ESTATE PLANNING FOR GIFT PLANNERS

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I. Introduction

High net worth individuals have done estate and financial planning in order to minimize taxes, maintain the wealth they have accumulated and maximize the transfer of wealth to heirs. The objective of this planning is to:

1. Provide for spouse's care and support
2. Provide for children or other heirs
3. Handle special needs such as infirm parent or disabled child
4. Minimize income, estate and gift taxes to pass the maximum wealth to heirs as possible
5. Provide for charity

This session will discuss the intersection of charitable gift planning and estate, financial planning and the probate process. We will cover the impact of the American Taxpayer Relief Act of 2012 on gift and estate tax planning.

II. Transfer Taxes

Historical background - The federal estate tax was adopted first, followed by the gift tax. The purpose of the estate tax was to raise revenue and redistribute wealth. The purpose of the gift tax was to reinforce the estate tax by discouraging people from giving away property during their lifetime in order to avoid the estate tax. Until 1976 the estate and gift taxes were largely independent of each other. If a person made a taxable gift during his or her lifetime, the tax was computed using the gift tax rate schedule. If the gift was made at death, the tax was imposed on the estate of the decedent and was computed using the estate tax rate schedule. It was generally advantageous for a wealthy person to give away as much as practical while living because the total tax would be less.

1976 Tax Reform Act - The 1976 act eliminated the dual tax system and thereby removed most of the incentive for transferring property during one's lifetime. The two tables were replaced by a single progressive rate schedule that applies to the cumulative total of all transfers during life and at death. Thus, if a person made $400,000 of taxable gifts during life and died with a taxable estate of $600,000, the transfer tax would be computed on a total taxable estate of $1,000,000.

Another revision brought about by the 1976 act was the substitution of a single "unified" credit for the lifetime $30,000 gift tax exemption and the $60,000 estate tax exemption. In 2013 the credit is $2,045,800 and it may be converted to an exemption equivalent of $5,250,000 million (known as the "applicable exclusion amount"). In other words, a person may transfer $5,250,000 million of bequests to non-charitable beneficiaries without incurring federal tax.

Economic Growth and Tax Relief Reconciliation Act of 2001- The 2001 act gradually reduced federal estate and gift tax rates and increased the estate tax exemption through

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2009. (Even though the gift tax exemption increased to $1 million in 2002, it was not due to increase in the years to come.) In 2010 the estate tax was repealed, though the gift tax remained.

Year	Tax Rate	Exemption
2002	50%	$1,000,000
2003	49	1,000,000
2004	48	1,500,000
2005	47	1,500,000
2006	46	2,000,000
2007	45	2,000,000
2008	45	2,000,000
2009	45	3,500,000
2010	estate tax repealed but gift tax retained. The top gift tax rate was the top income tax rate (35%).	

During 2010 the estate tax was repealed, but the basis of property acquired from a decedent was no longer stepped up to the date-of-death value. The decedent's estate could increase the basis up to $1,300,000 for transfers to non-spouses. The basis of assets transferred to a surviving spouse could be increased up to $3,000,000. Thus, the basis of property transferred to a spouse could be increased to a total of $4,300,000 for decedent's estates during 2010.

On December 17, 2010, Congress passed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. The 2010 Act reinstated the federal estate tax. The new law set the exemption for U.S. citizens and residents at $5 million per person, and it provided a top tax rate of 35 percent for the years 2011 and 2012.

III. Transfer taxes under the American Taxpayer Relief Act of 2012

The American Taxpayer Relief Act (ATRA) passed by Congress on January 1, 2013 inaugurated a host of changes to U.S. federal tax rules for income, estate, gift and capital gains. Without passage of ATRA federal estate, gift and generation skipping tax exemptions and tax rates would have reverted to the levels prior to passage of the Economic Growth and Tax Relief Reconciliation Act of 2001. The exemption amount would have plummeted to $1,000,000 and the gift, estate and GST tax rate would have gone from 35% to 55%. ATRA made permanent an area of tax law that had been in flux since 2001. The permanence of ATRA is not insured. The fiscal year 2014 budget called for lowering the estate tax exclusion, the generation-skipping transfer tax and the gift-tax exemption back to levels of 2009 as of the year 2018.

The highlights of ATRA are increased estate, gift and generation skipping tax exemption amounts and a modest increase in estate, gift and generation skipping tax rates. ATRA effectively repeals transfer taxes for Americans with modest estates because of the $5,250,000 exemption amount and the portability of the exemption between spouses that

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allows $10,500,000 to pass estate tax free in 2013. The exemption amount is adjusted for inflation in future years.

IV. Gift Taxes

The gift tax is a federal transfer tax that is assessed on an individual who transfers assets to another individual during life. The tax is computed using the Gift and Estate Tax Schedule applicable in the year of transfer and with reference to the donor's annual gift tax exclusion and available gift tax credit. Retention of control may make gift incomplete, and therefore not subject to gift tax.

The gift tax is cumulative and progressive. Therefore, not every dollar of gift is subject to tax at the same rate. However, the larger the gift, the higher the tax. If a net gift tax is due, it is usually payable by the taxpayer making the gift. .

Exclusions from gift tax

Annual Gift Tax Exclusion - An individual may give another individual up to $14,000 in cash or property *each year* without having to report the gift or incurring a gift tax. There is no limit to the number of individuals to whom such gifts may be made. Husbands and wives may join together (gift-splitting) and give up to $28,000 to any individual without gift tax. To qualify for the annual exclusion, the gifts must be present-interest gifts. That is, the donee must have a right to benefit from the property now. (Form 709)

Example: Harold and Julie Remington have three children. They can give each of them $28,000 in 2013, a total of $84,000, without making a taxable gift (and that doesn't count against their lifetime exclusion).

The increase in the annual gift tax exclusion should have little effect on planned gifts.

The annual exclusion is adjusted for inflation in increments of $1,000. Because inflation has been relatively low the exclusion amount only increases every three to four years. The inflation adjustment of the annual exclusion is unrelated to the adoption of ATRA.

Gift tax marital deduction - With the exception of certain gifts of future interests, gifts between spouses are not subject to gift tax whatever the amount. If the donee spouse is not a U.S. citizen, there is an annual exclusion of $143,000 in 2013 – this amount is indexed for inflation in later years – on the amount the donor spouse can give the donee spouse during life without beginning to incur possible gift tax liability.

Qualified transfers Payments made directly to service providers for tuition or medical care are not considered taxable transfers for purposes of gift taxes. These payments must be made directly to an educational institution or medical provider to be considered qualified transfers.

Gift Tax Credit For 2013 and beyond the exemption equivalent of $2,045,800 allows $5,250,000 of assets to pass free of gift taxes. Gifts in excess of the applicable annual exclusion can pass tax-free if there is sufficient gift tax exemption available. If the

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exemption amount is exhausted during life, it is gone and not available to offset transfers at death.

V. Estate taxes

The estate tax is a tax that is assessed on the assets in a person's estate after the person dies. The federal estate tax is assessed against a person's taxable estate, as determined on the federal estate tax return (Form 706). As with gift taxes, if a net estate tax is due, it is usually payable by the estate of the deceased taxpayer.

<u>Gross Estate</u> The total value of a person's estate before any deductions are made for taxes, funeral expenses, attorney's fees or administration costs. The proceeds of life insurance are included in the gross estate if the policies were owned or controlled by the decedent. One half of property owned jointly with the spouse included.

<u>Basis step-up</u> Appreciated assets passing to heirs are entitled to a step up on bases upon the death of the decedent. This step up increases the value of assets inherited upon the owner's death. The step up in basis erases the potential capital gain associated with an appreciated asset up to the decedent's date of death. Instead, cost basis of appreciated property passing to heirs is increased to its date of death value. If the heirs subsequently sell the property, the taxable gain is calculated based on the fair market value at the time of death, not the fair market value at the time the asset was purchased.

Example: Don was a long time employee of General Electric and fervently believed in the value of his General Electric stock. He began purchasing GE stock in 1962. There have been five 2 for 1 splits and one 3 for 1 split since then. At his death he directs that his GE stock, some with a cost basis as low as 70 cents a share, be distributed to his son. General Electric was trading at $24.815 a share at Don's death. If his son decides to immediately sell his inherited stock, any capital gain he might incur on that sale will based on the date of death value of $24.815 a share, not his father's 70 cents a share.

<u>Estate tax marital deduction</u> –The first spouse to die can leave an unlimited amount to the surviving spouse, who is a U.S. citizen, completely free of federal estate tax. The amount passing to the surviving spouse can qualify for this marital deduction if it is given outright or under certain approved trust arrangements (See below on QTIP property). Property passing to a surviving spouse, who is not a U.S. citizen, is not eligible for the marital deduction, unless the property passes to the alien spouse through a qualified domestic trust (QDT).

<u>Qualified Terminable Interest Property (QTIP)</u> The QTIP trust is a special kind of irrevocable testamentary trust that qualifies for the unlimited marital estate tax deduction and therefore incurs no transfer taxes at the time it is created. The trust is created in one spouse's will for the benefit of the surviving spouse during its term. The trust gives the spouse the right to all of its earned income for life. In addition, the trustee may be given the power to distribute trust principal to the spouse as necessary. When the trust

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terminates, typically at the death of the surviving spouse, the remaining principal is distributed to heirs, to charity, or to both according to the donor‘s wishes.

The major advantage of the marital trust under prior law was that the trust principal was subject to estate tax only once, at the death of the surviving spouse. ATRA makes permanent the portability of unused spousal gift tax and estate tax exemptions. This portability allows a surviving spouse to elect to use any unused exclusion remaining from his or her last deceased spouse. Therefore, a QTIP trust is not required to take advantage of both spouse's exemption amounts. If a surviving spouse remarries and the new spouse subsequently dies, the surviving spouse then has access to the unused estate tax exclusion of the second spouse only. Portability is available only if an election is made on the deceased spouse's estate tax return.

Even after the passage of ATRA, there are reasons that some couples will still elect to establish a QTIP trust besides estate tax planning. The QTIP trust is not included in the surviving spouse's probate estate, thereby reducing the estate settlement costs. Importantly for gift planners, the spouse who creates the trust directs the disposition of the trust assets, but can allow the trustee the flexibility to invade trust principal for the benefit of the surviving spouse if necessary. If the first spouse to die is passionate about your cause, the QTIP trust can provide support for the surviving spouse, but the first spouse to die can direct that anything left in the trust at the death of the surviving spouse goes to your organization.

Deductibility of lifetime gifts to charity - A donor is allowed an unlimited charitable gift tax deduction for lifetime gifts to qualified charities. However, the donor is required to complete a Gift Tax Return Form 709 if a decedent makes a future interest gift of any amount or a present interest gift of more than $14,000 if less than the entire value of the donated property qualifies for a gift tax charitable deduction (this can be the case with certain contributions for gift annuities, for example).

Deductibility of bequests to charity - A donor is allowed an unlimited charitable estate tax deduction. If the bequest is in the form of a charitable remainder trust with the surviving spouse as income beneficiary, the deduction is for the present value of the remainder interest. If a surviving spouse is the only income beneficiary, the combination of the marital deduction and charitable deduction will eliminate estate tax on the property.

Without ATRA, federal gift tax and estate tax exemption amounts would have plunged from $5,120,000 to $1,000,000 per individual on January 1, 2013. ATRA kept the gift tax, estate tax, and generation skipping tax exemptions substantially the same as they were in 2012. In 2013, these exemptions, which became permanently unified under ATRA, are $5.25 million per individual, $10.5 million for married couples.

This means that an individual can give up to $5.25 million during life before owing any gift tax. If the individual doesn't use up all of his gift tax exemption during life, then whatever remains can be used as an exemption from estate tax.

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Example: Karen McNeil dies in 2013, having made $1 million in lifetime taxable gifts. She leaves her entire $10 million estate to her husband so no estate tax is due at her death. If an election is made her estate tax return to allow her husband to use her $4.25 million unused estate tax exclusion, his available exclusion amount will increase to $9.5 million — his own $5.25 million plus his wife Karen's unused $4.25 million. He can use his $9.5 million exclusion for lifetime taxable gifts and any unused amount for taxable gifts made at death.

Portability is not available for the GST tax exemption.

ATRA's permanent adoption of high transfer tax exemptions that will continue to be adjusted for inflation, and portability of gift and estate tax exemptions between spouses, very few donors will have estates large enough to owe estate tax. For these donors, saving estate tax will not be a motivation for making bequests or other planned gifts. Gift planners will do well to focus on promoting to this group their organization's mission and the importance of leaving a legacy.

A big plus of the new law is that it lays to rest, at least for now, donor (and advisor) uncertainty over the future of transfer tax exemptions. Donors who were delaying their estate planning until this uncertainty was resolved can now proceed with their planning, including their charitable planning. This benefit applies to all donors no matter the size of their estate.

Increase in top gift and estate tax bracket and in GST bracket from 35% to 40%
ATRA increased the top federal gift tax and estate tax brackets from 2012's 35% to 40%. Consequently, the generation skipping tax (GST) rate also increased from 35% to 40%. This increase is permanent.

Here is the unified federal gift tax and estate tax schedule for 2013:

Taxable	Tax	% on
$0	$0	18
10,000	1,800	20
20,000	3,800	22
40,000	8,200	24
60,000	13,000	26
80,000	18,200	28
100,000	23,800	30
150,000	38,800	32
250,000	70,800	34
500,000	155,800	37
750,000	248,300	39
1,000,000	345,800	40

You'll notice that the 40% rate kicks in at a taxable gift/estate of just $1 million, far below the $5,250,000 exemption available against gift/estate tax. What this means is that any donor who needs to pay transfer tax will pay it at the 40% rate.

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The combination of a higher top income tax bracket and higher top estate tax bracket means that for donors who are in both, there's an even greater incentive for them to designate qualified retirement plan assets for charity. Since retirement plan assets and other income in respect of a decedent (IRD) are subject to both of these taxes if paid to the donor's estate, the potential combined tax rate on these assets if not given to charity has risen from about 58% to over 63%. (You don't just add 39.6% and 40% together because the income tax attributable to IRD assets is deductible from the estate taxable amount.)

For most planned gift donors, the increase in gift/estate tax rate will make no difference, as the generous gift/estate tax exemptions will be sufficient to eliminate all gift/estate tax. For donors whose estates are large enough to owe estate tax, the higher top rate for taxable transfers will increase moderately the incentive to make outright bequests or fund a planned gift during life or at death. For some in this group, the estate planning benefits of the charitable lead trust will be especially attractive.

State estate tax deduction

Once upon a time, before 2002, each dollar of state estate tax paid could be taken as a dollar-for-dollar credit against the federal estate tax up to limits established in a federal state estate tax credit schedule. The credit was then phased out over several years in favor of a state estate tax deduction. Although not limited by a federal schedule like the credit was, the deduction is generally less valuable to a taxpayer than the credit. Since 2005, there has been only a state estate tax deduction. Without ATRA, the state estate tax credit would have returned. ATRA, however, has made the state estate tax deduction permanent.

While most Americans will no longer be subject to federal estate taxes, sixteen states impose an estate tax at the state level. They are Connecticut, Delaware, District of Columbia, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, Oregon, Rhode Island, Tennessee, Vermont and Washington.

State estate tax exemptions are much lower than the federal exemption. For example, New Jersey's estate tax exemption is only $675,000 and imposes a top estate tax rate of 16%. On top of the estate tax, New Jersey (and five other states) also imposes an inheritance tax that is paid by the person receiving the inheritance. The further the relationship from the decedent, the higher the tax rate. Transfers to spouses are exempt from both the New Jersey estate and inheritance taxes.

VI. Generation Skipping Taxes

Generation skipping transfer (GST) tax is assessed on an individual who transfers assets to a "skip person" during life or by will. This tax is assessed in addition to gift or estate tax. Its purpose is to prevent decedents from avoiding transfer taxation in one generation by giving assets directly to the next generation.

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If a beneficiary is a direct lineal descendant of the decedent, the beneficiary will be considered a skip person if he or she is two or more generations younger than the decedent (a grandchild, for example). If a beneficiary is not a direct lineal descendant of the decedent, the beneficiary will be considered a skip person if he or she is more than 37.5 years younger than the decedent. The GST is assessed at the highest current federal estate tax rate.

Generation skipping taxes under ATRA The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) enacted a unified schedule of federal estate tax and generation skipping tax credit increases that applied to tax years from 2002 to 2009. These two credit schedules were not truly unified until 2004, however, as the generation skipping tax lifetime exemption amounts continued to be indexed for inflation through 2003. The federal estate tax credit schedule was not indexed. These credit schedules were not unified prior to the Act.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 created a new and higher GST exemption amount for 2011 – 2012. ATRA unified the GST exemption amount with the estate tax exemption, including indexing.

Who pays the GST? There are three kinds of skip: direct skip, taxable distribution, and taxable termination

Direct skip A direct skip occurs when the funds subject to GST are transferred directly from the donor to the skip person during the donor's life or by will. The executor pays the GST if the transfer is by will; the donor pays the GST if the transfer is made during the donor's life.

Taxable distribution A taxable distribution occurs when the funds subject to GST are transferred to the skip person by distribution from a trust. A charitable remainder trust makes taxable distributions when it distributes payments to a skip person, for example. The recipient of the distribution pays the GST.

Taxable termination A taxable termination occurs when the funds subject to GST are transferred to the skip person at the termination of a trust. A charitable lead trust makes a taxable termination when it distributes its remaining corpus to a skip person, for example. The trustee of the trust pays the GST.

VII. Advanced Non-charitable Estate Planning Techniques

Wealth replacement

A wealth replacement trust, also known as an irrevocable life insurance trust (an "ILIT") is an irrevocable trust created for the principal purpose of owning a life insurance policy. The trust has certain powers that permit specified trust beneficiaries to withdraw gifts made to the trust for a limited period of time. These are known as Crummey powers and allow gifts to the trust to qualify for the federal annual gift tax exclusion. The exclusion

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effectively exempts annual gifts up to the then applicable annual exclusion per trust beneficiary from the federal gift tax.

The primary reason for creating an ILIT is estate tax considerations. If an ILIT is properly structured, the death benefits paid to the trust will be free from inclusion in the gross estate of the insured. In addition, the ILIT can also be structured so that the trust will provide benefits to the insured's surviving spouse without inclusion in the surviving spouse's gross estate either.

An ILIT can be combined with an income producing planned gift so that the life income gift can be used to replace the asset donated to fund the charitable gift. The purpose of the policy is to replace the assets used to fund the gift for the benefit of the donor’s heir

For example, a donor might fund a charitable remainder unitrust and name himself and his wife as income beneficiaries. Then, the donor creates a life insurance trust (an ILIT) for the benefit of his children. The trust purchases life insurance on his and his wife’s lives. Each year the donor contributes enough of his CRUT income to the life insurance trust for the trustee to pay the premiums on the life insurance policy. When the donor and his wife die, the life insurance proceeds go to their children. The proceeds are free of estate taxes because the life insurance trust owns the policy, not the donor’s (or donor’s spouse’s) estate.

Qualified Personal Residence Trusts
A Qualified Personal Residence Trust (QPRT) is a modified form of a Grantor Retained Income Trust (GRIT) which were effectively eliminated by the Revenue Reconciliation Act of 1990 (RRA '90). A QPRT is a special form of irrevocable trust that an individual funds with his or her personal residence.

During the trust term, typically the donor’s lifetime, the donor may continue to live in the residence. When the trust terminates, ownership of the residence passes to heirs named by the donor in the trust instrument. The donor of a QPRT receives a gift tax deduction for the value of the donor’s retained interest. The difference between the value of the donor’s interest and the value of the property funding the trust is treated as a taxable gift to the heirs of the trust. The QPRT can be an effective technique for transferring a personal residence to a person’s heirs at reduced gift and estate tax cost.

Depending on the length of the retained interest, the reduction in the value of the gift can be substantial. Assuming that the home appreciates in value during the term of the QPRT, the grantor's home will be transferred to the remainder beneficiaries at a significantly discounted amount. While it is possible to fund a QPRT with a residence that is currently mortgaged, it is not recommended due to the additional complexities that must be addressed.

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Grantor Retained Annuity Trust

The limitations on the use of GRITs generally provide that any retained interest in a trust must actually be paid out to the grantor. This has led to the creation of the Grantor Retained Annuity Trust (GRAT) and the Grantor Retained Unitrust (GRUT). A GRAT is a form of irrevocable non-charitable trust. During its term, the trust makes fixed payments to the donor of the trust (the grantor). When the trust terminates, its remaining principal passes to remainder beneficiaries named by the grantor, typically children or grandchildren.

The grantor of a GRAT makes a taxable gift to the remainder beneficiaries. The amount of this taxable gift is computed when the trust is funded and equals the funding amount minus the present value of the payments that the trust will make to the grantor. Just as with charitable lead trusts, the low discount rate environment permits easily offsetting the transfer taxes on a GRAT with a relatively low payout to the grantor. There is no transfer tax assessed at the time the trust terminates and distributes its remainder to its ultimate beneficiaries. Consequently, a GRAT can be an effective method for transferring assets to heirs at reduced transfer tax cost.

Grantor Retained Unitrust

A grantor retained unitrust (GRUT) is a form of irrevocable non-charitable trust. During its term, the trust makes payments to the donor of the trust (the grantor) that are equal to a fixed percentage of the trust's value, as determined on a specified day of the year. When the trust terminates, its remaining principal passes to remainder beneficiaries named by the grantor, typically children or grandchildren.

The grantor of a GRUT makes a taxable gift to the remainder beneficiaries. The amount of this taxable gift is computed when the trust is funded and equals the funding amount minus the present value of the payments that the trust will make to the grantor. There is no transfer tax assessed at the time the trust terminates and distributes its remainder to its ultimate beneficiaries. Therefore, a GRUT can also be an effective method for transferring assets to heirs at reduced transfer tax cost.

VIII. Calculation of a Taxable Transfer

The calculation of a taxable transfer can be complicated. Not every transfer will necessarily give rise to the filing of a gift or estate tax return nor will every reported taxable transfer result in the payment of a gift or estate tax.

The unified nature of gift and estate taxes makes the calculation of taxable transfers dependent not just on the transfer at any given point, but prior taxable transfers as well. That is because the calculation of transfer taxes is cumulative as well as progressive.

Example: Sarah Shulman, who never married, dies in 2013 with an estate worth $8 million. She made $2 million in taxable gifts during her lifetime. If she includes no bequests to charity in her estate plan, her estate tax will be computed as follows:

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Estate value	*$8,000,000*
Prior taxable gifts	*+ $2,000,000*
Charitable bequests	*- $0*
Taxable estate	*$10,000,000*
Estate Tax Exemption	*- $5,250,000*
Taxable Estate	*$4,750,000*
Tax owed ($4,750,000 x 40%)	*$1,900,000*

If Sarah includes a $1 million charitable bequest in her will, her estate tax will decline by $400,000, 40% of her $1 million gift, as shown below.

Estate value	*$8,000,000*
Prior taxable gifts	*+ $2,000,000*
Charitable bequests	*- $1,000,000*
Taxable estate	*$9,000,000*
Estate Tax Exemption	*- $5,250,000*
Taxable Estate	*$3,750,000*
Tax owed ($3,750,000 x 40%)	*$1,500,000*

IX. The Intersection of Charitable Planning and Gift and Estate Planning

A. Life Income Gifts for Others

Life income gifts to benefit someone other than the donor give rise to potential transfer tax issues. Transferring assets to another can trigger transfer taxes in the form of gift taxes, if it is a lifetime transfer; and estate taxes, if it is a transfer at death.

Calculating the Taxable Gift If an income recipient of a life income plan is not the donor or the donor's spouse, the donor has made a taxable gift to the income recipient equal to the value of the recipient's income interest. Therefore, a gift of $100,000 to fund a gift annuity for an income beneficiary other than the donor will not result in a taxable gift equal to $100,000. It is the present value of the income to be paid from the annuity that is subject to transfer taxation.

The value of the gift taxable income interest is equal to the face amount of the funding principal of the life income gift minus the charitable deduction, which is the charitable interest in the gift. Therefore you can compute the value of the income interest, the amount subject to gift tax, by subtracting the charitable income tax deduction from the gift principal.

Example: Jeremy Bird wants to establish an immediate payment gift annuity that will pay income to his mother for life. Mrs. Bird is 84, so she would be entitled to a gift annuity

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rate of 7.6%. Suppose Jeremy funds a gift annuity with $100,000 for his mother. Jeremy is entitled to an income tax charitable deduction of $53,066. The value of Mrs. Bird's income interest is $46,934, that's the $100,000 principal minus the deduction of $53,066. Mrs. Bird will receive annual income of $7,600, a portion of which she will have to report as ordinary income and a portion of which is tax-free income.

What are the gift tax consequences of such a gift? Jeremy Bird is making a taxable gift of $46,934 to his mother. Jeremy will file a gift tax return reporting this amount as a gift. He can offset the gift with his $14,000 annual exclusion. If this is a joint gift with Jeremy's wife, they can use two annual exclusions and offset $28,000 of taxable gifts. Assuming two annual exclusions, there will still be a taxable gift of $18,934. If Jeremy has not used his $5,250,000 gift tax exemption amount, he can offset the rest of the taxable gift with his exemption amount. Jeremy is not then liable for any gift tax.

What if Jeremy does not want to file a current gift tax return or use any of his gift tax exemption? A gift tax is only triggered if there is a completed gift. One strategy would be for Jeremy to add a provision to the gift annuity agreement that allows him revoke his mother's income interest. Obviously, he isn't actually going to revoke Mom's income interest, or he can forget about getting a birthday card next year! The idea of the revocation clause is to make the gift to Mom incomplete, and the gift tax is not triggered.

Each year Mom is going to receive $7,600 income from the gift annuity, so these are completed gifts each year. Jeremy can easily offset these gifts using his annual exclusion. In fact, Jeremy can retain the right to revoke his mother's income interest and increase the gift principal to $368,421 so that his Mom receives $28,000 (7.6% of $368,421.05 equals $28,000) a year without any current gift tax. However, if Jeremy predeceases his mother, her life interest in the gift annuity must be revalued as of his death and included in his estate for estate tax purposes. So there are some tradeoffs to be considered in using a revocation clause, if Jeremy expects to pay estate tax.

Capital Gains Tax An additional element to consider is whether a life income gift for another is being funded with cash or an appreciated asset. If the donor is using appreciated property, there are potential capital gains tax consequences that will vary, depending on the type of life income gift the donor establishes.

A charitable remainder trust or pooled income fund gift funded with appreciated property does not trigger capital gains tax liability to the donor. A gift annuity can create a current capital gain tax liability for the donor if the annuity for another is funded with appreciated property. The donor is subject to capital gain tax on the gain attributable to the value of the income interest associated with the gift annuity. The gain can be reported prorata over the life expectancy of the annuitant if the annuity is non-assignable except to the charity and the donor is the sole annuitant or is the initial annuitant in a two-life annuity. Reg. Sec. 1.170A-1(d)(3) and 1.1011-2(a)(4)(i).

For most gift annuities, the donor is able to recognize any gain ratably over his life expectancy, rather than in the year the gift is made because the donor is most often also

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the annuitant. To receive this treatment, the donor must be the primary annuitant. If the annuity is for the benefit of someone other than the donor, this prorata capital gain treatment is not available. Reg. Sec. 1.1011-2(a)(4)(ii).

The prorata capital gain treatment is lost even if the primary annuitant is the donor's spouse. In that case, one strategy is to retitle the property in the spouse's name prior to making the gift. Retitling the property in both names may also be a good idea if appreciated property owned by only one of the spouses is being used to fund a two-life gift annuity; where both spouses are concurrent annuitants.

Let's examine the capital gains tax consequences of Mr. Bird's gift to his mother if funded with appreciated property.

Example: Assume that Mr. Bird in the example above decides to fund the annuity for the benefit of his mother with appreciated property with a cost basis of $60,000. The gift tax consequences of such a gift are identical to those in the example above. However, Mr. Bird would have to report capital gain income of $18,774 in the year of the gift because he is the donor and his mother is the annuitant. That tax is more than offset however by his income tax charitable deduction of $53,066. If he sold the stock and used the proceeds to fund the annuity, he would have $40,000 of capital gain income. Rather than selling the stock and donating the proceeds, it would be best for him to transfer the stock to fund the annuity.

B. <u>Simple Will</u> If a person dies having decedents have simple or reciprocal wills, on the death of first spouse, all assets pass to the surviving spouse at zero estate tax cost because of unlimited marital deduction.

Under the law prior to ATRA, such a plan failed to utilize the first spouses estate tax credit, the credit was wasted on the first death. Portability of the exemption will prevent loss of the first spouse's exemption amount.

Gift planners should be cautious about a simple will if the donor is married. A simple will does not protect against the surviving spouse failing to carry out the first spouse's charitable intentions.

C. <u>Credit Shelter/ Marital Trust Plan</u> This is a popular basic estate plan that uses certain trust arrangements at the death of the first spouse to maximize the use of the available estate tax credit amount. Prior to the portability of the estate tax exemption, this plan was required to take advantage of both spouse's exemption amounts. There are still non-tax reasons to establish parts of the plan.

<u>Credit Shelter Trust</u> Many high net worth individuals may still have a credit shelter trust in place if the plan is not updated after the passage of ATRA. The credit shelter trust is funded at the death first of the first spouse with an amount exactly equal to decedent's then available estate tax credit amount. The will contains a formula clause that matches the then available estate tax credit amount.

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Marital Trust (QTIP) The marital or QTIP trust is an irrevocable testamentary (funded at death) trust that qualifies for the unlimited marital estate tax deduction and incurs no transfer taxes at the time it is created. This trust is created at the death of the first spouse and is created for the benefit of the surviving spouse during its term.

The marital trust gives the surviving spouse the right to all of its earned income for life. In addition, the trustee may be given the power to distribute trust principal as necessary for the health, maintenance and welfare of the surviving spouse. However, the surviving spouse does not have the right to make a bequest of the marital trust property.

When the marital trust terminates, typically at the death of surviving spouse, the remaining principal distributed to heirs, to charity, or to both according to the wishes of the first to die spouse. This trust insures that first spouse’s wishes are carried out upon the death of the surviving spouse.

The marital trust is not included in the surviving spouse's probate estate, thereby reducing the estate settlement costs upon the death of the surviving spouse.

Impact of Charitable Gifts On Credit Shelter/Marital Trust Estate Plan
Where the credit shelter/marital trust estate plan is combined with a life income plan and the life income plan must be included in the gross estate (see Estate tax on charitable plans below) the amount by which the first spouse's taxable estate is increased is also subtracted. The funding amount is the maximum amount that may be passed on to the family without tax at the first death utilizing the first spouse's lifetime gift and estate tax credit exclusion.

The remainder of the first spouse's estate is placed into a marital trust that qualifies as a QTIP trust (qualified terminal interest property) for the unlimited marital deduction. As a result, no estate tax is paid at the first death, except where the estate plan is combined with the life income plan and the life income plan must be included in the gross estate (see Estate tax on charitable plans).

Estate Tax on Charitable Plans If a donor has an income interest in property that the donor placed in a charitable remainder trust or pooled income fund, that property must be brought back into the donor's taxable estate, subject to a charitable estate tax deduction for the value of the interest to charity.

Where the deduction exactly offsets the income interest includable in the estate and the surviving spouse is the only subsequent non-charitable beneficiary, in which case the surviving spouse's interest can qualify for the unlimited marital deduction. If there is a life income plan where the surviving beneficiary is not the donor’s spouse, the taxable estate is increased by the difference between the life income plan principal and the charitable deduction. Note that in the case of a married couple, the life income plan is included in the first or second spouse's estate if and to the extent of that spouse's share of the principal (100%, 50%, or 0%). A similar rule applies for regular or deferred gift

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annuities with a survivor annuitant. However, only the value of the remaining annuity payments is included in the donor's estate and there is no charitable deduction at that time.

X. The Probate Process

Probate is the court-supervised process of confirming a will and distributing assets according to the provisions of the will. Probate administration is required only for property owned by an individual at death, where it is necessary to prove who is entitled to that property as a result of the owner's death. The decedent's will controls how "probate" property passes to beneficiaries. Assets subject to probate include:

1. **Individual assets** - This asset type consists of all of the decedent's assets and property that is titled only in the name of the decedent. This type of asset has no other owner or beneficiary who can claim an ownership interest in it. This asset type is also not payable at the decedent's death to anyone. Typical individual assets may include bank accounts, investment accounts, bonds, stocks, cars, boats, planes, business interests and real estate.

2. **Tenant-in-common assets** - This is property titled in a decedent's name, as well as in the name of at least another party. The decedent and the other party own the property as tenants in common. Examples of tenant-in-common property are a jointly-held bank account, investment account, stocks, bonds, vehicles, boats, planes, real estate and business interests.

3. **Beneficiary assets** - These are assets that are payable at the death of the decedent to the decedent's estate, such as a health savings account, medical savings account, life estate, retirement account, life insurance policy, or annuity with all of the named beneficiaries predeceasing the decedent. Alternatively, this type of asset could comprise property when the decedent did not name any beneficiary.

   On the death of decedent, the following steps will take the better part of a year minimum, can be much longer. Here are the general steps to settle an estate.

- Filing will with probate court and appointment of personal administrator.
- Notification of legatees.
- Inventory of estate and appraisals of estate assets.
- Payment of debts and allowable claims.
- Payment of bequests. (Some may be paid sooner than others. Also, a bequest may be paid through a series of partial distributions.)
- Filing estate tax return.
- Audit of estate tax return and tax clearance letter from IRS.
- Final accounting and payment of fees.

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- Closure of estate.

Avoiding Probate

Some assets pass outside probate by their character such as qualified retirement plans, POD (payable on death) bank accounts, and life insurance. To avoid probate, one can fund a living trust. The living trust is private however; state trust laws may require the trustee to keep beneficiaries reasonably informed about the administration of the trust. The living trust is generally cheaper than probate.

Use of a living trust means there is no oversight of the process by a third party. Therefore, there is no guarantee that assets will be distributed according to the decedent's wishes. There is no finality to creditor's claims against assets passing outside of probate.

Probate and non-probate assets.

An entire industry has grown around the avoidance of probate. There are legitimate reasons to avoid probate, but there are drawbacks to passing assets outside of the probate process. Gift planners will encounter many estates that still pass the majority of their assets through probate.

Non-probate administration

The probate process can be complicated and time consuming, so it may take several years to completely resolve everything. Assets that pass outside of probate may be distributed to charity more quickly.

Wills and probate proceedings are matters of public record. Non-probate administration is private and records are not filed with the probate court. That means that charitable beneficiaries have much less access to information than with estates passing through probate. Nonetheless, most states have laws requiring those acting as a fiduciary to give a full accounting to beneficiaries. Charities should become familiar with these statutes and request disclosure if required by law.

Probate administration

Probate administration takes more time, is more expensive and is subject to public scrutiny. There are advantages to probate administration for charitable beneficiaries. Because the process is public, charities have access to much more information than a non-probate administration. Court supervision means the process is transparent and fair. It may take longer to get assets from probate, but charity can feel comfortable that it has received what it is entitled to.

Representing Charity during the Estate Administration

Review the will and secure an interpretation if necessary. Be alert to the following potential problems:

- The provision for the benefit of your institution is ambiguous.
- Your institution is not accurately identified.

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- The will does not state how taxes, expenses, and debts are to be paid and charity is a residual beneficiary.
- The charitable interest is to be satisfied as a percentage of the estate.

Review the inventory of the estate and other financial reports. If a specific dollar amount is designated for your charity, the inventory may not be important, assuming there are sufficient assets to pay the bequest. However, if charity will receive a percentage of the residue of the estate, the inventory and proper management of it will be quite important.

Review the reasonableness of executor and attorney's fees, claims the executor wants to pay, and proposed sales of estate assets. When some time has elapsed without correspondence about estate administration, call for a status report. Make sure the personal administrator knows you are paying attention, and create a tickler system so you do.

Request partial distributions if the estate is not likely to be settled for a long time. (This is appropriate when the charity is a residual beneficiary.) Exercise your right for a final accounting and review it. Sign a receipt only after you have actually received the distribution.

XI. Conclusion

Donors are not motivated to give or not give by taxes alone. However, taxes can affect the size and the timing of giving. Consider the impact of charitable giving on a donor's gift and estate tax situation when discussing a gift. A passing familiarity with the laws and techniques of transfer taxation discussed above will help you understand what motivates and interests your donors.

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