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Estate Freeze Strategies to Help Minimize Estate & Gift Taxes

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Estate Freeze

What is an estate freeze?

Estate freeze is an expression often used to describe various tools, techniques, and strategies used to manage the size and growth of your estate, and minimize potential gift and estate taxes. You transfer an asset (through a variety of methods) to your beneficiaries with the main goal of removing any future appreciation of that asset from your gross estate and thus potentially reducing any estate taxes that may be due. The value of the asset is "frozen" at its fair market value (FMV) on the date of the transfer.

> **Example(s):** John transfers appreciating real estate to James. The FMV of the property at the time of transfer is $200,000. John reports the transfer on his gift tax return using the value of $200,000. John dies ten years later when the FMV of the real estate is $300,000.

> **Caution:** Depending on the strategy used, the transfer may trigger capital gains tax or generation-skipping transfer tax (GSTT) and/or gift tax liability. However, federal gift tax/GSTT paid will be subtracted from estate taxes owed, if any. Also, the value of the property must be adequately disclosed on a gift tax return (Form 709). Otherwise, the IRS may revalue the property to its FMV on the date of your death.

> **Caution:** Some estate freezing strategies depend on the attribution of a low value to the assets that are transferred from your estate by sale or gift. Congress has enacted several rules intended to restrict the methods used in valuing assets transferred out of your estate. Consult a tax advisor when structuring any estate freeze strategy to be certain that you do not run afoul of these rules.

Why use an estate freeze technique?

May minimize estate taxes

The main reason to use an estate freeze technique is to minimize your gross estate and possibly reduce estate taxes. By transferring appreciating assets now, you remove any future appreciation in those assets from your estate--you freeze the value of the assets at their FMV at the time of the transfer.

You may retain an income stream from or control over the transferred assets

Other reasons to use an estate freeze technique is that, if properly structured, you may remove assets from your estate and still retain either an income stream from or control over those assets.

Helps buyers purchase your assets

Another benefit to an estate freeze technique is that it may allow you to structure a sale of your assets for periodic payments instead of a single lump sum. By spreading the payments out over an extended period of time, the buyer may be able to better afford the purchase price.

May lower capital gains tax

Some estate freeze techniques that are sales allow you to recognize the gain over time, as the payments are received instead of at the time of the initial transfer. This may allow you to defer capital gains to years in which you may be in a lower income tax bracket.

Allows a business owner to raise cash

An estate freeze technique method may provide business owners with a way to turn business assets to cash while continuing to use the assets in the business.

Estate freezing techniques

The following are some of the more popular strategies that an individual may use to freeze the value of his or her estate:

Lifetime gift

A lifetime gift is probably the simplest form of the estate freezing techniques. It is an outright and total transfer of property to another individual or entity in exchange for nothing or for property of less value.

Family bank

A family bank is a term used when a group of family members (typically, the older, wealthier generation) pools assets for the benefit of other family members (typically, the younger generation). Generally, a family bank works as a lender. A family member may borrow funds under certain circumstances and pay the funds back for little or no interest. The bank is usually meant to be maintained for several generations.

A family bank can be structured in many ways, but if an irrevocable trust is used, it can be an effective estate-freezing technique.

Irrevocable trust

Probably the most common form of the estate-freezing techniques, the irrevocable trust holds the transferred assets for the benefit of your beneficiaries. It is vital that the trust be irrevocable--assets in a revocable trust may be includable in your gross estate for estate tax purposes at their FMV on the date of your death.

Income produced by assets in the trust is generally taxable to the trust (unless it is a grantor trust), which generally enjoys a smaller exemption and pays tax at a higher rate than individuals.

> **Caution:** If the transferred asset is life insurance, the transfer must take place at least three years before your death in order to remove the proceeds from your gross estate.

For more information, see Irrevocable Life Insurance Trusts.

Family limited partnership

A family limited partnership (FLP) allows you to transfer assets to a limited partnership entity. You retain the general partnership interest (as little as 1 percent) and give away the limited partnership interests (as much as 99 percent) to your heirs. Additionally, you may utilize certain valuation discounts when establishing the value of the FLP interests for gift tax purposes. Furthermore, the limited partnership interests will be protected from the future claims of creditors.

Private annuity

A private annuity allows one person (the seller) to transfer complete ownership of an asset to another person (the buyer) who makes an unsecured promise to make periodic payments to the seller during the seller's life or the combined lives of the seller and a second person (typically the seller's spouse). The purchase price of the annuity is the FMV of the property at the time of the transfer, but, for income tax purposes, the seller recognizes the gain on the sale only as the payments are received, not at the time of the transfer. Generally, this transaction avoids all federal transfer taxes because it is a sale, not a gift. However, a sale for less than FMV may result in a taxable gift for the difference between the purchase price and FMV. Also, if the annuity is joint and survivor, the present value of future payments made to the survivor may be includable in the estate of the first to die.

Installment sale

An installment sale is similar to a private annuity, except that the time period over which payments are made may be for any period to which the buyer and seller agree (as long as some payment is made after the taxable

year in which the sale occurs). The present value of any unpaid installments may be included in the seller's estate if he or she dies before all of the payments have been made. Also, for income tax purposes, the gain on the sale is recognized by the seller only as the payments are received, but only if he or she is a cash basis taxpayer. The installment-sale income tax treatment is not available to taxpayers using the accrual method of accounting.

Gift-leaseback or sale-leaseback

With a gift-leaseback, you give away an asset to another party who leases it back to you.

A sale-leaseback is similar to a gift-leaseback. However, instead of gifting the asset (which must be a business asset), you sell it to another party who then leases it back to you. If structured properly, the seller may fully deduct the lease payments as a business expense for income tax purposes. Unlike private annuities and some installment sales, the gain on the sale must be recognized at the time of the transfer.

For more information, see Gift- or Sale-Leasebacks.

Bargain sale

A bargain sale lets you sell an asset for less than its FMV to either a charitable entity or an individual. You use the property's FMV on the date of the sale for income tax reporting purposes. In the case of a charity, you may deduct the difference between the lower sale price and the FMV as a charitable deduction, as long as the sale is to a qualified charity. In the case of an individual, the difference between the lower sale price and the FMV is considered a gift, subject to gift tax.

Split interest purchase

In a split interest purchase, one party (usually the parents or grandparents) purchases an income (life or term) interest in an asset and a second party (usually the children or grandchildren) purchases the remainder interest in the same asset. Each party pays his or her actuarial share of the purchase price. During the life or term period, the two parties own the property concurrently. At the end of the period, the party with the remainder interest takes sole ownership of the asset.

Only the value of the life or term interest may be includable in the estate of the party who owns that interest, unless that interest is subsequently sold or has been given away at least three years before the owner's death.

Recapitalization

A recapitalization involves changing the capital structure of an existing closely held company. The company exchanges the existing stock for two classes of stock--preferred stock and common stock. The preferred stockholder generally receives dividends before the common stockholders and generally holds all the voting rights. The common stock represents the bulk of the equity in the company.

Under this estate freeze technique, you would hold the preferred stock and give away the common stock. The common stock will reflect any future increase in the value of the company; thus, growth can be transferred to your heirs.

> **Caution:** Because of changes in the Internal Revenue Code that tend to increase the value that must be attributed to the common stock that is transferred as a gift, recapitalizations are not as attractive as they used to be.

Gifts: Estate Freeze Techniques

What is gifting?

Transfer of ownership without receiving value

Broadly speaking, a gift occurs when you transfer something (e.g., your business interests) to another party without receiving something of at least equal value in return. Generally, an uneven exchange is at least a partial gift. More specifically, a gift is a sale, exchange, or other transfer of your business interests or other assets from you (the donor) to another (the donee) without full and adequate consideration in money or money's worth. Full and adequate consideration in money or money's worth means receiving something of value (e.g., cash or services) that makes the exchange fair. Gifts made during your lifetime are called inter vivos gifts.

Gifting may satisfy multiple desires

Gifting your business interests or other assets can be a powerful estate planning tool because it lets you fulfill personal desires (e.g., you see your business passed on to your children) and may help you minimize income and potential estate taxes.

Gifting your business or other assets may help you save income tax by shifting any income earned by the business or other assets, or by any capital gain to the donee on its subsequent sale. In addition, you may save federal generation-skipping transfer tax (GSTT) and/or federal gift tax by taking advantage of the annual GSTT exclusion and/or the annual gift tax exclusion. Finally, since assets generally appreciate (increase in value over time), you may enjoy significant estate tax savings, because assets removed from your estate before you die are not includable in your estate for estate tax purposes (if estate taxes are imposed in the year you die). This is called an estate freeze technique.

> **Example(s):** Jonah owns a shop in a small seaside town in New England where he carves and sells scrimshaw and other souvenirs. Recently, the tourists have surged into Jonah's once sleepy little town, and Jonah finds himself spending more time serving customers and less time doing what he really wants: carving. The other day, a real estate agent offered Jonah four times what he thought his little shop was worth. Jonah's children want to take over the souvenir business so that Jonah can carve more. In addition, Jonah wants to transfer ownership of the shop to the kids now, instead of leaving it to them in his will, because the value of the shop keeps going up (and so may potential estate taxes). Jonah gives the shop in equal shares to each of his children. Jonah pays gift tax on today's value of the shop, less the annual gift tax exclusion and gift tax applicable exclusion amount.

> **Technical Note:** Full and adequate consideration is measured by the tax laws and varies according to the situation. It generally, but not always, matches its commonsense meaning.

What are the advantages to gifting?

Eliminates future appreciation from your estate

One of the prime reasons for gifting your business or other assets is to remove appreciating assets from your estate (generally, assets increase in value over time). Removing the business or other assets today keeps the appreciated value out of your estate later. Thus, the amount subject to tax will be less today than it will be in the future.

> **Example(s):** Darcy purchased improved real estate for $150,000. Five years later, the property is now worth $300,000, and she expects that it will double in value during the next five years. Darcy wants to give the property to her daughter Ellen. If Darcy wants to save tax, she should make the gift now instead of later, because now, $300,000 will be subject to tax, whereas in five years,

$600,000 will be subject to tax.

> **Caution:** Lifetime giving results in the carryover of your basis (generally, basis is the property's cost plus capital improvements) to the donee (as opposed to a bequest, which usually results in a basis to the recipient of fair market value (FMV) on the date of your death). This means that the donee may recognize a larger capital gain if the property is sold. Be sure this consequence is acceptable before making this type of gift.

Allows you to see your business passed on to your children

Most business owners want their business to be passed on from generation to generation. You may even have received your interest from your parent(s). Gifting your business while you are alive lets you see the younger generation carry on your family's traditional trade or livelihood.

Allows you to give your children financial independence

Most parents want to see their children enjoy the best possible life. Gifting your business or other assets to your children allows you to help them achieve financial security and a more worry-free life.

Relieves you of business management worries

Giving away your business can relieve you of the burden and responsibility of managing that property and let you enjoy a more worry-free life. This may be especially important if you are an older person entering your retirement years.

Keeps the business or other assets out of probate

Gifting your business or other assets can reduce probate (the court-supervised process of administering your will) and administration costs, because property you give away during life generally is not includable in your probate estate at death. In addition, removing the business or other assets from your probate estate keeps them from being subject to attack by estate creditors or unhappy heirs.

Shifts income to a lower income tax bracket

Since the income tax rate schedules are graduated, your total family federal and state income tax burden may be reduced if income-producing assets are distributed among several family members rather than concentrated in your hands only.

> **Caution:** Be careful if you are gifting income-producing interests to children. Your potential federal income tax savings of transferring income-producing property to your children may be reduced by the kiddie tax.

Shifts capital gains to a lower income tax bracket

Federal and state capital gains tax on the sale of appreciated property may be reduced by transferring the property to someone who is in a lower income tax bracket or who has losses to offset the gain.

Takes advantage of the annual gift tax exclusion

The annual gift tax exclusion allows you to give $12,000 per donee without incurring federal gift tax. Generally, married couples can double the exclusion amount . This exclusion allows you to distribute your property gift tax free and potentially put your estate into a lower tax bracket.

> **Tip:** Some states may have the equivalent of the federal annual gift tax exclusion.

Takes advantage of the gift tax applicable exclusion amount and GSTT exemption

The gift tax applicable exclusion amount (formerly known as the unified credit) is a federal exemption used to offset cumulative lifetime gifts. The GSTT exemption works like the applicable exclusion amount for gifts made to

skip persons. You may want to use the gift tax applicable exclusion amount and the GSTT exemption during your lifetime instead of waiting until your death because of the time value of money (money is worth more today than it will be tomorrow).

> **Tip:** Some states may also have the equivalent of the GSTT exemption and/or the federal gift tax applicable exclusion amount.

Takes advantage of the reverse gift technique

The reverse gift technique may step up the basis of property and better utilize a dying person's applicable exclusion amount. You may want to use this technique if you own property that has appreciated in value and your less-affluent relative or friend is diagnosed with a terminal illness. It works like this: You give the property to your dying relative or friend. More than one year later, your relative or friend dies. Because your relative or friend's estate now includes the appreciated property, your relative or friend's estate is able to better use the applicable exclusion amount (if estate tax is imposed in the year your relative or friend dies). Upon your relative or friend's death, the basis of the property is stepped up to FMV. If your relative or friend bequeaths the property back to you, you now own the same property but at a higher basis. This may save you income tax on the capital gain if the property is sold.

> **Caution:** In order for this technique to be successful, your relative or friend must live more than one year after the gift is made. If the death of your relative or friend is too near, do not attempt this technique because it may backfire, and you may have paid tax on the gift and/or used up your gift tax applicable exclusion amount for nothing.

Potentially reduces state death taxes

State death taxes are generally imposed on property you own at the time of your death. Removing your business from your estate during your life can minimize state death taxes.

> **Caution:** Some states will add back gifts you made during the three years prior to your death to your taxable estate. If death is imminent, gifting your business may not help reduce state death taxes.

Removes tax paid on lifetime gifts from your estate

The tax you pay on lifetime gifts is tax exclusive, whereas the tax paid on transfers made at death is tax inclusive. This means that funds used to pay tax on transfers made at death may be includable in your estate for estate tax purposes, but funds used to pay tax on lifetime gifts are not. You can save tax overall by making lifetime gifts because the amount of the tax you pay on those gifts is removed from your estate.

> **Caution:** Tax you pay on gifts made within three years of your death may be added back into your estate for estate tax purposes.

What are the tradeoffs?

You lose control over the property

An outright gift, or a gift made into an irrevocable trust, leaves your hands for good. This may not be a good strategy for you if relinquishing control over your business or other assets makes you feel uncomfortable.

May be subject to GSTT and/or gift tax

Gifts are taxable transfers for the generation-skipping transfer tax and/or gift tax purposes and may result in tax liability subject to the application of the annual gift tax exclusion, deductions, and the gift tax applicable exclusion amount.

How can you make a gift?

A gift of business interests or other assets can take many forms. Each has advantages and limitations.

Keep the business intact

You may own business interests that must remain intact by their very nature (e.g., stock), or you may own a business that is not easily segmented. Even if your business is easily segmented, it may not make sense to do so (e.g., you have only one beneficiary). If this is the case, you may need or want to gift the business intact.

Divide the business into segments

Many businesses can be separated into component parts (e.g., a restaurant and catering business). It may make sense to split up your business, keeping some assets and gifting to the younger generation only those parts that offer the greatest opportunity for growth.

Outright gifts

An outright gift is made directly to the donee. Making an outright gift of your business interests or other assets gives the donee unrestricted control. Outright gifts may present problems in two situations:

A. Gifts to minors: Outright gifts to minor children may not be a good idea because minor children generally do not possess the maturity to manage a business or other assets. In addition, because the child can't sell, lease, exchange, will, or otherwise deal with the property (minors can't enter into contracts by state law), the property will be tied up until the child attains the age of majority, and the property may be wasted.

> **Technical Note:** Minority is determined by state law. Generally, the age of majority is 18.
>
> **Tip:** Gifts to minors should be made in the form of a guardianship, under the Uniform Gifts/Transfers to Minors Act (UGMA or UTMA), or in a trust (e.g., Section 2503(b) trust or Section 2503(c) trust).
>
> **Caution:** Gifts made under UGMA or UTMA may reduce possible financial aid.

For more information, see the discussion on Custodial Accounts for Education Savings.

B. Gifts to spendthrifts or incapacitated persons: A spendthrift is someone who spends money foolishly. An incapacitated person is someone who is unable (physically or mentally) to make financial decisions. You may not want to put your business or other assets in either a spendthrift's or an incapacitated person's direct and unrestricted control.

> **Tip:** Gifts to spendthrifts or incapacitated persons should be made in a trust.

Gifts in trust

Generally, a trust exists when you transfer legal title to property to another person (or entity) who holds that property for the benefit of a third person(s). You can enjoy the same tax-saving benefits as gifting property outright as long as the trust is properly structured.

Gifts in trust are more difficult to make than outright gifts. Gifts in trust require the preparation of a trust document, and there may be fees associated (e.g., trustee fees, tax-preparation fees, accountant's fees, and attorney's fees). However, there are advantages to using a trust. Here are some of them:

- Protects property for the benefit of minor or incapacitated beneficiaries: Gifts in trust to minors or incapacitated beneficiaries give them income for life but place control over the assets in the hands of someone who is able to competently manage them.

- May protect property from beneficiary's creditors or estranged spouses: In some states, gifts in trust are kept out of the hands of the beneficiary's creditors or a spouse in case of divorce.
- Equalizes distributions of a business to children: You may have children who are not involved in the business but with whom you want to share some of the financial benefits. Outright gifting of shares in the business to nonemployee children can create conflicts. Through a trust, the economic benefits can be equally distributed among your employee and nonemployee children. At the same time, management control can be maintained in the hands of the employee children alone.

Caution: Properly structuring the trust to take advantage of the tax laws is essential. You should seek an experienced attorney to draft the trust document.

Titling the property in joint name

If you add a joint name to your property, you may be making a gift. For example, if you add your son's name to yours on the deed to your factory, you have made a gift of half your factory.

When the gift occurs depends on the type of property. Generally, the gift occurs when the joint name is added (as in the previous example). However, the gift may not occur for some types of property whereby the benefit is not received until later. For example, if you add your son's name to your checking account, there is no gift until your son withdraws funds.

Caution: By adding a joint name, you may give up some control of the asset and may expose the asset to the joint owner's creditors.

Tip: Titling property jointly in the name of your U.S. citizen spouse is fully deductible under the unlimited marital deduction.

Create a family limited partnership

Another method of gifting your business is to create an entity known as a family limited partnership (FLP). An FLP lets you take advantage of the tax laws while retaining control over the business.

Caution: An FLP is fairly complex. It is highly recommended that you seek the advice of an attorney experienced in partnership law.

To whom should you give?

The natural objects of your bounty

You will probably want to give to the natural objects of your bounty (i.e., your children or other family members). Business owners generally want to see the business passed on from generation to generation. It may be a good idea to bring the kids into the business and groom them to take over for a few years before you retire. This way, you can be sure that they are ready to handle the responsibilities.

Key employees

If you have no heirs, you may want to pass your business on to a key employee. Generally, there is at least one employee you trust and depend on to manage things when you're not there. Giving your business to a key employee may give you some personal satisfaction and perhaps some confidence that the business may continue to be run successfully.

Your spouse

You may want to give the business to your spouse for tax purposes. Gifts you make to your spouse may be fully deductible from gift tax under the unlimited marital deduction. The gift must meet certain requirements to qualify.

Minor children

Income-producing gifts to minors may not help save federal income tax because of the kiddie tax. However, there are still some ways to shift the business and save taxes by giving to minor children:

- Gifts made under the UGMA or UTMA: Generally, gifts made in trust are gifts of future interest, and gifts of future interest are generally denied the annual gift tax exclusion. However, gifts made under the UGMA or UTMA are eligible for the annual gift tax exclusion (and a custodian is allowed to maintain control over the property until the child reaches the age of majority).

Technical Note: The UGMA is retained by only a few states. In UGMA states, money, securities, certain life insurance policies, and certain annuities may be the subject of a custodial gift. UGMA has been replaced by the UTMA in most (at least four-fifths) states. UTMA allows custodial transfers of any kind of property. Since the laws of different states vary, it is important to check with your own state's laws.

- Gifts made to a Section 2503(b) trust: The Section 2503(b) trust (income trust) can be used to make a future interest gift that qualifies for the annual gift tax exclusion.
- Gifts made to a Section 2503(c) trust: The Section 2503(c) trust (discretionary trust) can be used to make a future interest gift that qualifies for the annual gift tax exclusion.
- Gifts made to a trust with Crummey provisions: The Crummey trust (a trust with Crummey provisions) can be used to make a future interest gift that qualifies for the annual gift tax exclusion.
- Employ your minor children: A minor child's earned income is not subject to the kiddie tax. The amount will be taxable at your child's income tax rate. In addition, your business will have a deduction at its tax bracket.

Skip persons

You may not want to give to skip persons. A skip person is a family member who is more than one generation below you (e.g., your grandchildren). Gifts to skip persons may be subject to the federal GSTT, and, if one is imposed by your state, the state GSTT. This tax is imposed in addition to gift tax, resulting in double taxation.

When should you make a gift?

When you are ready

Giving away your business is a huge step, so don't do it until you are comfortable handing the reins over to someone else. This means that you are looking forward to retiring (and maybe lying on a warm beach all day), or you at least don't mind letting go of control of the business. If you can't let go, you may end up disagreeing with the new owner's business decisions, and trouble may result.

When the donee is ready

It is imperative that the recipient of your business interests is ready. This means that someone capable of managing the business is taking over for you, ideally someone with knowledge of the business, skill, and experience. This may be accomplished by giving the business to a child who has worked with you in the business for a time or by giving to several children whose expertise combined will serve the business well. If the new business owner isn't capable, the business may suffer, and you may later regret your decision.

Now, for tax purposes

For tax purposes, now is the best time to make a gift. The sooner you start taking advantage of the annual gift tax exclusion, gift tax applicable exclusion amount, GSTT exemption, and any other exclusions your state may allow, the better (e.g., the lower the value of the property, the more the applicable exclusion amount is preserved). Furthermore, you can't save up the annual gift tax exclusion from year to year, so what you don't use, you lose.

When fair market value is lowest

You should make gifts of property that you expect to increase dramatically in value soon (or that widely fluctuates in value) when the market value is at its lowest, because property is generally valued at its fair market value on the date the gift is made for tax purposes.

What business interests or other assets should you give?

You should select business interests or other property that will satisfy your personal objectives and attain your tax-saving objectives to the greatest extent possible. However, where a particular selection attains one objective at the expense of the other, you will have to make the choice that is best for you.

Property expected to appreciate

For tax-saving purposes, the most advantageous type of gift you can make is of property that is likely to grow substantially in value over time (e.g., life insurance, common stock, antiques, art, and real estate). This strategy removes the future appreciation of this property from your estate, allowing you to make the gift when tax values are lowest. The result is that you may either pay less tax or use less of your gift tax applicable exclusion amount.

> **Example(s):** Sam Garcia starts a small department store in his hometown. After a few fairly successful years, Sam transfers 90 percent of his interest in the growing company among several family members. Sam utilizes the annual gift tax exclusion, the unlimited marital deduction, and his gift tax applicable exclusion amount to reduce his taxable gifts to a minimum amount. Sam pays a small amount of tax on the property transfers. Forty years later, Sam has opened hundreds of new stores, and the company is a highly successful nationwide business worth billions of dollars. Sam dies in a year in which estate taxes are imposed. Only 10 percent (the interest he retained 40 years ago) of the billion-dollar business is included in his estate for estate tax purposes.

Appreciated property

Be careful when gifting appreciated property. Since a property's basis (generally, its cost) is carried over to the donee, gifts of appreciated property (property that has increased in value) can be good in some circumstances, but not so good in others.

You may not want to give highly appreciated property if the donee will recognize a substantial capital gain when the property is sold.

> **Example(s):** Mr. Milligan pays $10,000 for stock in XYZ Corporation, and Mr. Milligan gives the stock to his friend Mr. Powell as a birthday present. Two days later, Mr. Powell sells the stock for $250,000. Mr. Powell has recognized (and must pay income tax at his high income tax rate on) a capital gain of $240,000 ($250,000 - $10,000).

However, you may want to make that gift if the sale of the property is imminent anyway and the donee is in a lower income tax bracket.

> **Example(s):** Mr. Powell pays $10,000 for stock in XYZ Corporation. Mr. Powell gives the stock to his friend Mr. Milligan as a birthday present. Two days later, Mr. Milligan sells the stock for $250,000. Mr. Milligan has recognized (and must pay income tax at his low income tax rate on) a capital gain of $240,000 ($250,000 - $10,000).

In addition, the IRS may allow an adjustment in basis for highly appreciated property. Under the adjustment, the basis to the donee is increased by the portion of gift tax that is attributable to the appreciation element. This means that the capital gain recognized by the donee may be less than it would be without the adjustment.

> **Caution:** Do not make gifts of appreciated property within one year of the donee's death if you are to receive the property back (the reverse gift technique). Such property will not receive the step-up in basis, and you may have needlessly paid gift tax and/or used up your applicable exclusion amount.

> **Tip:** Contrary to lifetime gifts, the basis of property transferred upon death is usually stepped up (increased) to FMV.

Property owned out-of-state

Generally, your property will be probated in the state in which it is located. You might want to give away property you own that is located in a state other than the state in which you reside. This will avoid an additional (ancillary) probate at the time of your death.

Business property that reduces your ownership to qualify for a discount

You may reduce your ownership interest in a closely held business or an interest in real estate so that it may be valued at a discount. For example, if you have a minority interest (49 percent) of the stock of a closely held business, you may qualify for a discount. In addition, a fractional interest in real property may be valued at a discount. It may be beneficial to make a gift of stock or an interest in real estate in order to qualify for the discount.

> **Caution:** This strategy may be inconsistent with removing certain nonbusiness holdings to help your estate meet percentage tests in order to qualify forSection 303 (redemption of stock),Section 2032A (special use valuation), or theSection 6166 (installment payout of taxes)tax treatment. If you want to preserve these benefits, it may be necessary to limit such gifts.

What property shouldn't you give?

Property that will adversely affect your standard of living

This may be obvious, but you should not give away property that you need to maintain your financial well-being. Do not give away assets that will reduce your standard of living. Be sure to consider the impact of any gift on your income, your capital needs (both present and future), and your need for liquidity. If giving away the store puts you in a bind, you probably shouldn't do it.

Property that is likely to depreciate (lose value)

Under the unified transfer tax system, lifetime gifts are added together with death time gifts for the purposes of computing estate tax. Generally, the value of the gift is its FMV at the time the gift is made. Therefore, you should avoid giving property that is likely to lose value after the gift has been made. The higher value of the gift when made may be added back into your estate for estate tax purposes. If you hold on to the property, it may be includable in your estate at the lower current FMV.

Depreciated (loss) property

Generally, it is not a good idea to give away depreciated (or loss) property. The donee's basis for recognizing a loss is the lower of your basis (carryover basis) or FMV (stepped-up basis). The donee may be unable to recognize the loss on property. Both you and the donee may lose the loss deduction.

> **Example(s):** Dan and Ann paid $80,000 (basis) for a bike shop. After several years of losses, they decide to give up the business. The current FMV of the business is $50,000. They put it on the market but can get no offer over $45,000 (selling price). If Dan and Ann had taken the offer, they would recognize a loss of $35,000 [$80,000 (basis) - $45,000 (selling price) = $35,000]. However,

Dan and Ann (the donors) decide to give the property to their son-in-law David to see if he can make a go of it. Dan and Ann lose their loss and make a $50,000 (FMV) gift. A few weeks later, David is offered a great job in Chicago. David sells the shop for $45,000 (selling price). David's basis for determining loss on the property is $50,000 (FMV) [the lower of the donor's basis ($80,000) and FMV]. David's loss is only $5,000 [$50,000 (FMV) - $45,000 (selling price) = $5,000].

Tip: It is a better idea for you to sell the property, take the loss deduction, and give away the cash proceeds.

Property that is mortgaged for more than its basis (cost)

You may own property that is mortgaged for more than its basis (cost). A gift of this property will result in taxable income to you in an amount equal to the excess of the mortgage balance over your basis.

Example(s): Steve buys a small Pacific island in 1969 for $15,000 (basis) in cash. Steve builds a small hotel on the beautiful island, and immediately thousands of people begin to flock there to enjoy nature unspoiled. Steve sees great potential in the island as a tourist resort and convinces the bank to mortgage his island for $100,000 (mortgage). Steve uses the money to build a bigger hotel. In 1970, Steve is offered the police chief's job on another island. This is what Steve has always wanted to do, so he gives his small island to his good friend Dan. Steve has immediately realized taxable income of $85,000 [$100,000 (mortgage) - $15,000 (basis)].

Property with positive tax characteristics

Avoid giving property that generates tax-exempt income (e.g., municipal bonds) or that shelters other income (e.g., depreciable assets), especially if you are in a high tax bracket.

Gifts that will result in adverse income tax consequences

Generally, making gifts will not cause you to realize income. However, there are some types of gifts that may cause you to recognize gain. For example, a gift of an installment obligation (installment notes receivable) will result in immediate recognition of the gain. The gain is measured by the difference between the FMV of the obligation at the time it is given and its basis (cost). A gift of investment credit property may trigger a recapture of a portion of the credit that you received on the property.

Stock in a closely held corporation

When giving stock in a closely held corporation, you must take care that you don't give away too much. If you retain too little of the stock, your estate may fail percentage tests used to qualify it for special tax treatment (e.g., Section 303, Section 2032A, Section 6166).

Are there any gifting traps you should avoid?

If you want to minimize or avoid taxes, your gifts must be properly structured. All your efforts may be for naught if you should fall into a trap. Here are some of the most common traps of which to beware:

The kiddie tax rules

Beware of the kiddie tax rules when transferring income-producing property to children under age 18. Unearned income above a specified amount is taxed at your marginal tax rate.

Gifts of retained interests or powers

Beware of making gifts of business property in which you retain some financial interest (e.g., life estates, right of reversion, or right of revocation) or powers (e.g., power of appointment, right to continue to vote stock, or certain powers as trustee of a trust). This property may be includable in your estate for estate tax purposes.

Example(s): Frank, Sr. transfers ownership of his home to his son Frank, Jr. on the condition that

Frank, Sr. is allowed to live in the home for the rest of his life. Frank, Sr. has retained a financial interest in the home, which may be includable in his estate for estate tax purposes.

Income taxation of gifts in trust

A trust is a tax-paying entity. Be sure to consider the consequences of paying income tax on trust income.

Overlooking gift splitting

Do not forget the gift-splitting privilege for spouses. This can double the annual gift tax exclusion.

Reverse gifts made within one year of the donee's death

Don't make a gift of appreciated property to a donee within one year of death if you are to receive the property back. There will be no step-up in basis, and you may have needlessly paid gift tax and/or used your gift tax applicable exclusion amount.

Overlooking the tax-exclusive nature of making lifetime gifts

Don't assume that lifetime gifts and death time gifts result in the same tax effect even though they are treated the same under the unified transfer tax system. Remember that the tax-exclusive nature of lifetime gifts results in overall tax savings because the tax is removed from your estate.

What else should you know about gifts?

If you are married and live in a community property state, gifts of community property you make to third persons may be limited by state law. For example, you may need the express or implied consent of your spouse, or you may be limited by the amount you give each donee.

The IRS may deem transfers made by your attorney-in-fact (agent or representative) to be revocable transfers. This means that those gifts may be includable in your estate for estate tax purposes. If you want your attorney-in-fact to make gifts on your behalf, make sure that you give express written authority in a power of attorney.

Qualified Personal Residence Trust

What is it?

A qualified personal residence trust (QPRT, pronounced "Q-Pert") is a specialized form of grantor retained interest trust (GRIT). It is an irrevocable trust into which you transfer an interest in a personal residence, and in which you retain the "income" interest--the right to use or live in the home for a specified term of years. At the end of the term of years or upon your death, whichever is earlier, the home passes to the remainder beneficiaries named in the trust document (typically children) or is held in trust for their benefit. You may continue to live in the home after the term of years ends as long as you pay fair market rental to the remainder beneficiaries.

Potential tax advantages of a QPRT include:

- The grantor's retained interest is subtracted from the value of the home when determining the amount of the gift to the remainder beneficiaries for federal gift tax purposes (i.e., the gift is "discounted"). The amount of the discount is determined using a calculation based on the IRS' assumed rate of return in effect during the month the transfer is made (this is known as the Section 7520 rate, hurdle rate, or discount rate). Any gift tax due can be offset to the extent of the grantor's available $1 million lifetime gift tax exemption.
- Property transferred to a QPRT will not be included in the grantor's gross estate as long as he or she outlives the term of the retained interest. If the grantor dies before the term of the retained interest ends, however, the full value of the property on date of death will be included in the grantor's gross estate for federal estate tax purposes.
- Appreciation in the property after being transferred to the QPRT will also not be included in the grantor's estate.

Example(s): Jill transfers her home valued at $1 million into a QPRT with a 10-year term. The Section 7520 rate at the time is 5.6 percent (i.e., the IRS anticipates that the property will grow at this rate). The QPRT specifically provides that Jill has the right to live in the home rent free for 10 years. According to IRS valuation tables, Jill's retained interest is valued at approximately $420,090. The value of the remainder interest, and the taxable gift, is approximately $579,910. Jill owes no federal gift tax, however, because it is totally offset by a portion of Jill's $1 million lifetime gift tax exemption. After the 10-year period ends, the house plus all appreciation passes to Jill's remainder beneficiaries free of any additional federal gift or estate tax consequences.

As explained above, a QPRT can minimize gift and estate tax, but only if it is successful. For a QPRT to be successful, the grantor must outlive the term of the QPRT. If the QPRT is not successful, though, the grantor is in some ways no worse off than he or she was before creating the QPRT. For example, if the grantor dies before the term of years expires, the property will be included in the grantor's gross estate for estate tax purposes, just as it would have been had the QPRT not been created. If the property does not appreciate greater than the Section 7520 rate, the result is merely that little or no additional value is transferred gift tax free. The only risk associated with an unsuccessful QPRT is any costs incurred to create and maintain the trust.

Tip: Each person is permitted to create two QPRTs, one for a principal residence and one for an occasional or vacation residence.

When can it be used?

A QPRT generally works best for people who are expected to outlive the specified term of years, and have multiple residences or enough income to pay fair market rental to continue living in the home after the term of years expires.

Strengths

Use of QPRT may allow transfer of residence to be discounted for federal gift tax purposes

Transferring a residence to a QPRT is considered a taxable gift to the remainder beneficiaries. However, since the grantor retains a valuable interest and the remainder beneficiaries of the QPRT will not receive the property until some time in the future, the IRS generally allows the grantor to discount the value of the gift for gift tax purposes. The size of the discount depends on the length of the term of years and the applicable Section 7520 rate. The longer the term of years and the higher the Section 7520 rate, the more the value of the gift may be discounted.

If there is a taxable gift, however, gift tax due may be offset by the grantor's $1 million lifetime gift tax exemption, to the extent it has not already been used up.

> **Caution:** If the grantor lives in one of the handful of states that impose their own gift tax, state gift tax may also be due.

Value of property in QPRT will not be included in grantor's gross estate as long as grantor outlives the term of years

As long as the grantor outlives the term of years set out in the trust document, the value of property in the QPRT will not be included in the gross estate of the grantor for estate tax purposes. The grantor need only outlive the term of years for one day. Thus, a QPRT can be an excellent vehicle for transferring a home's future appreciation gift and estate tax free.

QPRT may avoid ancillary probate if you own a residence located in another state

If you own property in more than one state when you die, probate proceedings will have to be conducted in each state where the properties are located. This means that you will have to hire an attorney in each of those states and go through the time and expense to conduct separate probate proceedings. However, if the only property located in another state is a residence (a vacation home, for example) and you transfer that residence to a QPRT, then that property will avoid ancillary probate if you outlive the term of years.

Tradeoffs

Property in QPRT will not escape estate taxation if grantor does not outlive the term of years

Failing to outlive the term of years throws the QPRT property back into the grantor's gross estate, and the advantages of the QPRT are lost.

> **Tip:** To provide for this contingency, many estate planners recommend that the remainder beneficiaries purchase a life insurance policy on the grantor for the term of years. Then, if the grantor dies too early, the remainder beneficiaries will have the funds to pay the estate taxes.

Transfer of property to QPRT is a taxable gift

Since a QPRT is an irrevocable trust (i.e., it cannot be changed or ended except by its terms), a transfer of property to the QPRT is considered a taxable gift to the remainder beneficiaries. Therefore, gift tax may have to be paid if the amount of the taxable gift is above the $1 million lifetime gift tax exemption or if the grantor's exemption has already been used.

Transfer of property to QPRT does not qualify for annual gift tax exclusion

A transfer of property to a QPRT does not qualify for the annual gift tax exclusion. To qualify for the annual gift tax exclusion, the donees (i.e., recipients) must have a present interest in the gift (i.e., the donees must be able to currently possess, use, and enjoy the gift). However, with a QPRT, the remainder beneficiaries will not have a

present interest in the property until the grantor's retained interest ends at some point in the future.

You must pay rent to if you wish to live in home after term of years expires

If you wish to occupy the home once the specified term of years expires, you must pay fair market rental to the remainder beneficiaries of the trust.

> **Tip:** If this situation occurs, you must enter into a written lease with the remainder beneficiaries, and should do so only at the end of the term of years. The lease should contain all the standard lease terms for that type of rental. The remainder beneficiaries should strictly enforce the terms of the lease.

Cost of creating QPRT may be wasted if QPRT is unsuccessful

There may be costs incurred to create and maintain a QPRT. First, a competent and experienced estate planning attorney will be needed to draft the trust document. Second, the attorney will have to transfer and retitle the home in the name of the QPRT. Third, a qualified, experienced real estate appraiser should be hired to appraise the value of the residence that you transfer to the trust (you should have a written appraisal in case the IRS challenges the valuation that you use for the residence). Finally, the transfer is considered a taxable gift. Gift tax returns will need to be prepared and filed, and gift taxes may need to be paid. If the QPRT is unsuccessful, these costs may be incurred for nothing.

QPRT not generally appropriate for generation-skipping transfers

The federal generation-skipping transfer tax (GSTT) (and perhaps state GSTT as well) will apply to a transfer made to a QPRT if some or all of the remainder beneficiaries are two or more generations below the grantor (these are known as skip persons). However, the transfer does not occur until the grantor's retained interest ends. Thus, the grantor cannot allocate his or her GSTT exemption to the transfer until the end of his or her retained interest (or estate tax inclusion) period (this is known as the estate tax inclusion period or "ETIP" rule). Allocating the GSTT exemption when the trust property has already appreciated fails to leverage the exemption. Thus, a QPRT may not be an appropriate device for making transfers to skip persons.

> **Tip:** A grantor may be able to circumvent these generation-skipping transfer limitations if the remainder beneficiaries sell the remainder equivalent to a dynasty trust. This remainder sale strategy is a sophisticated estate planning technique and beyond the scope of this discussion. An experienced estate planning attorney should be consulted.

Income tax consequences of QPRT

QPRT considered a grantor trust for income tax purposes

For income tax purposes, a QPRT should be a grantor trust. Being classified as a grantor trust means that all items of income and deductions flow through to the grantor. The grantor continues to pay for all repairs, insurance, and property taxes. This also preserves the grantor's ability to take the home sale capital gain exclusion in case the home is sold before the term of years expires.

Remainder beneficiaries do not receive a step-up in basis

Unlike property received because of the death of the transferor, property transferred to the remainder beneficiaries does not receive a step-up in basis.

Questions & Answers

Can you transfer more than one residence to a QPRT?

No, you cannot transfer more than one residence to a single QPRT. However, you are allowed to set up two QPRTs and then transfer one home into each trust. In theory, a husband and wife could transfer up to three

homes to QPRTs--one home that is jointly owned and then one home owned by the husband and another home owned by the wife.

Can mortgaged property be placed in a QPRT?

Yes. You can transfer mortgaged property to a QPRT. However, any mortgage payments that you make will be considered gifts to the beneficiaries. For this reason, some estate planners recommend that you not transfer mortgaged property to a QPRT.

Must the grantor live in the home during the term of years?

To attain the tax benefits, you, your spouse, or your dependents must occupy the residence for the term of years. The home must be available for residential use at all times and cannot be used for any other purpose or sold (unless a replacement home is purchased). The home may be either your principal residence or a vacation house. Although the primary use must be as a residence, you are allowed to have a home office or some other secondary use in the home.

Can other property be transferred to a QPRT?

Property that is transferred to the QPRT may include not only the actual home but also other structures (e.g., a separate garage) that are appurtenant to the home. You may also include the surrounding land that is reasonably appropriate. You may not transfer personal property such as furniture.

A QPRT can also hold cash for the initial purchase of a residence, but the purchase must take place within three months of the transfer. Cash can be held by the trust for the replacement of an existing residence, but again the replacement must be purchased within three months. A QPRT can also hold cash for up to six months for the payment of certain trust expenses such as mortgage payments and improvements to the property. If the property is sold or a fire destroys the property, there is generally a two-year replacement period. The trust may hold the cash received either from the sale or from the insurance proceeds for up to two years before a replacement residence has to be bought and transferred to the QPRT.

> **Caution:** Any excess cash held by the trust must be distributed at least quarterly to the grantor. If the trust is terminated, all funds in the trust must be distributed to the grantor; distributions to persons other than the grantor are not allowed.

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