DAVIDSON, DAWSON & CLARK LLP
C O U N S E L L O R S A T L A W

A BRIEF SURVEY OF CURRENT TECHNIQUES FOR ESTATE AND GIFT TAX REDUCTION

For clients who already have a tax-efficient estate plan, further estate tax reduction frequently involves significant gifts. The following survey covers a wide range of possibilities, but it is necessarily abbreviated and general, and it is not comprehensive. Each technique has more requirements, risks, benefits, advantages and disadvantages than can be presented in a broad survey. The techniques presented are not suitable for all clients, nor are they listed in order of importance, as each individual's planning needs are different.

If you nevertheless believe one or more techniques may be suitable for you, or if you are interested in learning about other techniques, you should contact one of your Davidson, Dawson & Clark attorneys. The acronym by which each technique has become known is included for ease of reference.

- **Efficient Use Of The Gift Exemption Amount And Annual Exclusion**

  Individuals whose finances permit should consider making maximum use of the annual exclusion for gift tax purposes (currently $15,000 annually per donor, per donee the) and also should consider making lifetime gifts of some part or all of their federal lifetime exemption amount, which, under current law, is $11,400,000.

  Over time, such gifts can shift to one's beneficiaries a significant amount of capital, appreciation and income that might otherwise eventually be taxed at federal estate tax rates of 40%. Use of the gift tax exemption amount reduces the estate tax exemption dollar-for-dollar, but any post-gift appreciation or earnings on transferred assets escape estate tax completely.

  In large estates, it can even be beneficial to go beyond the tax-free amounts and make gifts that incur gift tax. First, the tax rate may be higher in the future than today's 40%, and in some states (such as New York) there is an estate tax but no gift tax. Second, the benefit of starting to remove post-gift appreciation and earnings of transferred assets from the estate at an early date can be advantageous. Finally, if the donor lives for three years from the date of the gift, the gift tax paid is also removed from the estate for estate tax purposes and constitutes a further reduction the donor's overall tax burden. (By contrast, estate funds used to pay estate tax are subject to estate tax).

Thus, for example, starting with $100 you can transfer $71 by gift, but only $60 by Will, after paying gift or estate tax at a 40% rate.

- **<u>Spousal Lifetime Access Trusts ("SLATS")</u>**

  The tax law requires that a donor relinquish all benefit from and control over property before it is removed from the donor's taxable estate. When large gifts are under consideration, this rule may cause a donor concern about his or her own financial security, and that of his spouse. Fortunately this rule does not apply to gifts to a donor's spouse. A properly drafted trust can therefore be exempt from estate tax in the donor's estate even if the spouse is the trustee. The donor spouse can therefore have indirect access to the funds in the SLAT through the donee spouse's appointment as trustee and beneficiary.

  The comfort afforded by such arrangements necessarily relies on the spouse's cooperation, but it is essential to avoid any actual or apparent agreement, even unwritten, about benefiting the donor. Nevertheless, with the increased federal lifetime gift tax exemption until 2026, such trusts are expected to be a popular option.

- **<u>Dynasty Trust Using Generation-Skipping Transfer ("GST") Tax Exempt Amount</u>**

  To employ this technique, the donor creates a trust and funds it with any amount up to the maximum amount (currently $11,400,000) that he or she can exempt from GST taxes. The donor later files a gift tax return applying his or her GST exemption to the trust. So long as the trust continues, it can benefit generation after generation of the donor's descendants without incurring gift or estate taxes. The avoidance of federal estate tax potentially saves 40% (or perhaps more in the future) at each generational level, an extremely significant savings for the family over time. Such a trust is typically drafted to allow discretion as to income and principal distributions to beneficiaries, including all descendants of the donor living at any time. The trust can continue for as long as the law will permit — 80 to 100 years in most states and indefinitely in others.

- **<u>Low Interest Loans to Family Members</u>**

  With interest rates still very low, intra-family loans can be an effective means of transferring wealth from a senior generation to a junior generation. Such loans, made at a minimum interest rate published by the IRS each month (called the "Applicable Federal Rate" or "AFR"), are not considered to be gifts, provided that the interest is actually paid by the borrower. The AFR will vary depending on whether the loan is short term (3 years or less), midterm (more than 3 years, up to 9 years) or long term (more than 9 years). The three rates for January 2019 are 2.72%, 2.89% and 3.15%. If the younger generation borrower can invest the borrowed funds and achieve a return higher

than the applicable AFR rate, wealth has been transferred with no estate or gift tax cost.

- **Lifetime Transfers Of Interests In Partnerships, Corporations Or LLCs**

  The Internal Revenue Service has recognized that the fragmentation of assets into parts allows the resulting partial interests to be transferred as gifts at discounted values. Discounts of as much as 30% to 40% can be applied to the value of such gifts through the combination of a discount for minority voting rights and a discount for lack of marketability. Accordingly, many taxpayers transfer ownership interests in their businesses to younger family members through the mechanism of creating limited partnerships, limited liability companies or closely-held corporations and then giving minority interests in these entities to younger generation family members as annual exclusion gifts or lifetime exemption gifts.

- **IRAs And Retirement Accounts**

  IRAs and qualified retirement plans can be a significant part of an estate, but they are difficult planning assets because they cannot be transferred during life, they are subject to estate tax at death, and they constitute fully taxable income when received by the beneficiaries. A currently popular planning technique is to designate one or more young family members as the beneficiary, which permits a longer payout period (and thus a longer period for income tax deferral, which can lead to much larger total payouts). Alternatively, philanthropically-minded clients may consider designating a charity or charities as beneficiary of retirement benefits, since they can receive the funds with no estate or income tax burden whatsoever.

- **Single Life Insurance Trust ("ILIT")**

  Life insurance is a unique asset, in that the owner-insured frequently expects no personal benefit, and ownership can usually be transferred to an irrevocable trust with little or no gift tax consequence. The result is that, beginning three years after the transfer, the life insurance proceeds will not be subject to estate taxes. Otherwise the life insurance proceeds may, ironically, increase the very estate taxes they were intended to pay.

- **Second-To-Die (Survivorship) Life Insurance Trust**

  Insurance on the life of both spouses which is payable only when the second spouse dies is frequently purchased in order to provide cash to pay estate taxes at the time of the second spouse's death. It has become popular because estate tax is typically not due until the second spouse dies, and insuring two lives affords a substantially lower premium rate than insuring one life alone. If the

insurance is purchased by, or its ownership is assigned to, an irrevocable trust, the proceeds can escape estate taxation in both spouses' estates.

- **<u>Qualified Personal Residence Trust ("QPRT")</u>**

  An anomaly in the tax law allows a donor to transfer a personal residence to a specific type of trust at a discounted gift tax value. The trust must provide that the donor retains the free use of the residence for a specified term of years. The greater the length of the term and the age of the donor, the greater the gift tax discount, but the tax benefits are lost if the donor does not survive the term of free use. Upon the expiration of the term, estate tax is avoided for the donor. Typically the trust continues to own the residence and rents it back to the donor or his spouse at fair value. If the trust is properly drawn it may even be possible to avoid treating the rental payments as taxable income.

- **<u>Grantor Retained Annuity Trust ("GRAT")</u>**

  An individual with assets that he believes have potential for short-term appreciation at rates higher than the IRS's prescribed interest rate (3.4% for January 2019; the rate is reset monthly by the IRS) might consider creating a series of short-term (2 to 5 year), high payout grantor retained annuity trusts (GRATs). With careful number crunching, these trusts can pass any appreciation in value in excess of the IRS interest rate to the next generation with little or no gift tax consequence to the donor.

- **<u>Lifetime Charitable Remainder Trust ("CRT")</u>**

  A charitable remainder trust is an irrevocable trust that (a) permits a donor to sell (through the trust) appreciated assets without capital gains taxes, (b) usually increases a donor's income, (c) generates a current, often substantial, income tax charitable deduction and (d) reduces eventual estate taxes. Such a trust would be used to create an income interest for the donor and possibly for other family members for life or for a period of years selected by the donor, followed, at the end of the trust's term, by a distribution of any remaining trust assets to one or more charitable organizations of the donor's choice. If the only income beneficiaries are the donor and the donor's spouse, no gift tax is due at the creation of the trust.

  Properly structured, a variant of a CRT can serve as a private retirement plan for a donor who wants to put away retirement assets in high income years but who is over the limit on pension and profit-sharing plan contributions.

  A CRT is particularly useful for a client who has an independent intention to benefit charity; it diverts money from the government to the charitable beneficiary or beneficiaries chosen by the client. The disadvantage is that the trust property eventually ceases to benefit the family.

In some cases it may be possible to purchase life insurance to replace the trust assets that will be diverted to charity at the end of the trust term by using some of the income tax savings and some of the increased income generated by the CRT to pay insurance premiums. The proceeds of insurance held in an ILIT should not be subject to estate taxes and can, in some cases, more than compensate the family for the assets transferred to charity from the charitable remainder trust on an after-tax basis.

If the donor does not wish to part with assets during life, a CRT may be included in a Will. Again, this technique is best for an individual with charitable intent, because rather than increasing the wealth of the family, the CRT diverts dollars from estate taxes to selected charitable beneficiaries.

- **Lifetime Charitable Lead Annuity Trust ("CLAT")**

  The income from the assets of a CLAT is distributed to charity for a term of years selected by the creator of the trust. At the end of the chosen term the CLAT terminates and the principal reverts to members of the family. Given the right payout and the right term of years, gift taxes payable on the principal that will revert to the other family members can be substantially reduced, and any growth in the principal will escape transfer taxes entirely. A CLAT can also be included in a Will if a donor does not wish to part with the property during life, in which case it reduces estate taxes rather than gift taxes.

  In either case, this technique is best suited to families that have an independent desire to benefit charity and that have younger generation beneficiaries who can do without the trust property for a period of years.

- **Private Foundation**

  Individuals who contribute a substantial amount to charity on a regular basis or who receive a large amount of nonrecurring taxable income in one year might consider the establishment of a private foundation. The donor obtains a charitable contribution income tax deduction for the full fair market value of publicly-traded appreciated stock contributed to a private foundation, and no capital gains taxes are payable by the donor or by the private foundation. The donor may continue to control the charitable purposes for which the foundation's assets are used.

  One of the primary advantages of a private foundation is that it offers the donor's family members an opportunity to work together in the areas of asset management, investment choices and charitable giving.

Tax Matters: *To the extent this summary concerns tax matters, it is not intended or written to be used, and cannot be used by a taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under law.*