

spend the money, sell the assets, or even require that the income on the assets be distributed to him. The limited partner has no control. This lack of control reduces the value of the assets. Depending on the type of assets owned by the partnership and the terms of the partnership agreement, the value of a limited partnership interest might be discounted 20% to over 50%.

When real estate is held jointly with another person in undivided interests, neither of the owners can sell the entire tract without the consent of the other owner. If one person wanted to sell half of the property and the owners could not agree on how to divide the property, the owner who wanted to sell would have to go to court to seek to have the property partitioned into two equal parts. The IRS agrees that the value of an undivided interest should be discounted; however, the IRS determines the reduction in value by the cost of partitioning the property, estimating the cost at 5% to 15%. One-half of the original tract is not generally equal to one-half of the value of the tract as a whole. In addition, a partition not only costs money, it takes time. As we all know, markets can change over time, which could create a loss. In addition, losing the use of our money for a period of time costs money. The court cases which have considered the reduction in value of property when it is held in an undivided interest with another have discounted the value of the property by 20% to 44%.

Leveraging. Leveraging is a term used in finance when a person will borrow funds to purchase additional assets. The individual will use other people's money to maximize the use of his money. The type of leverage we use in estate planning is by reducing the value of the gift for tax purposes by discounts (as discussed above) or through some other means such as an intervening interest. An asset may be transferred by retaining the income interest for a period of years. For example, if an asset is valued at $1 million and has income of $100,000, the receipt of the $100,000 for a period of years reduces the value of the $1 million asset. The longer the period during which the income (generally in the form of a fixed annuity equal to the income), then the smaller the gift. The gift can be further leveraged by one of the techniques used to reduce the value of the asset. For example, if the $1 million asset is an office building, then further leverage is obtained by giving one-half of the asset to a trust for one child and one-half to a trust for another child. The one-half interest may be valued at $350,000. Since the value of the asset is smaller, the period during which the $50,000 is paid to the parent is shorter. For

> The type of leverage we use in estate planning is by reducing the value of the gift for tax purposes by discounts or through some other means such as an intervening interest.

> Transferring the appreciation on assets can be very effective as an estate planning technique.

discussions of trusts utilizing this type of leverage, see the discussion in the sections entitled "Grantor Retained Annuity Trusts" and "Defective Grantor Trusts."

TRANSFERRING APPRECIATION IN ASSETS.

Transferring the appreciation on assets can be very effective as an estate planning technique. When one considers the dramatic increase in the value of assets over time by the compounding of the income and gain on the asset, transferring the appreciation in an asset can provide dramatic results. Generally, the appreciation is transferred by retaining part of the income and transferring all of the gain over that amount. See the discussion on "Grantor Retained Annuity Trusts."

COMBINING MULTIPLE TECHNIQUES - THE MOST POWERFUL TOOL

Dramatic results can be achieved by combining two or more of these techniques. As was mentioned in the leveraging section, combining a reduction in value of an asset with the reduced value caused by retaining an annuity from the asset for a period of years can produce much more dramatic results. If these techniques are combined with the transfer of an asset which is appreciating, the benefits are compounded. If the trust to which the asset is being transferred is structured so that the grantor is taxed on the income in the trust, the results are further multiplied.

Dramatic results can be achieved by combining two or more of these techniques.