FOULSTON

ATTORNEYS AT LAW

Foulston Siefkin Estate Planning:

WHAT GENERAL STRATEGIES CAN MINIMIZE FEDERAL ESTATE TAXATION?

Taxes were invented by governments to prevent citizens from hoarding money.

-Winston Churchill

Over and over again, courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everyone does so, rich or poor, and all do right, for nobody owes any public duty to pay more than the law demands.

-Judge Learned Hand

Gifts during lifetime or at death do not subject the donee (the gift recipient) to any income tax liability. However, the federal government does impose a transfer tax on taxable lifetime gifts and transfers made or taking effect at death. The only deductions (other than for administration expenses at death) are for gifts or bequests made to a charity or surviving spouse, both of which are fully deductible. Against this transfer tax, there is a credit (the "applicable credit amount") offsetting a specified amount of taxable transfers (the "applicable exclusion amount") which applies against both lifetime and death transfers. Currently, the federal tax rate is 40% once the applicable credit amount is exhausted. The gift and estate tax credit is termed "unified," as any remaining credit not utilized on lifetime gifts is available for assets remaining in an individual's taxable estate at death. Estates of a value in excess of the decedent's remaining applicable exclusion amount are required to file a federal estate tax return. The return (Form 706) is due nine months following the decedent's death, unless a six month extension is requested. In 2012, the estate tax applicable exclusion amount is increased to $5.0 million, and indexed to increase annually for inflation.

Doubling the Benefit of the Applicable Exclusion Amount for Married Persons

With proper planning, the benefit of the applicable exclusion amount can often be made available to both husbands and wives, thereby sheltering a total of twice the applicable exclusion amount. Normally, this is done by leaving an amount equal to the applicable exclusion amount in trust for the surviving spouse. The surviving spouse may have access to the trust assets for health, maintenance and support needs without the trust assets being includible in the surviving spouse's estate, irrespective of the amount such assets may have appreciated to during the surviving spouse's lifetime.

Using Valuation Discounts

Individuals may also use valuation discounts to reduce the size of their taxable estates. The applicable criterion for valuing assets for gift or estate tax purposes is the fair market value of such assets, i.e., what such property would sell for in an open market with both the buyer and seller being apprised of all relevant facts and neither party being under any compulsion to buy or sell. Thus, if property would otherwise be discounted by an appraiser applying this criterion due to the property not having a ready market for sale (e.g., an interest in a closely held business, corporation, family limited partnership or limited liability company), being only a fractional interest in property (e.g., an undivided interest as a tenant in common in real property), or not being a controlling interest in an entity (e.g., a 49% voting interest in an entity such as a corporation, family limited partnership or limited liability company), such resultant valuation reductions (which can range from perhaps 10%-60% depending on the circumstances) are applicable in valuing such

© 2014 Foulston Siefkin LLP

property for gift tax purposes as well as estate tax purposes in the decedent's estate. This is normally the case even if the total value of the property to the family is unreduced due to the other interests in the property being owned by other family members such as a spouse or children. Through proper estate planning, family property can be transferred to an entity or fractionalized among other family members to maximize the valuation benefits of such property interests for gift tax purposes upon a later transfer of such property to other family members as discussed below, as well as for estate tax purposes following death.

Gifts

Lifetime gifts within the annual exclusion are not taxable and thus do not use up any of the unified gift and estate tax credit. The annual exclusion amount has been indexed for inflation, increasing in $1,000 increments when inflation adjustments merit such increase. The annual exclusion is currently $14,000. Thus, any individual currently can give $12,000 to any other person every calendar year without utilizing any of the credit. For example, in gifting to five individuals, the total of such gifts within the current annual exclusion would be $70,000 every year. The same exclusions also would also apply to gifts made by the donor's spouse.

There is a special benefit accorded spouses under the gift tax laws. Any spouse can, with the consent (which must be made on a gift tax return filed with the Internal Revenue Service) of the other spouse, deem all gifts made by either spouse during the calendar year to have been made one-half by the other. For example, a husband wishing to give $28,000 of his own assets to one person, with his wife's consent, could deem such $28,000 gift to be made one-half by his wife, thus reducing the gift made by each for gift tax purposes down to the $14,000 level within the annual exclusion.

There is also a special exemption for gifts for medical care or education. Gifts for medical care and education (limited to tuition) are gift tax free and are thus not subject to annual exclusion limitations. However, to fall within this special exemption, gifts must be made directly for the donee's benefit to the educational institution or medical care provider. Otherwise, because there would be no assurance that such gift would be so used if gifted to the donee, this special exemption does not apply.

In circumstances where outright gifts to individuals are undesirable (as, for example, in the case of minor children or grandchildren, to keep the gifted assets from being subject to inclusion in a beneficiary's taxable estate, to protect beneficiaries from the claims of spouses or creditors, or such outright gifts are not conducive to family harmony considerations due for example to increasing expectancies of future gifts or there are unequal numbers of individuals between each family group consisting of a child and such child's children, they can be made to an irrevocable trust with provisions allowing the gift to qualify as a "present interest" eligible for annual gift tax exclusions (normally through short-term withdrawal rights given to beneficiaries which are referred to as "Crummy" powers). The trust could be created for one or more beneficiaries. The provisions of the trust would name the Trustee(s) and control when beneficiaries are to receive distributions from the trust, in what amounts or for what purposes. The donor may serve as Trustee, but normally may not be a beneficiary of the trust if the trust assets are to be excludable from the Grantor's estate for federal estate tax purposes. However, with proper drafting, the donor's spouse may be both a beneficiary and Trustee of the trust, and both the donor's and donor's spouse's annual gift tax exclusion may be utilized for the donor's gift to all beneficiaries of the trust other than the spouse, all without the trust assets being includible in either the donor's or donor's spouse's estate for federal estate tax purposes. If the donor or donor's spouse is serving as a Trustee, the income of the trust will remain taxable to the donor, irrespective of to whom the trust income is distributed pursuant to the terms of the trust instrument.

In addition, the donor, even if not serving as Trustee, may control who or what entity is serving as Trustee. If gifts are made in trust, in a properly drafted irrevocable trust, such gifts can qualify for the annual exclusion for all descendants of the donor who are beneficiaries of the trust. Moreover, unlike outright gifts made to children and grandchildren, the provisions of the trust can provide that upon termination of the trust (usually upon the donor/grantor's death) each child and such child's descendants can be left an equal share of the trust assets either outright or to continue in trust for their benefit. Had the gifts been made outright, a family grouping consisting of a child and such child's descendants would receive a greater benefit if such child had more descendants than another child.

Life insurance is a particularly good candidate for gifting to an irrevocable trust, as it often has little value during lifetime, but could cause a substantial federal estate tax liability. The entire death benefit of a life insurance policy will be included in the insured's estate if ownership of the policy is retained by the insured until death. Without causing trust assets to be includible in the Grantor's estate, the irrevocable life insurance trust (or "ILIT") may lend money to the insured's probate estate or Revocable Trust estate (or purchase assets from the probate estate or Revocable Trust

© 2014 Foulston Siefkin LLP

estate) at death in order to provide liquidity to pay debts, expenses or taxes. If the insured is married, the ILIT may also provide for the needs of a surviving spouse before trust assets are distributed following the surviving spouse's death either outright or in trust to children or other beneficiaries.

Gifts to individuals under the age of 21 can also be made to a Custodian under the Uniform Transfer to Minor's Act (UTMA). This is an inexpensive and a relatively simple procedure effectuated through titling with reference to the UTMA without having to resort to the creation of a trust. Under the UTMA, the Custodian may hold any type of property and spend it for the minor's benefit, e.g., health, maintenance and education. The drawbacks are the property belongs to the beneficiary of the account at 21, there can be only one custodian and only one beneficiary of the account, and if the beneficiary dies before age 21, the UTMA property becomes part of the probate estate of the beneficiary (thereby normally, unless the beneficiary leaves surviving children or a spouse, passing back to parents under the law of intestacy), rather than going automatically to other beneficiaries. Further, if the donor of the property serves as Custodian, the entire account will be in the Custodian's estate for federal estate tax purposes should the Custodian die before the account is distributed. For these reasons, although gifts under the UTMA qualify for the annual gift tax exclusion, they are normally not utilized for gifting substantial amounts.

Any gift which exceeds the annual exclusion and does not fall within the education or medical exception discussed above will result in a taxable gift which uses up some of the applicable unified credit amount. The available credit is exhausted with regard to taxable gifts once cumulative taxable gifts during lifetime exceed $5.0 million, as indexed. In that situation, the taxable estate would have to exceed the applicable exclusion amount (currently $5,340,000) before there would be any estate tax owing. If the taxable estate will not exceed the applicable exclusion amount (or two applicable exclusion amounts for married individuals utilizing estate planning techniques which permit each of them to secure the benefit of the applicable exclusion amount), there is no gift or estate tax benefit to making gifts during lifetime because there would be no estate taxes owing even in the absence of such gifts at death.

For larger estates currently in excess of, or likely to appreciate to a value greater than, the applicable exclusion amount, gifts should be considered. It is better to use annual exclusion gifts whenever possible, as these do not reduce the donor's applicable exclusion amount. However, there may be insufficient annual exclusions available to sufficiently reduce the size of the donor's estate over a reasonable period of time. In that situation, it might appear that gifts in excess of the annual exclusion would be a "wash" and not of any long-term benefit, since such gifts would have the effect of proportionately reducing the applicable credit amount (which would otherwise be available to offset the amount of the taxable gift) at death. There are, however, two potential advantages. First, as gifts are valued for gift tax purposes at time of gift, all subsequent appreciation and income from the property after the date of gift would be excluded from the donor's taxable estate, thereby lowering estate taxes by the amount of estate taxes such income and appreciation would have incurred had the gift property been retained. For most gifts (a notable exception being gifts of life insurance policies), the old pre-1981 "contemplation of death" rule, whereby gifts made within three years of death are brought back into the estate, is no longer applicable. Thus, these benefits usually will be obtained irrespective of how long the donor lives after making the gift.

Secondly, although gift and estate taxes are "unified," for total taxable gifts which exceed the current $5.0 million as indexed, applicable exclusion amount, the effective rate of tax imposed on a gift is less than the effective rate of tax imposed at death. This is because the gift tax is a tax imposed on the amount of property given away, which does not include gift taxes paid by the donor. The estate tax, on the other hand, is imposed on all property in the taxable estate, including the property that will be owing to the government for estate taxes. However, if an individual makes a taxable gift, pays the applicable gift tax, and then dies within three years, this tax advantage is lost, as the gift tax paid is required to be included in the estate for purposes of the estate tax computation.

Beyond giving up control of the gifted property, there also can be a detrimental income tax consequence in gifting property. Although gifts are not subject to income tax under the Internal Revenue Code, the Code provides that the donee of a gift normally takes the donor's income tax basis in the gifted property. For example, if a donor paid $10 for a share of stock and gave it to his son at a time it was worth one hundred dollars, his son would have a $10 tax basis in the stock. The son thus would recognize a taxable gain of $90 if he later sold it for $100. However, had such stock been retained by the decedent until death, the decedent's heirs would have taken as their income tax basis the fair market value of the stock at the time of death (the so-called "step-up" in basis). If this date of death value is one hundred dollars, the difference between the fair market value of the stock at the time of the decedent's death (one hundred dollars) and the decedent's income tax basis (ten dollars) would never be taxed. Of course, to the extent the gifted property at time of gift is worth no more than the decedent paid for it (after deducting any applicable depreciation on depreciable property), or is in the form of cash, there would be no "built-in" gain in the gifted property. Thus, it is preferable that gifted property have the lowest possible "built-in" gain.

© 2014 Foulston Siefkin LLP

It is important to note that the estate tax brackets for estates over the applicable exclusion amount are higher than the income tax rates on capital gains. The estate tax brackets, once the unified credit is exhausted, are imposed at a uniform rate of 40%. Under legislation enacted in 2003, the normal maximum capital gain rate is 20%. Consequently, the estate tax benefits of gifting within the annual gift tax exclusion, even if there is some "built-in" gain in the gifted property, normally substantially outweigh any income tax detriment which might result upon the later sale of the donated property. This is particularly true if the property is not likely to be sold until long after the donor's death, thereby deferring any capital gains upon sale. Capital gain also might not later be incurred at all if the donee retains the property until the donee's subsequent death, at which time the property would then receive a "step-up" in basis.

For gifts in excess of the annual exclusion, (i.e., taxable gifts), the same amount of applicable credit utilized in making the taxable gift would have been utilized had the decedent died immediately prior to the gift owning that same property. Consequently, for such gifts to be of a tax benefit, any income tax detriment in gifting property with a "built-in" gain (i.e., losing the "step-up") must be more than offset by the estate tax benefits of the subsequent income and appreciation from the property accruing after the transfer being out of the donor's estate. Obviously, the older the donor in such circumstances, and the greater the amount of "built in" gain on property at the time of a gift, the less likely such taxable gifts will be of an overall long-term tax benefit.

There is also a tangible non-tax benefit in making lifetime gifts which should not be overlooked. A donor is able to see the donees (normally children and/or grandchildren) derive pleasure and benefit from the gifted property during the donor's lifetime.

Determining the value of the taxable estate at death commences with calculating the fair market value of the entire estate. Generally, this includes any property, whether going through probate or not, which the decedent owns directly or indirectly, such as real property, cash, retirement plans, and any life insurance death benefits. It also includes certain property previously transferred in which either an interest has been retained, or for certain limited types of property, such as life insurance policies, transferred within three years of death. This gross value is then reduced by deductions for debts, administrative expenses, and transfers to a spouse or charity. The applicable credit amount is available to every person. With proper planning, husbands and wives have enough unified credit to avoid gift and estate taxation on two applicable exclusion amounts.

Trusts created for spouses, children and other beneficiaries of the decedent's estate in order to keep assets out of their estate for estate tax purposes, also have many other desirable benefits (e.g., asset management, asset protection, and income tax savings) to trust beneficiaries. These benefits would be lost if the Will or Revocable Trust provisions were amended to provide for outright distributions. In addition, it is possible, but not a current trend, that states, in the face of budgetary problems, may enact legislation increasing their state death taxes. Assets left in trust for beneficiaries are substantially protected from incurring any state tax liability upon the death of a trust beneficiary.

Farms and Closely Held Businesses

Taxpayers owning farms and family-owned businesses may qualify for special estate tax treatment. Since 1976, provided there is the requisite material participation of family members in agricultural property prior to death and the adjusted gross estate consists of a certain requisite percentage of real property (25%) and all agricultural property (50%), agricultural real property can be valued at its use value (based upon its income for agricultural purposes), rather than its fair market value. The maximum reduction in value achievable from fair market value using a use value appraisal is $750,000. Under the Taxpayer Relief Act of 1997, this $750,000 amount was indexed for inflation for tax years after 1998. This benefit is available in addition to the applicable exclusion amount. With proper planning, this benefit can often be made available to both husbands and wives.

Estates utilizing special use value not only have strict material participation requirements of family members prior to death, but family members are also required to participate following death. If such participation does not continue for at least ten years following the decedent's death, the IRS can recapture all or a portion of the additional estate tax benefits achieved by using these provisions.

Farms or family-owned businesses constituting at least 35% of the adjusted gross estate are also eligible for installment payment of estate taxes attributable to such property. Only interest is owed on such estate tax liability for the first four years, with installments of the tax and interest payable over the next 10 years. For qualifying estates, there is a very favorable interest rate of 2% per annum on the tax liability on the first $1.0 million dollars of the taxable estate of such farm or closely held business in excess of the applicable exclusion amount and any other applicable provisions which

© 2014 Foulston Siefkin LLP

reduce the estate tax liability. For any taxes resulting from the taxable value of the farm or closely held business being in excess of such $1.0 million dollar amount, there is a favorable interest rate applicable to such tax liability which floats at a level considerably below the interest rate the federal government pays on Treasury bills.

These federal statutory provisions benefiting farms and family-owned businesses are very complex. Careful estate planning is thus necessary to ensure that applicable farms and family-owned businesses qualify for, and maximize, these benefits.

Conclusion

Estate planning to utilize two applicable exclusion amounts for married persons, employ valuation discount strategies, and the making of gifts are the basic staple of estate planning attorneys in minimizing the estate taxation of their clients. These techniques are quite beneficial and can save substantial amounts of estate taxation in estates which would otherwise exceed the applicable exclusion amount. However, they should not be implemented without the advice of an experienced estate planning attorney.

In the event estate taxation cannot be totally avoided through the use of such strategies, other sophisticated strategies can be employed. Some of these strategies use time value of money and property tables of the Internal Revenue Service in structuring transactions to the advantage of the taxpayer. Within this category are what are termed self-canceling installment notes, private annuities, grantor retained annuity trusts, and installment sales. Another strategy is to structure gifts or sales to irrevocable trusts in a manner in which the income of such trusts remains legally taxable to the person creating the trust while the assets remain outside such person's taxable estate. The trust assets in such "intentionally defective" (for income tax purposes) trusts will grow income tax free outside such person's estate with the payment of the income tax thereon by such person not constituting a taxable gift to the beneficiaries of the trust. The discussion of such other techniques is outside the scope of this summary.

Foulston Siefkin's Estate Planning and Probate Group

Foulston Siefkin LLP, the largest Kansas law firm having offices exclusively in the state of Kansas, has more than 90 attorneys and is headquartered in Wichita, Kansas. The firm has additional offices in Kansas City and Topeka. The firm's Estate Planning and Probate Practice Group currently consists of eleven attorneys who collectively practice in all significant estate planning, probate and trust areas. Viewers are invited to click here for information on the Group's practice areas and attorneys, law summaries of estate planning areas of special interest, regional and national estate planning articles authored by Group attorneys, related links and other estate planning information which may be of interest.

Note: The summary above is copyrighted and the duplication of any of its contents which is not specifically authorized by an attorney in Foulston Siefkin's Estate Planning and Probate Practice Group is strictly prohibited. This document has been prepared by Foulston Siefkin for informational purposes only and is not a legal opinion, does not provide legal advice for any purpose, and neither creates nor constitutes evidence of an attorney-client relationship.

For Further Information

Foulston Siefkin regularly counsels clients on issues relating to Estate Planning and Probate. If you are interested in additional information regarding these matters, please visit our website at **www.foulston.com** or if you would like to discuss specific ways in which Foulston can help you, contact Tim O'Sullivan at 316.291.9564 or **tosullivan@foulston.com**, or Stewart Weaver at 316.291.9736 or **sweaver@foulston.com**, or Matt Bish at 316.291.9729 or **mbish@foulston.com**.

####

Established in 1919, Foulston Siefkin is the largest law firm in Kansas. With offices in Wichita, Kansas City, and Topeka, Foulston provides a full range of legal services to clients in the areas of administrative & regulatory; antitrust & trade regulation; appellate law; banking & financial services; business & corporate; construction; creditors' rights & bankruptcy; e-commerce; education & public entity; elder law; emerging small business; employee benefits & ERISA; employment & labor; energy; environmental; ERISA litigation; estate planning & probate; family business enterprise; franchise & distribution; government investigations & white collar defense; governmental liability; government relations & public policy; healthcare; immigration; insurance regulatory; intellectual property; litigation & disputes; mediation/dispute

© 2014 Foulston Siefkin LLP

resolution; mergers & acquisitions; Native American law; oil, gas & minerals; OSHA; privacy & data security; private equity & venture capital; product liability; professional malpractice; real estate; securities & corporate finance; senior housing & care; supply chain management; tax exempt organizations; taxation; trade secret & noncompete litigation; water rights; and wind & solar energy. This document has been prepared by Foulston Siefkin LLP for informational purposes only and is not a legal opinion, does not provide legal advice for any purpose, and neither creates nor constitutes evidence of an attorney-client relationship.

© 2014 Foulston Siefkin LLP