



# **Advanced Estate Planning Techniques**

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## Introduction

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There are nine (9) basic advanced planning strategies that we at Midgett & Preti PC use, along with your will or revocable living trust, to transfer your estate to whom you want, when you want, and to minimize or eliminate federal estate taxes that may otherwise be due at the time of your death. Each of these strategies will be briefly reviewed in this brochure. There may be other strategies or opportunities available to preserve your estate from unwanted taxation, but in general, the following plans usually provide adequate relief from estate tax, one of the most oppressive taxes levied under the Internal Revenue Code. The strategies that will be discussed are:

1. Annual giving, without tax, to your children and others.
2. Using part of your estate tax exemption while living.
3. Using life insurance to replace wealth or pay estate or income taxes.
4. The Qualified Personal Residence Trust.
5. The Family Limited Partnership.
6. Retained Income Trusts.
7. Charitable Trusts.
8. Generation Skipping Exemption (Dynasty) Trusts
9. Sales to Family Members - The Self -Cancelling Note.

Each of these topics will be discussed in general terms on the following pages. Not every technique may be available or appropriate for you. This discussion is intended to provide valuable information concerning the use of each planning strategy, but should not be construed as specific legal advice for your individual situation. You should seek the advice of a competent estate planning attorney or other tax advisor before undertaking any of these advanced estate planning strategies.

If you have any questions regarding the information presented in this brochure, call the **Midgett & Preti PC** at **(757) 687-8888**.

## Annual Giving

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Annual giving offers one of the easiest methods of planning your estate, and the advantages are easily understood. The estate tax laws as currently written allow a portion of your estate to pass free of federal estate tax (See the table at the end). Thereafter, the government imposes a tax on the value of your estate at a rate of 45% (or more, depending on the date of your death) of all that you own. When annual gifts are made, each dollar given away is removed from your taxable estate. This means that the federal government is, in reality, contributing 45 cents for every dollar you give to your beneficiaries.

The annual exclusion from gift taxes says that in each calendar year you may give up to \$12,000 to as many persons as you wish, without having to pay a gift tax or even file a federal gift tax return. If you are married, you may transfer as much as \$24,000 per person each year, even if all of the property given away is owned by only one spouse. This is called "gift splitting" and requires a minimal filing of a gift tax return to indicate, in writing, your spouse's consent to make this gift, and use his or her annual gift tax exclusion.

When you use the annual exclusion rules, you and your family can get one or more of these benefits:

- ◆ You pay no gift tax.
- ◆ The donee of the gift (the recipient) pays no income taxes on the value of the gift.
- ◆ The annual exclusion amount does not reduce the amount you can transfer tax-free during your life or at death.
- ◆ No report of the gift is required, except in the event of gift splitting by a married couple.
- ◆ For every \$12,000 gift made, you keep \$5,900 from going to the IRS.
- ◆ You can witness the donee's use and enjoyment of the gift.

Think of annual giving as a game created by the IRS. You play the game by writing a check every year in an amount you wish to give to someone you care about. You can also play the game by transferring stocks, bonds, real estate, or anything else that has an economic value. You win the game by transferring more value to your heirs than they would receive if you waited to make all transfers at your death and an estate tax would be due. In this game you win, your heirs win, and the IRS loses.

## Annual Giving

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In addition to the \$12,000 annual exclusion there are three other ways to give property away without paying any gift taxes. These exclusions are **unlimited**, which means that you may transfer any amount, no matter how large, without payment of gift taxes. The unlimited gift tax exclusion is available for

- ◆ Transfers to your spouse, and
- ◆ Transfers for education or medical expenses of another person; and
- ◆ Transfers for medical expenses of another person.

There are no important restrictions on transfers to your spouse, but transfers under the education or medical expenses exclusions require that the gift of tuition be paid directly to the school, college or university, and that the gift for medical expenses be paid directly to the hospital or doctor providing health care services. Payment to the beneficiary directly will not qualify for the unlimited exclusion, and will be limited to the \$12,000 annual amount, unless a gift tax is paid or the exclusion against gift or estate taxes is used.

The major disadvantage to annual giving is that the gifted asset is no longer available for your needs, and you lose all control over the asset, and its value. It also becomes fair game for the recipient's creditors.

Utilizing annual giving, along with the unlimited exclusions from gift tax for medical and education expenses offers simple and flexible planning alternatives to nearly every person having a taxable estate.

## **Using Part Of Your Estate Tax Exemption Now**

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While you are alive you can give a large portion of your money or property without paying one dime of gift tax. Most people think of using this exemption, or credit amount, only for estate taxes, but it can be utilized against gift taxes as well. Think of this exemption as a special account worth as much as \$1,000,000! You may make gifts from this "account" during your life or at death. The "account" is not renewable. Once it is empty, it is gone forever. If you are married, both you and your spouse each have an "account" worth as much as \$1,000,000. By combining these exemption "accounts", you may give away up to \$2,000,000 free of gift or estate taxes.

The advantage to giving away money or property during your lifetime is that the income and future growth of that asset are both removed from your estate, and will escape estate taxes when you die. For example, suppose you had a stock that you purchased that is today worth \$700,000. Ten years later, when you die, the stock is worth \$2,000,000. The IRS will allow you to transfer \$1,000,000 tax free in 2009, but the tax on the \$1,000,000 difference can be as high as \$450,000. Suppose instead you give this stock to your child during your lifetime. Using your lifetime gift tax exemption, there is no gift tax due. At your death, the stock value is not part of your estate and escapes estate taxation. Your child saves \$450,000 in both estate and gift taxes.

The disadvantages are the same with the \$12,000 annual gift tax exclusion discussed earlier, except on a larger scale! In addition, income tax considerations involving capital gains will be a concern when you gift stocks or property. Gifts have the same income tax basis (cost) for the gift donee (recipient) as they do for the gift donor (giver). When the donee later sells the asset for a profit, capital gains taxes will be due based upon the increased value. If the same property were received at death, the income tax basis will be the date of death value, reducing the amount of capital gains taxes due upon sale of the property. However, you could be trading a 15% tax for one that can be as high as 45%.

## **Irrevocable Life Insurance Trusts**

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Everyone knows the benefits of life insurance. A death benefit is paid to your heirs at your death, providing needed funds to pay bills or replace lost income. What most people don't realize is that life insurance that you own or control is part of your estate for estate tax purposes, and the death benefits paid will be counted as part of your taxable estate. When your estate exceeds the amount of your estate that you can pass free of estate taxes, payment of estate taxes can reduce the death benefit from insurance up to 45%.

An Irrevocable Life Insurance Trust (ILIT) can have three (3) important benefits: First, the life insurance owned by the ILIT will not be subject to estate tax upon your death, preserving the full value of the death benefit for your family. Secondly, the ILIT can help pay any estate taxes that may be due by providing a tax-free fund for payment. Thirdly, an ILIT can provide a tax free fund to pay any income taxes that might be due at death on the value of qualified retirement plans or individual retirement accounts. With some foresight and planning each of these benefits can be obtained. Here's how it works:

You create the ILIT document, which, like the revocable living trust, dictates who is to benefit from the trust assets, and when. The ILIT also names a Trustee, but unlike the revocable living trust, this Trustee must be independent. This means that you or your spouse cannot serve as Trustee. Remember, control is one of the measures for including insurance in your taxable estate, and naming an independent Trustee helps eliminate this type of control.

The next step is to fund the ILIT. This can be done with an existing insurance policy that you own, or can be done with a policy purchased by the trust. If you transfer an existing policy to the ILIT, the proceeds will be treated as part of your taxable estate for a period of three (3) years. This is a remnant of the tax rules that treated gifts within three (3) years of death as if they had not been made. For new policies purchased by the ILIT, this three (3) year rule does not apply.

Purchasing a new policy means that there is no risk that the proceeds will be included in your taxable estate, even if you pass away within three (3) years of creating the trust.

The next step is to pay the premiums on the insurance policy. This is the responsibility of the ILIT Trustee, the owner of the policy, and in order to do this, you will need to transfer cash to the trust. This is the same cash that you would have paid for the insurance anyway, so the transfer to the ILIT does not usually carry a heavy financial penalty. There are some traps to avoid, however, and this is where the ILIT becomes a bit complicated.

## **Irrevocable Life Insurance Trusts**

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The ILIT is designed to provide a benefit in the future, as are most trusts. But the IRS says that in order to have a valid gift, and therefore to remove the asset (and its proceeds) from your estate, the beneficiary must have some present or immediate right to use or enjoy the gift. Estate Planners have gotten around this trap by giving the beneficiaries of the ILIT the right to withdraw the value of each transfer to the trust. This is based on a case brought against the IRS in the 1960's, Crummey v. Commissioner. As a result of this famous case, the beneficiaries of the ILIT are given the power to withdraw the annual contribution to the ILIT ("Crummey powers") within a reasonable time, usually no less than 30 days, from the date of the transfer. If the demand to withdraw funds is not made, the funds are outside of your estate and can be used to purchase or pay for the insurance policies.

An ILIT gives you these advantages:

- ◆ Life insurance owned by the ILIT will not be included in your estate or subject to federal estate taxes.
- ◆ Life insurance proceeds in the ILIT are exempt from creditor's claims and available to pay estate settlement costs.
- ◆ ILITs are private and avoid probate.

## Qualified Personal Residence Trusts

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Congress has enacted a law within the Internal Revenue Code that offers a great estate planning benefit to homeowners. The formal name for this type of trust planning is the "Qualified Personal Residence Trust", or Q-PRT. According to one nationally syndicated columnist, Kenneth R. Harney, the Q-PRT is "expected to turn into one of the . . . most popular techniques for minimizing federal estate taxes on real estate assets." The idea behind the Q-PRT, which we will refer to as the Residence Trust, is to reduce the exposure of perhaps your most valuable single asset from the harsh effect of estate taxes. For taxable estates over the exemption amount, the estate tax rates are 45%. The Residence Trust allows you to give away the future appreciation of your home, as well as the right to use it in the future, while retaining the right to continue living in the residence for a number of years. This type of trust is generally limited to your home, but a second or vacation home can also qualify for the tax savings. Here's how it works:

Let's assume that you have a residence valued at \$400,000 today, and further assume that it will grow in value to \$600,000 at your death. If that residence were owned by a Residence Trust, the \$200,000 of growth would pass to your heirs free of estate tax. In addition, the tax laws allow you to discount the value of the residence for gift tax purposes. You see, the right to occupy the house, rent free, for a number of years has a value. The greater the period of occupancy, the greater the value. The value of your gift to your heirs is the right to occupy the house in the future, which is sometimes referred to as the remainder value. Subtract the value of your lifetime right from the total value of the residence, and you get the remainder value of the gift. Since this is a future interest gift, you cannot use the annual gift tax exclusion to avoid gift taxes. Taxes are avoided by using part of your estate tax exemption now, rather than at death.

What is the value of the interest you retain? Assume, using our example above, that you retain a right to live in the house for a period of ten (10) years.

Using IRS approved tables your retained interest in the trust is just \$227,924. The remainder value transferred to the heirs is only \$172,076. This is the amount subject to gift tax, which can be paid using part of your lifetime gift tax exemption amount (\$1,000,000). At the end of the ten (10) year trust term, your children own the house, tax free, at its then full market value, at a gift tax cost of but a fraction of its actual value. Additional savings can be obtained by married couples by creating two (2) Q-PRT's and transferring a fractional interest in the residence into each trust.

There are some cautions. The length of the term you choose for the Residence Trust is critical in achieving estate tax savings. If you die before the end of the trust term, the IRS says you have a retained interest at death, the property is taxed as if it was a part of your estate, and at the highest rate applicable to your assets. This is no worse than doing nothing. The trick is to pick a term for the trust that you are likely to outlive in order to beat the IRS at this game.

## **Qualified Personal Residence Trusts**

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A second problem results from improvements made to the house while it is owned by the Residence Trust. Capital improvements, such as major renovations or additions, constitute new gifts and will require a gift tax to be paid or further use of your lifetime gift tax exemption.

Finally, when the term of the residence trust ends, your children (or other beneficiaries) will own the house. If you wish to continue living there, you must pay the owners fair market rent. If you stay but don't pay, the IRS can tax your estate for the full value of the house on the date of your death. Paying rent isn't as bad as it may seem. For every dollar you remove from your estate, you will deprive the federal government 45 cents in death taxes. Rent is not computed as part of your annual gift amounts, and can allow you to move additional assets, gift and estate tax free, to your family.

## **Family Limited Partnerships**

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Recent developments at the IRS have focused a great deal of attention on Family Limited Partnerships (FLP) as a means of reducing or eliminating federal estate taxes. By using the FLP, you can transfer assets to your family, utilizing the annual gift tax credit, without parting with any cash, or losing control of the assets owned by the partnership. The FLP is usually composed of real estate holdings, but most types of investment assets (and sometimes life insurance), can be held alone, or in conjunction with real estate in the FLP.

One of the problems with outright gifts is the loss of control that follows such transfers. That can be a problem with real estate, as all of the owners (and sometimes their spouses) of a parcel of property must sign deeds or mortgages for the property. The opportunity for disagreement increases as more owners are added.

A FLP resolves this problem by vesting all management and control of the partnership assets in a general partner, whose overall interest usually is small, sometimes less than 5%. The remaining interests are owned by the limited partners, who are deemed "investors" only with no ability to remove the general partner or to control the partnership decisions. It is the limited partnership interests that are given away each year to your family, insuring that you maintain control over your hard-earned assets owned by the FLP. For each year the gifts are made, your estate will be reduced and the amount given away escapes estate taxation. These transfers put more of your assets in the hands of your family, and less in the hands of Uncle Sam!

Ordinarily, the ability to make gifts while retaining control would seem to be sufficient to recommend the FLP as an estate planning device, but there is more to it than meets the eye. The FLP Agreement generally restricts the ability of the limited partners to give away or sell their interests or shares.

This lack of marketability reduces the value of the partnership interests to others. The lack of control over management of the partnership further reduces the value of the limited partner's interests. Each annual gift of a minority interest is eligible for these discounts. Lack of control adds to the amount discounted.

For example, assume that a 15% discount can be justified for lack of control, and that a 15% discount can be justified for lack of marketability. Limited partnership interests representing \$14,285 can be transferred at a gift tax value of \$10,000. Multiply the extra value of assets transferred by the number of beneficiaries in your family (children and grandchildren), and it is not hard to see why the FLP has become so popular in estate planning circles as a means for quickly reducing your estate tax exposure.

## **Family Limited Partnerships**

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When you die, your estate may also be eligible to apply a discount on the value of the limited partnership interests you retained. Using the same discounts in our example above, a person's estate, consisting of \$2,857,000 of limited partnership interests could avoid estate taxation utilizing the \$2,000,000 exclusion available in 2006. Remember, the lower the date of death value of your estate, the lower your estate tax bill.

A FLP must be operated according to the rules set out in the agreement, and should never be funded with assets needed to maintain your lifestyle expenses. Recent IRS victories in court have emphasized the need to operate a FLP as a business rather than a personal investment account.

The advantages of the FLP are:

- ◆ Only the general partner's signature is needed to sell the Partnership property, vesting sole control in the general partner.
- ◆ The general partner can be paid a "reasonable" compensation for duties performed, allowing the general partner latitude in distributing income. Discounts can be generated for FLP shares, to "turbocharge" your gifting program.
- ◆ Transfers by your beneficiaries is prohibited, insuring that the benefit of your work and investment remains in the family.

## **Retained Income Trusts**

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Many times our clients will not consider transfers of property during their lifetime because of their need to receive the ongoing income stream produced by that asset. The retained income trust is an example of how an asset or investment item can be gifted, while at the same time retaining a right to the income produced.

With Retained Income Trusts, you give the asset to a trust that pays you an income for a period of years. Your retained right to the income has a value, just as your retained right to use a residence has value when using a Qualified Personal Residence Trust. The more years that you receive the income, the less the value of your gift (the remainder interest) to your heirs. Since the "gift" to your heirs is a right to use the trust property sometime in the future, you cannot use your annual gift tax exclusion to avoid gift taxes. To eliminate gift taxes, you will need to use part of your estate tax exclusion. But the value of the gift has been substantially reduced by your right to receive the income, which means that less of this tax credit will be needed to pay the gift tax now, rather than estate taxes due at death. At your death, the trust is not included in calculating your estate tax, so that all growth and appreciation occurring after you make the gift to the trust will escape estate tax.

A Retained Income Trust can be constructed to pay all of the income produced to you for a term of years. This is a Grantor Retained Income Trust ("GRIT"). The trust can be designed to pay a fixed return, like a savings account. In this case the trust is a Grantor Retained Annuity Trust ("GRAT"). Or the trust can be written in such a way to pay a fixed percentage of the value of the trust property, including its growth, on an annual basis. This is a Grantor Retained Unitrust ("GRUT").

We would be happy to assist you in the mathematical calculations needed to determine whether a GRIT, GRAT or GRUT is right for your situation.

## Charitable Trusts

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Gifts to schools, churches or synagogues, or other equally worthwhile causes happen every day. As we have discussed in this brochure, when you die, the IRS will get a share of what you own. But, anything you leave to a charity escapes an estate tax. There are several ways that you can secure the benefits of charitable giving.

First, you can create a Charitable Remainder Trust ("CRT") during your lifetime. Like the Retained Income Trusts, you keep the income produced during the period set out in the trust, or for your lifetime. Since you create the trust, you get to choose how long it is to last. At the end of the trust term, whatever is left in the trust goes to the charity you named to benefit from this arrangement. A variation of this is the "Charitable Lead Trust ("CLT"). As you might guess, with a CLT the charity gets to use the trust income for a period of years, and then it comes back to you or your heirs.

Many times our clients have assets that they have owned for a long time, and which were purchased at a cost much less than their current value. A sale of these assets would generate a type of income tax called capital gains. The current federal capital gains tax rate is 15%. The payment of the capital gains tax reduces the amount of the value of your property you can use. A popular use of charitable trusts is to give highly appreciated assets to the trust. Charities do not pay capital gains tax, and can sell assets without incurring tax liability for you. In this way, you can receive income from 100% of the value of appreciated property, rather than the 85% remaining after payment of tax.

The creation of a charitable trust reduces your estate tax by removing part of the gifted asset's value from your estate. It avoids gift tax, because gifts to charities are favored under the tax laws. You can also take an income tax deduction for the value of the gift going to the charity. This method of advanced planning produces "triple tax" benefits for you and your family.

## Generation Skipping Transfer Trusts

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Your wealth will be taxed twice - once when you die and once when your child dies. There is a way to prevent the IRS from getting that second chance at your estate if you use a generation skipping transfer, or a skip trust. What a skip trust does is this: income is provided for your child for his or her lifetime from the trust, but your child does not own or control the property in the trust, and at your child's death, your grandchildren get the property, without being subject to estate tax arising from your child's death.

Suppose John Doe creates a skip trust for his grandchildren, using as the gift to the trust \$2,000,000. At John Doe's death there is no estate tax due for the lifetime transfer, as the estate tax exemption eliminates the payment of gift or estate tax to the IRS. The children get the use of the money for the balance of their lives. At their death the trust passes to the grandchildren, free of estate tax, allowing your children to distribute their estate, up to their estate tax exemption limit, tax-free, in addition to the amounts in the skip trust. If the trust produces 5% income per year, and your children live 20 years beyond your death, they will receive the full value of the original transfer to the skip trust, without the burden of unnecessary estate taxes. With proper planning the trust principal, the amount you put into the trust, can grow without an increase in estate taxes.

There are some limits to how much you can transfer tax-free using a skip trust. The IRS has gotten wise to this type of plan to avoid taxes. The tax code now provides for a Generation Skipping Transfer Tax (the "GST Tax") which imposes a horrendous tax on any skip trust or other generation skipping transfer in excess of \$2,000,000. This exemption allows a married couple to each utilize the GST Tax exemption so that your grandchildren could be the beneficiaries of a skip trust worth over \$4,000,000 without the excessive GST Tax. This method of planning is very complex, due to the high tax rate, and requires coordination with your other plan documents and, in some cases, your children's plan documents.

## **Self Canceling Installment Notes**

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Have you ever wondered what would happen in this scenario? You sell an asset to one of your children, and take back a promissory note for the purchase price. Your child pays you on the note every month, including interest, but before the note is paid off, you die. Instead of owning the asset, you own the note and, at your death, the balance remaining on the note is part of your estate, subject to estate taxes.

Imagine instead that you provide in the note that at your death the obligation to repay the note is terminated. At your death this piece of paper is worth nothing, and therefore no estate taxes would be due on this asset. This type of note is called a Self Cancelling Installment Note, or SCIN, and in order to take advantage of the tax savings features of a SCIN, certain rules must be followed.

First, the note itself (and any contract for sale of the asset) must include the cancellation feature. If your will cancels the note, this is a bequest for value, and will be subject to estate taxes. Second, as the seller of the asset, you cannot retain any control over the property you sell to your children. Retaining control causes an estate tax to be imposed. The property sold can be collateral for the note, however, without causing any impermissible control for estate tax purposes. Finally, in sales between related parties (family members), it will be necessary to include a premium for the cancellation feature. This will take the form of an increased price, subject to calculations on the seller's life expectancy, or an increased interest rate, or perhaps both.

However, since the use of a SCIN is relatively unsettled in terms of estate and income tax treatment at death, this type of planning will involve complex computations to determine the value of the note and will require you and your income tax advisor to consider the effects of the sale in exchange for a SCIN. In spite of the risks, SCIN's offer an excellent planning alternative.

## Conclusion

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Estate and gift taxes are complex and expensive. The tax code offers us many alternatives for avoiding these oppressive taxes, at a rate of 45% on all assets owned at death. The purpose of this article is to identify and briefly summarize the complex concepts of some popular tax planning opportunities so that you may discuss them in detail with us or your income tax advisors.

The methods we have reviewed in this brochure range from the very simple, annual giving, to the more complex, skip trusts and SCIN's. This is not an exclusive list. It is merely a review of some of the most prevalent planning methods available to the majority of people facing the specter of gift or estate taxes. What will be right for you will depend on a variety of factors, including:

- ◆ Your family and their abilities.
- ◆ Your property and what it's worth.
- ◆ Your cash needs for the rest of your life.
- ◆ Your charitable inclinations, if any.

As with your will or Revocable Living Trust, it is imperative that you consult with an experienced estate planning attorney and/or tax advisor regarding these or other estate or gift tax planning strategies. The lawyers at Midgett & Preti PC have been helping families preserve their estates from unnecessary taxes since 1978. With our experience we can review the methods of planning your estate that are most appropriate for you and compatible with your current situation and needs. Please feel free to call us at **(757) 687-8888** to set an appointment to discuss one or more of these estate, gift or income tax savings techniques.

You'll have the peace of mind that comes from knowing that you have done all that you can to provide for your family and protect your hard earned assets.

*This article was prepared by Midgett & Preti PC and is intended to provide general advice only. For answers relating to a specific situation, you should consult a competent estate-planning lawyer.*