GIFTS: THE KEY TO ESTATE TAX SAVINGS

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Estate taxes can take a significant bite out of your estate at your death. For example, in 2014, the combined Federal and Massachusetts estate tax on a $6,000,000 taxable estate will be $570,480. A well designed gift program can reduce this tax bite significantly so that more of your assets will pass to your family members or other beneficiaries.

THE FEDERAL TRANSFER TAX SYSTEM

ESTATE TAXES: The United States has imposed an estate tax based on the value of a decedent's estate. The value of the net taxable estate in excess of $5,340,000 (adjusted annually for inflation) will be taxed at the rate of 40%. Certain deductions from the gross estate are allowed in determining the taxable estate. Federal law permits the deduction of state estate taxes, debts, administration expenses and gifts to charity, and provides for a marital deduction. Federal law also permits certain credits, the most important of which is the "unified credit," which also operates as a credit against the gift tax (see below).

Massachusetts, Maine, and numerous other states have enacted a separate state estate tax, typically with a lower tax threshold of $1 million and separate tax rates. Other jurisdictions, notably New Hampshire and Florida, do not impose a separate estate tax.

As a result, estates may be subject to state estate tax even when the total value of the estate is below the federal estate tax threshold. Furthermore, even when an individual resides in a state with no separate estate tax, if the estate includes real estate located in one or more “taxable” jurisdictions, separate tax reporting requirements and state estate tax liability may exist.

GIFT TAX: A federal gift tax is imposed on gifts made by a person during his lifetime. The gift tax is designed to prevent a person from avoiding the estate tax on his property by giving it away during his life. The tax is imposed on the person making the gift, but if it is not paid it can be collected from the gift in the hands of the recipient. In many instances, the first $14,000 (adjusted periodically for inflation) of gifts to each donee in a given tax year can be exempt from the gift tax. This is the "annual exclusion." A person's spouse may join in any gift, thereby effectively increasing the annual exclusion to $28,000 per recipient per year. There is also an unlimited gift tax exclusion for certain amounts paid on behalf of a donee directly to an educational organization for tuition or a health care provider for medical services. Gifts between spouses generally are not taxed at all if the recipient spouse is a U.S. citizen. The gift tax on amounts in excess of any available exclusion is calculated according to the same rate schedule as the federal estate tax, and the unified credit (referred to above in the discussion of estate taxes), is available to offset the tax so calculated. If a person has made taxable gifts during his lifetime, his federal estate tax is adjusted so that his estate tax rate bracket will be the same as if his estate still included the property given away, and his unified credit is reduced to the extent it was used to offset gift taxes otherwise due while he was living. Gift taxes paid during life are credited against the estate tax due -- as if they were a kind of down payment toward estate taxes.

GENERATION-SKIPPING TRANSFER TAX: The federal generation-skipping transfer tax is intended to prevent a person from avoiding estate and gift taxes by making transfers directly to a lower generation (i.e., skipping a generation). For example, an estate tax is imposed on property bequeathed by a parent to his or her children. When the children bequeath the same property to their children, an estate tax is once again imposed. If there were no generation-skipping tax, the parent could avoid this second tax by bequeathing the property directly to the grandchildren. The generation skipping tax eliminates this tax "loophole" by imposing a tax (equal to the highest federal estate tax rate) on gifts (either directly or made by means of a trust) to persons at least two generations below the person making the gift. An exemption equal to the federal estate and gift tax exemption of $5,340,000 (subject to annual adjustment for inflation) (the "GST exemption"), however, will be provided for each person making a generation-skipping transfer. A husband and wife, therefore, may give $10.680,000 to grandchildren or more remote descendants without incurring any generation-skipping transfer tax. The tax is extraordinarily complex, and careful planning is necessary for persons with large estates who desire to make generation skipping transfers or to avoid the unintended imposition of the tax.

GIFT-MAKING BASICS

In general. Although the value of gifts made during life is taken into account in determining the estate tax when the donor dies, income from, and increases in, the value of property given away are not included in determining the estate tax.

Early gifts. The earlier a gift program is undertaken the better. An early gift means that more income and appreciation is shifted to the next generation free of transfer tax. This is especially true for property whose value is currently depressed but may increase in the future. Gifts of interests in real estate are good examples.

Basis step-up. Property transferred at death generally receives a step-up in basis for income tax purposes. If appreciated property is held until death, capital gains tax on pre-death appreciation can be eliminated when the property is sold by the estate or beneficiary. There is no basis step-up for property that is given away during life, so the new owner of the property may pay capital gains tax on its sale; however, the Federal long-term capital gains tax rates of 15% and 20% are significantly lower than the maximum Unified Transfer Tax rate. Moreover, capital gains tax only applies to the gain whereas the Unified Transfer Tax applies to the full value of transferred property.

Annual Exclusion Gifts. An individual may give up to $14,000 (this amount is indexed) each year to each donee, for an unlimited number of donees, without being subject to gift tax. A married individual may give each donee up to $28,000 through "gift-splitting". Annual exclusion gifts are not taken into account in determining the estate tax when the donor dies. Over time, significant amounts of property may be given away completely free of gift and estate tax through use of the annual exclusion. Annual exclusion gifts to grandchildren also escape the generation-skipping transfer tax. The annual exclusion is generally available only if the donee has immediate access to and enjoyment of the gift property. Gifts in trust must be properly structured if this requirement is to be satisfied.

Gifts for Medical and Education Expenses. Payments made directly to providers of certain medical services and tuition payments made directly to educational institutions are not taxable gifts even if they benefit individuals the donor is not obligated to support.

Gift Tax Lifetime Exemption. The Estate Tax Applicable Exclusion Amount makes it possible to transfer up to $5,340,000 in taxable gifts free of gift tax. The Lifetime Gift Tax Exemption is subject to further increases for inflation.

When the donor dies, the value (as of the date of the gift) of taxable gifts sheltered from gift tax by the Gift Tax Exemption is added to the value of the property the donor owns at death in determining the estate tax but post-gift appreciation in value of the property and income derived from the property is not.

Marital and Charitable Deductions. There is an unlimited transfer tax deduction for the value of property passing between spouses and for property passing to charity. Property passing to a spouse, and all appreciation on such property, will be subject to estate tax at the death of the second spouse.

Generation-Skipping Transfer Tax Exemption ("GST Exemption”). The GST Exemption makes it possible for an individual to skip generations and transfer without generation-skipping transfer tax up to $5,340,000 ($10,680,000 for a married couple). The GST Exemption is a valuable tool for clients who wish to make sure that their grandchildren and great-grandchildren share in their wealth.

GIFT STRATEGIES

$ **Make Gifts of Minority Interests in the Family Business**. A discount may be available in valuing gifts of non-controlling interests in businesses and real estate investments. If gifts are structured so that the interests given away cannot be readily sold or otherwise converted to cash, a discount for lack of marketability may also be available. In some cases, the total discount for such gifts **may** be 40% or more.

$ **Create a Qualified Personal Residence Trust ("QPRT")**. A homeowner may make a gift of a personal residence to a trust, retain use of the residence for a term of years and provide that at the end of the term, ownership will pass to his or her children (who may rent the residence to the parent). The value of the donor's retained right to use the residence during the term will be subtracted from the value of the residence when it is transferred to the trust in determining the value of the gift to the children. The result is that a family residence may be transferred to children at a substantially discounted gift tax value.

Example: A 65-year old parent transfers a vacation home worth $750,000 to a QPRT with a 14-year term. If the applicable IRS interest rate is 2.4% the value of the gift would be $352,297, and a portion of the parent's Gift Tax Lifetime Exemption would shelter the transfer from gift tax. If the parent lives at least 14 years, he or she would have succeeded in transferring an asset worth $750,000 (or more) to the children at a gift tax value of $352,297.

An added attraction of a QPRT is that any appreciation in value of the residence after the transfer to the QPRT will escape gift and estate taxation.

$ **Establish a Grantor Trust**. Gifts may be made in trust so that the trust assets will not be subject to estate tax upon the donor’s death. Generally, the Gift Tax Lifetime Exemption of the Donor is utilized to shield the gift from gift tax. Typically, the income of such a trust is taxed either to the trust or to the trust beneficiaries. It is possible to design a trust as a "grantor trust" so that (1) its assets will not be subject to estate tax upon the donor's death but (2) the income of the trust will be taxed to the donor even though it is distributed currently to the trust beneficiaries or accumulated in the trust. The donor's payment of tax on the trust income makes it possible for the trust assets to grow on a "tax-free" basis while reducing the donor's remaining assets and, consequently, also reducing the estate tax payable at the donor's death.

$ **Transfer Property to a Grantor Retained Annuity Trust ("GRAT") or a Grantor Retained Unitrust ("GRUT").** Clients frequently ask whether they can make a gift to their children but retain the income from the gift property for a period of years. The GRAT and the GRUT make this possible. In a GRAT or GRUT, an individual transfers property to a trust and retains the right to receive either fixed (annuity) or fluctuating (unitrust) payments for a specified term of years. At the end of the term, the assets pass to children without further transfer taxation (provided that the transferor outlives the term). When the GRAT or GRUT is established, the transferor is considered to have made a gift of the value of the children's right to receive the trust assets at the end of the term. The gift is valued using the applicable IRS interest rate for the month in which the trust is established. If the value of the assets that the children ultimately receive is greater than the gift tax value of their future interest determined when the trust was established, transfer tax reduction will result.

Example: A 65-year old parent transfers a $750,000 securities portfolio to a GRAT with a 14-year term and retains the right to receive an annuity of $30,000 (4%) per year. If the applicable IRS interest rate is 2.4%, the value of the gift would be $308,538.75, and the gift may be sheltered from gift tax by the parent's Gift Tax Lifetime Exemption. If the securities appreciate in value by 2% annually, the value of the portfolio would be $809,889.36 at the end of the 14-year GRAT term, when it would pass to the children free of any further gift tax.

$ **Create a Limited Liability Company**. A limited liability company ("LLC") can be an effective way to transfer to future generations interests in various kinds of property at substantially discounted gift tax values and shift the future appreciation in value and the income attributable to such property away from their estates. Here are some of the reasons why LLCs can make sense:

$ The donor may retain control over the property by being, or retaining control over, the company;

$ Gift tax valuation discounts (25% or more) may be available for gifts of LLC interests due to their minority ownership rights and the fact that they are unmarketable. The discounts make it possible for more property to be given away without triggering a substantial gift tax;

$ A LLC lends itself to annual exclusion gifts. The LLC simplifies gift-making since (in the case of real property) multiple deeds are not required and simple assignments of limited liability company interests do the trick;

$ The LLC agreement may provide restrictions on the transfer of interests, thus enhancing the ability to keep property "in the family";

$ Assets of the LLC are insulated from the claims of outside creditors of the members; and

$ The LLC may be amended.

$ **Own Life Insurance Through an Irrevocable Trust**. Life insurance proceeds are subject to estate tax if the insured owns the policy or the proceeds are payable to the insured's estate. If the proceeds are paid to the surviving spouse of the insured, they will not be subject to estate tax in the first estate but they will be taxed at the surviving spouse's death. An irrevocable insurance trust makes it possible for life insurance proceeds to escape estate taxation in the estate of the insured and the estate of the spouse while keeping the proceeds available for the family and for payment of debts, administration expenses, death taxes and other needs. Second-to-die or survivorship life insurance should generally be owned by an irrevocable insurance trust to insulate the proceeds from estate tax.

- $ **Make Loans to Family Members**. Family loans can be simple but effective ways to transfer wealth to family members. An individual may make a loan to a family member who will invest the proceeds and repay the loan with interest. Appreciation on investments made by the borrower will escape transfer taxation as will income earned (less interest payable to the lender). In essence, a family loan can "freeze" the value of property in the estate of the lender. Family loans may be structured as part loan and part gift (bargain loans) and this may enhance their utility in certain cases.

- $ **Skip Generations**. Properly structured gifts for the benefit of grandchildren and great-grandchildren may save estate tax by skipping the estates of children. This may be accomplished by outright gifts or by gifts in trust, including trusts which make it possible for income and principal to be paid to children if needed, while ultimately benefitting grandchildren or great-grandchildren. Use of the GST Exemption may perpetuate family wealth for several generations.

The matters addressed in this memorandum are for general informational purposes only, and are not intended to be applied to the specific needs of individual clients without further consultation.