THE SCIENCE OF GIFT GIVING

After the Tax Relief Act

Presented by

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AFTER THE TAX RELIEF ACT – AN ESTATE PLANNING UPDATE

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I. Introduction

A. Overview

People make lifetime gifts of property for a variety of reasons and motivations. In the context of federal estate tax planning, the objective is rather simple: to reduce the value ultimately subject to the federal estate tax. In attempting to accomplish this objective, the planner and the client have a number of options available, including doing nothing. The purpose of this program is to examine those options and their actual effectiveness in accomplishing that goal, while at the same time suggesting a method of analysis to assist in making that determination in individual situations.

In addition, the Tax Relief Act of 2010 has, for this year at least, altered the equation by raising the level of the Basic Exclusion Amount to an unprecedented level while at the same time lowering the estate and gift tax rates to a historic low of 35%. This raises the legitimate question of: *"should clients make lifetime gifts this year in order to take advantage?"* Although the answer may seem like an obvious yes, upon further reflection the true answer is more complex. The discussion must first begin with a look at federal estate tax planning advantages and disadvantages of making lifetime gifts.

II. Issues to Consider

A. Non Tax Issues

Before anyone should make transfers of significant property during their lifetime, there are a number of factors one must consider, including the following:

1. The estate planning objectives of the client;
2. The need for the client to retain control of his or her property during his or her lifetime;
3. The need of the client to retain income and value from his or her property; and
4. The desire to transfer property to family members for the lowest tax cost.

This program will focus primarily on the fourth objective, the desire to transfer the assets to family members at the lowest tax cost.

B. Tax Issue

Again, as referenced earlier, in the context of federal estate tax planning the question seems rather straight forward and simple: "*will a transfer of property today ultimately reduce the value subject to the* *federal estate tax?*" Rather, the real question should be: "*Will a transfer of property today increase the Net After Tax Value passing to the heirs of the transferor?*"

C. This Program

That straight forward question, however, can only be answered if one understands not only the various alternatives available for making the transfer, but also the ramifications of those alternatives. We will begin with an overview of the federal estate and gift tax system, which is called a "unified transfer tax system." We will then take a look at the various planning alternatives available to a practitioner and outline an analytical process that can be used to determine which alternative makes the most sense in each case. Finally, we will focus on the answering the initial question: "*should clients make lifetime gifts this year in order to take advantage of the Tax Relief Act changes?*"

III. Comparison of the Federal Estate Tax and the Federal Gift Tax

A. Overview of the Unified Transfer Tax System.

A basic understanding of the federal estate and gift taxes, how they are different and how they are the same, is fundamental to an understanding of when lifetime gifts make sense and when they do not. The federal estate tax is, together with the federal gift tax and the federal generation skipping transfer tax, a part of the federal unified transfer tax and credit system. Generally, the federal estate tax and the federal gift tax work in tandem. The fundamental objective is to make it a tax neutral decision as to whether one makes a lifetime gift or transfers his or her property at death. However, in spite of this inherent objective, there are important differences in the way the estate tax and the gift tax are calculated which can distort the calculation. These differences may make a lifetime transfer more or less advantageous than one made at death. These differences will be highlighted in the next section.

B. Comparing the Calculation of the Federal Gift Tax to the Federal Estate Tax.

1. Overview.

Let's begin by comparing the various steps which must be taken to calculate the federal estate tax and the federal gift tax:

a. Determine the Value Transferred

The federal estate tax is a tax on the gratuitous transfer of property at death. The federal gift tax is a tax on the gratuitous transfer of property during lifetime. Both taxes begin with a determination of the fair market value of the property interest transferred. Under the estate tax, the determination is made on the date of death. However, the federal estate tax also allows the determination of value to be made on an aggregate basis at an alternate valuation date six months after the date of death. Under the gift tax, the determination of fair market value is made as of the date of the transfer. The estate tax value is based on the value of property owned by the decedent while the gift tax is based upon the value of what is received by the individual donee. This is a subtle distinction, but one that will prove important.

b. Determine the Allowable Deductions

The next step in both calculations is to determine which, if any, deductions are available to the transferor or the estate. Estate deductions include expenses incurred by the estate during the period of administration as well as losses sustained by the estate during that period. In addition, a deduction is allowed for the value of qualifying property passing to a surviving spouse (a "martial deduction") and for testamentary gifts to qualifying charities. After subtracting these deductions from the fair market value of property transferred at death, the net result is the "taxable estate." In calculating the gift tax, deductions are also allowed for marital gifts and gifts to qualifying charities. After subtracting those deductions, the net result is the "taxable gifts."

c. Calculate the Gift Tax Exclusion

The gift tax then allows an exclusion of $13,000, per donee, per year (the "annual exclusion") for gifts of so-called "present interests."[1] Due to the annual exclusion, only gifts in excess of $13,000 to a particular recipient during the year are subject to the gift tax. As will be discussed below in **Section IV.C.,** the use of this exclusion can be a valuable planning device to reduce an individual's taxable estate.

d. Add Prior Transfers

After establishing the amount of the taxable estate or the taxable gifts, the next step in both calculations is to add to these amounts the aggregate value of the prior taxable gifts made by the donor during his or her lifetime (i.e., gifts made in prior tax periods in excess of any annual exclusions which apply to such gifts). The reason behind this step is not to tax the prior transfers a second time (a credit for the taxes paid on such transfers is allowed), but rather to insure that later transfers are subject to progressively higher marginal tax rates. The resulting total is termed the "tentative tax base."

e. Determine the Tentative Tax

[1] *The annual exclusion is currently $13,000 for gifts of "present interest". This exclusion applies each year against the gifts made to a particular donee. As a result, if the donor in a particular tax year makes a $50,000 gift to one donee, he or she would be entitled to one $13,000 exclusion; if the on the other hand the donor made two gifts of $25,000 each to two donees he or she would be entitled to two $13,000 exclusions.*

In both cases, the next step is to determine a "tentative tax" determined by using the unified rate schedule provided in §2001(c) of the Internal Revenue Code to the tentative tax base. The maximum tax rate for both taxes is currently 35%.

f. Determine and Subtract the Tax on Prior Transfers

The next step is to determine the gift tax that would have been due on prior taxable gifts had the current unified rate schedule been in effect at the time of those transfers. This amount is then subtracted from the tentative tax. By subtracting the tax on prior transfers, the effect of their inclusion in the tentative tax base is offset.

Note: The gift tax subtracted in this step is the tax due on prior taxable gifts had "the current unified rate schedule been in effect at the time of those transfers." We will take a look at the possible ramifications of this so-called "claw back issue," discussed below.

g. Apply the Available Applicable Credit

The final step in the calculation is to determine the available "applicable credit" and offset that amount against the net amount determined in the step above. The net difference is the tax actually due.

Note: The "applicable credit" is a credit allowed by the Code against the federal gift and federal estate tax. The applicable credit available used to offset estate tax and gift tax is currently $1,772,800 which effectively exempts $5,125,000 (the "Basic Exclusion Amount") of taxable transfers.

The available applicable credit is computed by determining the applicable credit available for the year of the transfer, and the reducing that figure by the applicable credit used against tax in all prior periods. Any amount of the applicable credit which is used to offset gift tax reduces dollar for dollar the credit available to offset federal estate tax.

h. Example of the Gift and Estate Tax Calculation

In the current tax period, Mr. A made gift of $513,000 to his children. In the prior tax year Mr. A had made taxable gifts of $250,000. A year later Mr. A dies with a Gross Estate of $7,500,000, all of which is left to his children. The estate incurs $250,000, of deductible administration expenses. Here is the Gift and Estate tax Calculations:

Gift Tax Calculation		Estate Tax Calculation	
Value of gifted property	$ 513,000	Gross Estate	$7,500,000
Annual Exclusions	- 13,000	Deductions	- 250,000

Net Gifts	*$ 500,000*	*Taxable Estate*	*$7,250,000*
Prior Tax Gifts	*+ 250,000*	*Prior Tax Gifts*	*+ 750,000*
Tentative Tax base	*$ 750,000*	*Tentative Tax base*	*$8,000,000*
Tentative Tax	*$ 248,300*	*Tentative Tax*	*$2,780,800*
Tax on Prior Gifts	*- 70,800*	*Tax on Prior Gifts*	*- 248,300*
Gross Gift Tax	*$ 177,500*	*Gross Estate Tax*	*$2,532,500*
Available Credit	*$1,659,200*[2]	*Available Credit*	*$1,482,500*[3]
Allowable Credit	*$ 177,500*	*Allowable Credit*	*$1,485,500*
Tax Due	*-0-*	*Tax Due*	*$1,050,000*

2. Determination of Basis in the Hands of the Transferee

An important difference between the federal estate tax and the federal gift tax, which is not directly involved with the tax calculation but is very significant in assessing whether an inter vivos or testamentary transfer is appropriate, is the determination of the transferee's basis in the property transferred. The transferee of gifted property generally takes the transferor's basis in the transferred property (i.e. "carry over" basis) while the transferee of estate property receives a "step up" in basis equal to the property's federal estate tax basis, which is the fair market value on the date of death or the alternate valuation date. Depending on the level of the "step up," this difference may create a significant tax justification for keeping property in the estate rather than making a lifetime transfer.

3. Comparison of the Estate Tax and the Gift Tax

Let's compare how the estate tax and the gift tax the same and how there are different:

Here's how they are the same:

- *Both taxes are based on the fair market value of the property transferred.*
- *Both allow deductions for qualifying transfers to spouses and charitable organizations.*
- *Both taxes gross up the tax base for the value of prior taxable transfers.*
- *Both allow an offset of tax based on the grossed up tax base for the taxes paid on those transfers.*
- *Both calculate the tax due based on the same unified rate schedule.*

[2] 2011 Unified Credit of $1,730,800 reduced by $70,800 Tax on Prior Gifts.

[3] 2011 Unified Credit reduced by tax on Prior Gifts of $248,300.

Here's how they are the different:

- *The gift calculation is based on the value of the transfer on the date of the transfer*
- *The estate is based on the value of the transfer on the date of death or the alternate valuation date.*

- *The gift tax is based on the value of the property interest received by the transferee.*
- *The estate tax is based on the value of the property interest held by the estate.*

- *The gift tax calculation allows an annual per donee exclusion while the estate tax has no comparable exclusion.*

- *Both the gift tax and the estate tax together allow a credit of $1,772,800 which effectively exempts $5,125,000[4].*

- *The gift tax excludes the gift tax payable from the tax base while the estate includes the estate tax payable in the tax base.*

- *The gift tax is due on April 15th of the year following the transfer while the estate tax is due nine months after the date of death.*
- *The estate tax allows for a 15 year deferral of the tax due on the value of closely held business while the gift tax does not.*

- *The transferee of the gifted property takes the transferors basis in the transferred property (i.e. "carry over" basis) while the transferee of estate property receives a "step up" in basis equal to the property's federal estate tax basis.*

In the areas where the taxes are similar there is little tax advantage in making lifetime transfers as opposed to transfers at death. It is the areas where the taxes are different that the planning advantages and disadvantages lie.

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[4] It should be noted that this amount will be reduced by any exemptions used during lifetime to exempt gifts

IV. The Case for Testamentary Transfers

A. Overview.

There are certain advantages in retaining property in the estate rather than making inter vivos transfers. The more important of these advantages are discussed in this section.

B. Step Up in Basis

One of the primary advantages of retaining any property interest within the estate of the owner is the availability of the "step up" in basis. In situations where the estate tax incurred is less than the tax benefit of a step up in basis, an inter vivos transfer may not be advisable. Because the top estate tax rate is 35% and capital gains are currently only taxed at 15%, larger estates may have difficulty finding such a benefit. However, since $5,125,000 of the value from every estate is not taxed, potentially $10,250,000 for a married couple, it is the effective tax rate that is relevant. Further, because of the nature of the unified transfer tax system, an inter vivos transfer of property does not avoid the transfer tax but simply taxes the current rather than future value.

Here is an illustrative example:

> *Property has a fair market value of $100,000, and a basis of $100,000. It is predicted that over the remaining life expectancy of the owner the property will appreciate to a value of $1,000,000. Is it better to transfer the property by lifetime gift or is it better to keep the property in the owner's estate and transfer it at death. That depends – on the taxability of the owner's estate. If we assume this is the owner's only asset – keep in the estate – here's why – by keeping it in the estate – because the estate is under the Exemption Amount no estate tax will be incurred – What will be lost however is the step up in basis to $1,000,000. If the asset is a capital asset this could cost the owner's heirs tax benefit potentially worth $135,000. That is the $900,000 basis step up times the long term capital gain rate of 15%.*
>
> *On the other hand if the asset were included in the estate and taxed at 35%, an inter vivos gift of the property might be advisable – the gift would remove $900,000, from the taxable estate, resulting in a tax savings of $315,000, compared to the tax benefit of the step up of only $135,000.*

C. Chance to Defer Tax

1. Overview

Since estate tax is not due until nine months after the date of death, an estate has the potential to take advantage of the deferral by retaining and reinvesting funds which will ultimately fund the tax liability. Whether this actually works to the advantage of the estate will depend on the particular case.[5] In addition

[5] *Example: Ignoring the Basic Exclusion Amount, applicable exemptions $10,000,000 retained in the estate will generate an estate tax of $3,500,000 leaving net $6,500,000, for the heirs. If that same amount were gifted and used to pay the gift tax a net gift of $7,407,407, leaving 2,592,592, to pay the 35% gift tax.*

the federal estate payment may also be deferred beyond the otherwise due date if it can meet the requirements of IRC Sections 6166, 6163, or 6161.

2. Sec. 6166

IRC Section 6166 provides for an additional extension of time for the payment of the estate tax where an estate consists of a specified percentage of one or more interests in a closely held business. If the gross estate of a U.S. citizen or resident includes an interest in a closely held business valued at more than 35% of the adjusted gross estate, the executor may elect to pay part or all of the estate tax in two or more (but not more than (10) equal installments.[6]

3. Other Estate Tax Delayed Payment Opportunities

a. Section 6163: Reversions and Remainders

IRC Section 6163 provides for an extension of the time for the payment of estate tax attributable to inclusion of the value of a reversionary or remainder interest in property. The right to elect this tax payment extension is limited to reversionary and remainder interests. At the election of the executor, the estate tax payment can be postponed until six months after the precedent interest in property is terminated. The postponement is limited to the estate tax attributable to the interest in the property. A further deferral is permitted for no more than three years when the IRS finds "reasonable cause."

b. Section 6161: Commissioner's Discretion

The IRS can exercise discretion in permitting the deferral of estate tax liabilities in circumstances that do not qualify for postponement under the elective provisions described above. The IRS can extend the time for paying the tax for a "reasonable period" not to exceed twelve months. The effect of a twelve-month extension is to make the tax due twenty-one months after death. Upon the expiration of the extension period, the estate may apply for another extension. The IRS can grant an extension of the time to pay estate taxes for up to ten years if "reasonable cause" exists.

Reasonable cause might exist, for example, because estate assets cannot produce sufficient present cash to pay estate tax liabilities and a significant economic loss would be inflicted on the estate if these assets were required to be sold at distress prices. The assets might be located in several different jurisdictions and not be otherwise immediately subject to the control of the executor. Alternatively, a claim to substantial assets might not be collectible without litigation, thereby postponing liquidity in the estate and

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[6] *The "adjusted gross estate" is the value of the decedent's gross estate reduced by deductions allowable under §2053 and §2054 of the Internal Revenue Code. Interests in two or more "closely held business" may be combined and treated as a single business interest for the purposes of the 35% test if at least 20% of the total value of each business is included in the decedent's gross estate.*

the availability of cash for estate tax payments. The Service will want to examine all the relevant facts and circumstances to verify that reasonable cause does exist for a payment extension.

V. The Case for Inter Vivos Transfers

A. Overview: The Tax Strategy of Gift Giving.

The case for making inter vivos gift transfers of interests in property lies in the opportunity to reduce the value that is ultimately subject to transfer tax. Lifetime transfers can achieve a meaningful and permanent reduction of that value in several ways. First, if the property is appreciating property, a lifetime transfer will remove any post transfer appreciation from the taxable estate. In addition, if the property is income producing property, the post transfer income will also be removed. Another aspect of the gift tax that is often not considered is the fact that the tax paid on inter vivos gifts is effectively removed from the tax base, while in the case of the estate tax, the tax is included and taxed in the tax base. Finally, there is the ability to discount the taxable value transferred by taking advantage of the annual exclusion and certain discounting techniques, discussed below. The primary disadvantage in making lifetime gifts to be considered is the loss of the step up in basis that occurs when assets are retained in the taxable estate until death.

B. The Availability of the Annual Exclusion and Gift Splitting.

1. The Annual Exclusion

The Internal Revenue Code allows for an exclusion from gifts of $13,000,[7] per donee per year (this is called the "annual exclusion") for gifts of “present interests.”[8] As a result, a single transferor may deduct $13,000 from the taxable transfers made to each transferee each year. The value that qualifies for the annual gift tax exclusion is never taxed. Over time, following a plan of annual gift giving can remove significant value from the taxable estate by taking advantage of the annual exclusion. In order to qualify for the annual exclusion, the property interest transferred must constitute a gift of a "present interest." A present interest must grant the donee the immediate right to use, possess, and enjoy the gifted property. An outright gift will constitute a gift of a present interest, but a transfer of property in trust may or may not constituted a gift of a present interest, depending on the terms of the trust.

2. Gift Splitting

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[7] *This figure is adjusted for inflation.*

[8] *A “present interest” is an interest that the donee has the present right to enjoy the ownership of the transferred property.*

Through a concept known as "gift splitting," a married couple can utilize the annual exclusion of both spouses in regard to a particular donee, even if only one spouse makes the actual transfer. Therefore, if in a particular tax year, a wife makes a $26,000 gift to a particular donee and the husband makes no gift, the couple is allowed under "gift splitting" to treat the wife's gift as made one-half by each spouse. As a result the wife would be treated as having made a $13,000 gift to the donee, and the husband would also be treated as having made a $13,000 gift to the same donee. Both the wife and the husband would then be allowed to offset the gift with a $13,000 annual exclusion.

Gift splitting does not increase the number of annual exclusions that are available to a married couple; it simply allows the transferring spouse to take advantage of the unused exclusions of a non-gifting spouse. If the other spouse had also made gifts to the same donees in the same year only the amount of their unused exclusion would be available for gift spitting.

Example: Mr. C has three children. Each year he gifts them $26,000 a piece. His wife makes no gifts. Mr. C is entitled to take one annual exclusion of $13,000 for each gift he has made to each of his children; and by reason of gift splitting he is entitled to a second $13,000 exclusion per donee. As a result none of the gifts are taxable.

C. The Chance to Remove Future Appreciation

By making a gift of a property interest the taxable value of the transferred interest is limited to the value of that interest at the time of the transfer. Any post transfer appreciation is removed from the taxable estate. Under the right circumstances an inter vivos gift may remove significant value from the taxable estate.

Example: Mr. D owns stock in MNO, Inc. Its current value is $5,000,000. He gifts all the stock in MNO to his children. Mr. D lives for another 15 years. At the time of his death MNO, Inc. is worth $12,000,000. As a result of the lifetime gift $7,000,000 of value is never taxed.

D. Removal of Tax Paid from the Tax Base

An aspect of the gift tax that is often not considered is the fact that the tax paid on inter vivos gifts is effectively removed from the tax base while in the case of the estate tax the tax is included and taxed in the tax base, provided the gift takes place within three years of the death of the transferor. Here's an example:

Example: Mr. E has an estate of $20,000,000. If he makes a lifetime gift of $10,000,000 – the resulting gift tax of $1,706,250 is removed from his taxable estate. On his subsequent death only the $8,293,750, remaining in his estate will be taxed resulting in an estate tax and additional transfer tax of $2,902,812. This would leave net $15,390,937 for the heirs.

If on other hand he made no lifetime transfers the entire $20,000,000 will be subject to the estate tax on his death, the estate tax would be $5,206,250, leaving the heirs with $14,793,750, after tax.

E. The Chance to take Advantage of Preferential Transfers

1. The Overview

There are several ways that an inter vivos transfer can be made other than a straight gift of the property. These alternative methods may result in transfer tax savings. Three of those options are discussed in this section: (i) the Grantor Retained Annuity Trust, (ii) the sale to an Intentionally Defective Grantor Trust in exchange for a private annuity, the sale to an Intentionally Defective Grantor Trust in exchange for a Self-Canceling Installment Note, and (iv) the Qualified Personal Residence Trust.

2. The Grantor Retained Annuity Trust

a. Overview

Pursuant to a Grantor Retained Annuity Trust ("GRAT"), an owner transfers his or her ownership interest in the property to an irrevocable trust retaining a current income interest in the trust for a specified term (anticipated to be shorter than the grantor's life expectancy). At the end of the term, the GRAT terminates and the remainder interest in the trust property passes to designated heirs either outright or in further trust.

b. Subtraction Method

Under §2702 of the Internal Revenue Code, the value of the gift of property transferred to the GRAT is determined by the "subtraction method," i.e., by subtracting the present value of the retained income right from the fair market value of the property transferred. If the term is long enough and the level of retained income interest are set high enough the value of the retained right to income can be equal to the value of the interest transferred. In that case the value of the gift will be zero.

c. Qualified Interests

Under the §2702 retained income interests are valued at zero unless they are "qualified interests." Section 2702(b) defines three types of qualified interests: (1) an annuity trust interest (i.e., an income interest equal to a fixed amount or fixed percentage of the initial fair market value of the property transferred); (2) a unitrust interest (i.e., an income interest equal to the fair market value of the property transferred determined on an annual basis); and (3) any non-contingent remainder interest if all of the other interests in the trust consist of either unitrust or annuity trust interests.

d. Advantage

As a basic principal, if the qualified income interest zeros out the value of the gift value equal to the value removed from the estate will be added back through the qualified payments. While this may seem pointless, the transferor has at least frozen the value of the property transferred and can defer the tax on the value of that property until death.

e. Example

Here's an example of how this works: assume Mr. G's interest in UVW, Inc is worth $1,000,000. Assume further that Mr. G makes a transfer of the entire interest to a GRAT retaining the right to a $117,230 annual distribution from the GRAT for 10 years. Under the §2704 of the IRC the gift value of this transfer would be determined to be as follows

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Assumed Value	$1,000,000
Assumed Term	10 years
Income Interest Retained	$ 117,230
Gift Value	-0-
Gift Tax Due	-0-
Estate Tax	-0-

f. Other Considerations

(1) Effect of Qualified Interest

There are certain other aspects of the GRAT planning which should be pointed out. In our example, assuming a trust term of ten years, in order to "zero out" the gift tax, the owner must actually be paid the annual payments of $76,986. It is assumed that the funding for this payment comes from distributions in relation to the property held by the GRAT. While the annual distribution of $76,986 from the GRAT is not taxable, because a GRAT is for income tax purposes a "grantor trust", the owner will be taxed on the income earned by the assets held by the GRAT.

(2) Survival Requirement

In addition, in order for the GRAT to realize the tax benefits described, the owner must actually survive for the period during which he or she has retained the distribution rights from the GRAT. If the owner dies within that period the value of the interests held by the GRAT will be included back in his taxable estate, thereby possibly reversing the tax benefit initially created by the GRAT.

(3) Basis of Transferee

Finally the transferee will receive a carry over basis rather than a basis step in the property transferred a GRAT.

3. Sale – Private Annuity

a. Overview

An alternative to a transfer by gift to a GRAT is the sale to an "Intentionally Defective Grantor Trust" (IDGT) in exchange for a lifetime annuity payment. Under this option, the owner would first establish an irrevocable trust. The trust is intentionally designed to be a grantor trust, i.e. it is drafted with provisions which make it a grantor trust making any income earned by the trust taxable to the grantor. Because in the view of the IRS the trust needs to have economic substance before it can validly issue debt, the owner then transfers funds with a value equal to approximately 10% of the value of the interest to be sold to the IDGT. This amount is taxable as a gift to the remainder beneficiaries of the trust.

After the IDGT is established and funded, the owner then "sells" his or her interest in the business to the IDGT in exchange for an annuity payable for life (i.e. a "private annuity"). Normally a sale creates taxable income to the seller based on the gain realized. In the case of the IDGT, however, because the trust is designed to be "grantor trust," the sale is not considered taxable (the IRS essentially looks at the grantor trust and the trust creator as one taxpayer) and the gain realized on the "sale" is not recognized for tax purposes.

b. Gift Tax Consequences

In order to avoid gift tax consequences, the private annuity must be set at a sufficient level that it is equal in value to the interest transferred. In this case because the transfer is an exchange for fair value in money and moneys worth, there are no gift tax consequences resulting from the transaction. Upon the death of the transferor the private annuity terminates and there is nothing left to be taxed in the transferor's estate. From an estate tax point of view, the property interest is removed from the taxable estate without gift or estate tax consequences. The owner on the other hand, receives a lifetime annuity funded by distributions from the property to the IDGT, which will add value back to the estate, at the same time the interest in the property is being removed.

c. Advantages

The advantage of the IDGT/Private Annuity is that, unlike the GRAT, there is no danger of assets being pulled back into the estate if the owner dies prematurely. However, because the number of payments is unknown, if the owner survives past his life expectancy the aggregate value of the overall the payments may be greater than the actual value of the property transferred. On the other hand, they may be significantly less if the owner dies prematurely. The private annuity works particularly well if the owner's actual life expectancy is greater than 18 months but shorter than normal. Generally the IRS allows the use of its actuarial tables to determine life expectancy in determining the value of the private annuity, however if the owner/transferor's life expectancy is less than 18 months his or her actual life expectancy will be used.

d. Other Considerations

Like the GRAT, discussed above, the owner must actually be paid the annuity payments, and like the GRAT, while the annuity payment not taxable, because an IDGT is for income tax purposes a "grantor trust", the owner will be taxed on the income earned by the assets held by the IDGT. Finally, the transferee will receive a carry over basis rather than a basis step in the property transferred by an IDGT.

4. Use a Self Canceling Installment Note or SCIN

a. Overview

Under this planning option the transaction is the same as that described in regard to the private annuity except that instead of a private annuity the transferor receives an installment note in the exchange that cancels by its terms at the time of the transferor's death (i.e. a "self cancelling installment note" or SCIN). Again, to avoid income tax consequences, the sale is made to an IDGT.

Generally, the SCIN is established for a term just short of the life expectancy of the seller, but it can be any period as long as it is less than the client's life expectancy. This will relieve the problem of uncertainty associated with a private annuity, i.e. the greatest amount that can be paid under the note can be calculated. The SCIN, however, shares the advantage of the private annuity in that the obligation to make annual payments ends at the death of the transferor. Another benefit is the unpaid balance of the SCIN is not included in the client's estate should he or she die prior to it being paid in full.

b. Drawbacks

There are certain drawbacks associated with utilizing a SCIN which should be pointed out, however. In order to avoid gift tax, the amount of the note and the interest rate provided under the note must be set at reasonable premium in relation to the value of interest exchanged. Since amount of the note and the interest rate are a function of actuarial determinations based on the life expectancy of the transferee, if the client's actual life expectancy is shorter than his actuarial life expectancy the IRS may challenge the transaction. Finally, upon the death of the client, the deferred gain may be recognized as income in respect of a decedent by the estate.[9]

5. Qualified Personal Residence Trust

a. Overview

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[9] The Tax Court has disagreed with this opinion, but the Eighth Circuit overturned that decision and sided with the IRS. As such, it appears that upon the death of the client, their estate must recognize the deferred gain.

In order to implement a QPRT, the transferor transfers legal ownership of the residential property (or properties) to the QPRT. Under the terms of the QPRT, the transferor will have the right to continue to live in and manage the residence for a specified period of time (the term of the trust). In addition, the transferor will still be primarily responsible for all costs associated with the property, including the mortgage, insurance, and taxes. If the transferor place funds into the trust for these expenses, the trust will pay them with those funds.

At the end of the trust term, assuming the transferor survive the trust term, the property will pass to the trust beneficiaries the transferor named in the trust agreement. The trust agreement can provide that the property passes to the beneficiaries outright or that the property is to be retained in further trust for them. At this point, the transferor can continue to occupy the residence, but a lease arrangement should be made with the beneficiaries at a fair market rental price since they will be the owners of the property. The transferor can reserve his or her right to lease the residence at the time the transferor establishes the QPRT.

b. Tax Benefit

The primary advantage of the QPRT is the potential for estate and gift tax savings. When the transferor transfers the residence to the QPRT, the transferor is making a gift to the trust which may result in gift tax. The same result would occur if the transferor were to give the property directly to the transferor's children. The advantage of a QPRT is that it significantly reduces the amount of federal gift tax that would normally apply.

The gift tax that the transferor pays as a result of any gift is based upon the value of the interest transferred. Therefore, if the transferor transfers a residential property outright to his or her children, the gift tax will be based on the entire value of the property. Assuming that the value of the property is $1,000,000, the gift tax rate would be 35% and the tax liability due on the gift would be $350,000. The QPRT works as a tax savings device by reducing the value of the interest that is transferred. Once contributed to the QPRT, the residence is theoretically divided into two interests: the interest the transferor retain for a term (the "retained interest"), and the interest that is gifted to the beneficiaries (the "remainder interest"). Since the transferor will be keeping the retained interest, and gifting only the remainder interest, the gift tax is based only on the value of the remainder interest rather than the value of the entire property.

> *Example - Assume the transferor, at age 71, transfer a $1,000,000 residence to a QPRT for a retained term of ten (10) years. The value of the retained interest would be approximately $927,000 and the value of the remainder interest would be approximately $73,000. Therefore, the gift tax would only have to be paid on the $73,000, not the full*

$1,000,000 as in the previous example.[10] *Therefore the tax on transfer is reduced from $350,000, to $25,550. In addition, any appreciation in the property after the transfer to the trust will also pass tax free. At the end of the ten year period, the property would either be distributed to the beneficiaries or held in further trust for their benefit. No further estate or gift tax is incurred upon this transfer.*

c. Final Comments

The remainder interest that is gifted is valued according to rules and regulations set out under the Internal Revenue Code. The idea behind valuing the remainder interest is that even though the beneficiaries will receive the entire property at the end of the trust term, it is worth less than if they were to receive the whole interest today because they have to wait until the end of the trust term. The rules and regulations take into account many different factors including the transferors' ages, certain interest rates, and the term of the trust. The factor which the transferor can control is the length of the trust term. The longer the transferor make the trust term in the trust agreement, the greater the value of the retained interest, and the lesser the value of the remainder interest. A lower value for the remainder interest results in lower gift tax. The risk in choosing too long a term for the QPRT is that if the transferor does not survive the term, then the QPRT will terminate and the entire property will come back into his or her estate rather than passing to the designated beneficiaries. In this case, the entire value of the property will be subject to the estate tax as if the transferor had never implemented the QPRT at all.

F. Greater Opportunity to Take Advantage of Valuation Discounts

1. Overview

A valuation "discount" is a reduction in the otherwise determined value of an equity interest in an ownership interest in an entity, such as a corporation, partnership or limited liability company. One significant advantage of making a lifetime transfer of property which involves an interest in business or income producing property is the ability to utilize valuation discounts which are often difficult to obtain through a testamentary transfer. This section discusses this planning opportunity and will also discuss some of the more significant discounting techniques which are available to the planner.

2. Valuation Discounts

Generally there are two discounts which may be appropriate when valuing an equity interest in a closely-held business entity, the discount for "lack of marketability" and the "minority interest" discount. The "lack of marketability" discount is based on the premise that equity in any closely-held business cannot be

[10] Since the unified estate and gift tax exemption is currently $5,000,000, you will actually incur no of-of-pocket gift tax until your lifetime gifts exceed that amount.

readily sold on an established market. The lack of marketability discount is generally available whether the interest is transferred at death or by inter vivos gift. The "minority interest" discount is a discount in the value of an interest in a closely held business representing a lack of control in terms of vote. The "minority discount" is based on the premise that a non-controlling or "minority" interest has less value than an interest representing an otherwise equal interest that has the ability to vote.

3. The "Minority Discount"

In order to understand why taking advantage of a minority discount is more readily available through an inter vivos transfer, one must first appreciate a fundamental difference between how the gift tax is determined as compared to the estate tax. *The gift tax is based on the value of the property interest received by the transferee while the estate tax is based on the value of the property interest held by the estate.* This difference can significantly affect the taxable value of the interest transferred - but why does this make a difference? Consider the hypothetical situation*:*

> EFG, Inc. has an aggregate value of $4,000,000. Mr. F holds all the issued and outstanding stock of EFG, Inc. – which consists of 100 shares of voting common stock. Mr. F wishes to transfer those shares to his four children in equal gifts of 25 shares a piece. If he retains all 100 shares in his estate and makes the gift at death – the taxable value for federal estate tax purposes will be determined by valuing the 100 shares of EFG, Inc. stock as a block – *the interest held by the estate.* The result will be that the stock will have a value equal to the $4,000,000 value of EFG, Inc.
> If on the other hand Mr. F transfers the stock in four inter vivos gifts of 25 shares to his children the determination of taxable value will be based on the value of four separate gifts of 25 shares – *the property interest received by the transferee.* The difference is that each such gift viewed alone represents a minority interest in the corporation and for valuation purposes may be entitled to a "minority discount" of 30% to 40% off its otherwise pro rata value of the corporation.[11] Assuming a 30% discount, as a result for gift tax purposes the gift of the 100 shares of EFG, Inc. stock will be determined as follows:

Value of ABC, Inc.	$ 4,000,000
	X .25
Pro rata Value of 25 shs	$ 1,000,000
Reduced by .30 minority discount	- 300,000
Value of 25 Share Gift	$ 700,000
	X 4

[11] At one time the IRS took the position that gifts which looked at individually represented a minority interest should be valued without a minority discount when made within a family. In light of numerous contrary decisions in the courts, the IRS abandoned this position in Rev. Rul. 93 -12.

Total Gift Value $ 2,800,000[12]

What this means in practical terms is that the lifetime gift of an entire controlling equity position in a closely held business made in fractional shares each representing a minority position can take advantage of minority discounts, while a testamentary transfer of the same interests to the same donees may not. Since many owners of family owned businesses own all or close to all of the issued and outstanding equity this can be a valuable planning tool.

4. The Opportunity to Create Minority Discounts

The result in the preceding subsection assumes that the gift of 100 shares of stock is transferred in four separate gifts of 25 shares, each individual gift representing a less than controlling interest. If all 100 shares of voting stock were transferred pursuant to an inter vivos gift to *one donee* no minority discount would result and the full value of the stock, i.e $4,000,000 would be taxed. It is possible to create a “minority discount” in an interest, even in stock which possesses a disproportionate right to income and distribution proceeds. In addition the recapitalization can achieve such discounts while allowing the owner to retain control over the business entity during his or her lifetime.

Here’s how it is done. Ownership of equity ownership in a business whether stock in a corporation, a partnership interest, or a membership interest in a limited liability company represents three basic rights: (i) the right to distribution of income, (ii) the right to participate in the distribution of the net assets of the entity in liquidation, and (iii) the right to vote. Most family owned corporations have only one class of stock: voting common stock. Generally, each share of common will be entitled to a pro rata share based on the number of shares outstanding of the income, net assets, and vote – that is if there are 100 shares of stock outstanding each share would be entitled to one percent of the income and net assets and one vote out of 100. Pursuant to the plan of recapitalization, the equity structure both changed to provide both voting and non-voting stock. The voting interests could be entitled to a very small percentage of the cash distributions and the net proceeds in liquidation, *but all of the management control.* On the other hand the non-voting interest may be entitled to a significant portion even most of the right to cash distributions and net proceeds in liquidation, *but none of the management control.* Because the non-voting interest has no right to participate in management decisions, its value for gift tax purposes is considered a "minority” interest and will be discounted for purposes of transfer tax valuation by 30% to 40%.

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[12] This conclusion assumes that the gift of 100 shares of stock is transferred in four separate gifts of 25 shares each – each individual gift representing a less than controlling interest. If all 100 shares of voting stock were transferred to one individual donee no minority discount would apply and the full $4,000,000, value would be taxed.

The following example will illustrate just how this works:

Assume all of the outstanding stock of a closely held family corporation, LMN, Inc. (represented by 100 shares of voting, common stock) has a current fair market value of $10,000,000, and all of the stock is owned by Mr. G. Mr. G wishes to transfer his ownership interest in LMN, Inc. to his son. An outright gift of the stock to his children will result in a taxable gift equal to the full value of LMN, i.e., $10,000,000.

Step One

Under the recapitalization plan however the capitalization of the corporation is changed to 1 share of voting common and 99 shares of non-voting common. After the recapitalization the one share of voting common stock is entitled to 1% of the cash distributions from the corporation, 1% of the net proceeds in liquidation, but all of the vote and therefore all of the management control. The 99 shares of non-voting stock is entitled to 99% of the cash distribution from the corporation, 99% of the net proceeds in liquidation, but no vote and as a result none of the management control.

Step Two

The next step is for Mr. G to transfer the 99 shares of non-voting stock to his son, either outright or in trust. This transfer is a taxable gift. The 1 share of voting stock is retained by Mr. G. Logically, the gift tax value of the transfer of the non-voting stock should be equal to 99% of the fair market value of the corporation (i.e., $9,900,000), since that is the value that the shareholders holding the non-voting stock would be entitled to in liquidation of the corporation. When the stock is recapitalized before the transfer, however, this is not the outcome. Because the non-voting stock interest has no right to participate in management decisions and because it is not tradable on a recognized securities exchange, its value for gift tax purposes is discounted for "minority" and "lack of marketability". These discounts will together result in the gift tax value of the 99 shares of non-voting stock being reduced by 35%. As a result, $9,990,000 in real fair market value can be transferred at a gift tax value of only $6,435,000. Due to the discounts, the difference of $3,465,000 is never taxed.

5. The Family Limited Partnership.

A "Family Limited Partnership" is a means of transferring property to heirs which attempts to take advantage of the discounts due to "minority" and "lack of marketability," by first transferring assets, sometimes non-business property, to a limited partnership. Under the FLP, a limited partnership is first created. As a next step, the assets are transferred to the FLP by a senior family member, in exchange for a 1% general partnership interest and a 99% limited partnership interest in the FLP. By design, the general partnership interest is entitled to 1% of the cash distributions from the FLP, 1% of the net proceeds in liquidation, and, by law, all of the management control. The limited partnership interest is entitled to 99% of the cash distribution from the partnership, 99% of the net proceeds in liquidation, but by law none of the management control. For the next step, the senior family member transfers the 99% limited partnership interest to chosen heirs, either outright or in trust. This transfer is a taxable gift. The 1% general partnership interest is retained. Like the recapitalization described above, the gift tax value of the transfer of the limited partnership interest should be subject to a discount for "minority" and "lack of marketability."

Particularly when no-business assets, such as marketable securities, are transferred to the FLP, the IRS has sought to challenge the validity of the discounts for estate and gift tax purposes with varying success. Often the challenge is based upon the application of Code Section 2036(a)(1), which provides that the value of the estate includes property transferred by lifetime gift when the transferor retains the right to the possession, enjoyment or income form the property or the right to control the possession, enjoyment or income from the property, until death. The Service has been most successful when the factual background of the contested case includes one or more of the following facts: (i) the transferor transfers most of his or her assets to the FLP, (ii) the transferor continues to use the property transferred as if it is his or her own, (iii) the transferor commingles personal and partnership assets, (iv) the transferor takes disproportionate distributions from the FLP, or (v) uses the entity funds for personal expenses. The IRS has also had some success when the transferor has failed to observe the legal formalities of the FLP, such as maintaining separate bank accounts.

VI. A Method of Analysis and a Transfer Strategy

A. Overview

The advantage achieved by making lifetime gifts lies in the opportunity to remove the value in the taxable estate. Since the estate tax and gift tax rates are equal that removal in value must be realized either in the form of: (i) taking advantage of the annual gift tax exclusion, (ii) removal any future appreciation in value, (iii) removal of the gift tax incurred from the tax base, (iv) removal of the income realized by reason of ownership of the transferred property after the transfer, or (v) taking advantage of permanent valuation discounts. The tax benefit achieved by removing the value cited must be weighed against the fact that with certain techniques, e.g., GRATs, private annuities value, and sales to IDGT, for example value is also added back to the estate. In addition, the value of the loss of basis step up which occurs when property is gifted during lifetime rather than transferred by testamentary transfer must also be considered.

There is no one planning method that will result in the best result in every case. The planner must undertake an analysis of each alternative in order to determine the appropriate method of transferring the interest considering the situation and the objectives of the client. In the case of an estate having little realistic exposure to the federal estate tax, lifetime gifts of property to lower generation heirs make little sense in terms of reducing taxes. Any reductions in taxable value which can be achieved by making lifetime transfers will produce no tax benefit to such an estate, and the loss of step up in basis available for assets retained in the taxable estate will potentially increase the heir's income tax on the sale of inherited property.

For estates whose potential value at the point it will be subject to estate will in all likelihood exceed a level at which federal estate tax will be incurred the planner must determine the tax reduction that can be achieved through lifetime gift planning as compared to the value potentially added back and the cost of loss of basis step up. The following Case Study is as much to suggest a method of analysis as well as to highlight the advantage and disadvantages of the planning options.

B. The Method of Analysis

1. Overview

The object of the suggested method of analysis is to first determine and then compare: (i) the net after tax value that will actually pass to the next generation under each alternative transfer strategy considered, to (ii) simply retaining the assets in the estate. In making the determination which method will produce the greatest net after tax value, it is necessary to have the facts of the particular case in hand and also to make certain assumptions.

2. The Facts

You should know the following facts:

(1) The current fair market value of the property interest to be transferred, and its potential to appreciate.

(2) The level of income produced by the property interest transferred.

(3) The fair market value of the owner's assets other than the property transferred, and their potential to appreciate.

(4) The manner in which the assets held by the owner will be disposed under his or her estate plan.

(5) The Transferor's and the transferee's marginal income tax brackets.

(6) The Transferor's basis in the assets held by the Transferor.

(7) The value of any other lifetime gifts made by the client before the transfer in question.

3. The Assumptions

You must also make certain assumptions including the following:

(1) The annual rate at which the property interest transferred will appreciate.

(2) The annual rate at which the assets not transferred will appreciate.

(3) The discount rate to be used for determining present and future values.

(4) The life expectancy of the client.

4. The Steps in the Analysis

Perform the following Calculation first assuming no transfer and then for each of the alternative methods of lifetime transfer considered.

Step One *– Start with a determination of the Fair Market Value of the Assets to be Retained.*

Step Two *– Then determine the Fair Market Value of Assets to be Transferred.*

Step Three *– Determine the Gift Tax on Assets Transferred.*

Step Four *– Subtract the Gift Tax determined in Step Three from the Current Fair Market Value of the Assets Retained.*

Step Five – Determine the Total Future Value of Assets Retained.

Determine the Future Value of Assets Retained

Start by determining the Future Value of the Assets Retained by taking the current Fair Market Value of Assets Retained multiplied by the Assumed Rate of Appreciation compounded over the transferor's life expectancy.

For example if the Fair Market Value of the Assets Retained is $5,000,000, the transferor's life expectancy is 15 years, and the Assumed Rate of Appreciation is 3% per annum – the calculation of the Future Value of Assets Retained = $5,000,000 x 1.03^{15}

Determine the Future Value of the Net After Tax Income Earned by the Assets Retained

You must add to this figure the Future Value of the Net After Tax Income Earned by the Assets Retained. Determine the Net After Tax Income earned by the Assets Retained by estimating the annual income earned on those assets and reducing it by the estimated income tax on that income using the assumed marginal tax rate of the Transferor. Compound that figure over the Transferor's assumed life expectancy.

For example if the estimated income earned on the Assets Retained is $500,000, the transferor's life expectancy is 15 years, the assumed marginal tax rate is thirty-five (35%) percent, and the Assumed Rate of Appreciation is 3% per annum – the calculation of the Future Value of the Net After Tax Income Earned by the Assets Retained = ($500,000 – ($500,000 x.35)) x 1.03^{15}

Determine the Future Value of the Add Backs

You must now add to this figure the Future Value of the Add Backs. The "Add Backs" are the distributions rights which are retained by the Transferor by reason of the nature of the transfer, e.g., if the transfer is made by using a GRAT, the Add Back would be the Future Value of the qualified income interest, and in the case of the sale to the Intentionally Defective Grantor Trust, the Add Back is the value of the private annuity which must be paid to the Transferor or the interest on the SCIN.

For example if the qualified income interest is $200,000, the specified period over which the qualified income interest is 15 years, and the Assumed Rate of Appreciation is 3% per annum – the calculation of the Future Value of the Add Backs. = ($200,000) x $1.03^{15.}$

The total of the three figures equals the Total Future Value of Value Retained.

Step Six – Determine Estate Tax on Assets Retained

Determine the Federal Estate Tax on the Total Future Value of Value Retained, determined under Step Five, above.

Step Seven – Determine the Net Value of the Assets Retained

Subtract the amount determined under Step Six from the amount determined in Step Five.

Step Eight – Determine Total Future Value of Assets Transferred

Determine the Future Value of Assets Transferred

Determining the Future Value of the Assets Transferred by taking the current Fair Market Value of Assets Transferred multiplied by the Assumed Rate of Appreciation compounded over the transferor's life expectancy in the same manner as you determined the Total Future Value of the Assets Retained, in Step Five, above.

Determine the Future Value of the Net After Tax Income Earned by the Assets Retained

You must add to this figure the Future Value of the Net After Tax Income Earned by the Assets Transferred in the same manner as you determined the Net After Tax Income *earned by the Assets Retained in Step Five, but of course substituting the assumed marginal tax rate of the Transferee.*

Determine the Future Value of the Add Backs

You must subtract the Future Value of the Add Backs. The "Add Backs" are same Add Backs determined in Step Five

Step Nine – Determine Value of Basis Step Up

Determine the value of the Value of the Basis Step Up by determining the difference between the Future Value of the Total Future Value of Assets Retained and the basis of those assets in hands of the Transferor

Step Ten – Add the total of Steps Seven, Eight and Nine.

This is the Total Net Value to be Transferred. Perform this calculation for each Alternative Method of Transfer considered, including retaining all of his assets within the Estate.

VII. Impact of the Tax Relief Act

A. Impact of the Tax Relief Act – How it Alters the Equation.

After a one year repeal, the Tax Relief Act of 2010 reinstated the federal estate tax for at least 2011 and 2012, and if elected by the estate of someone dying in that year, for 2010, as well. During those years, the highest marginal estate tax rate will be 35%, and the exemption amount (termed the "Basic Exclusion Amount") is increased to $5 million per individual for 2011, and will be indexed for inflation thereafter. Starting in 2011, the gift tax exemption will be unified with the estate tax exemption. This means that a $5 million Basic Exclusion Amount will also be available for gifts. Prior to 2010, an individual was entitled to a $3.5 million exemption for their estate, but only $1 million for gifts. Because gifts in excess of that amount required payment of gift tax out of pocket, many potential donors were hesitant to make those gifts. Now, an additional $4,000,000 can be transferred gift tax free. Barring any further action by Congress, the Basic Exclusion Amount will reset at $1,000,000, after 2012. Therefore there is the very real question as to whether the higher exclusion amount will remain after the end of this year.

B. Portability

1. Overview

Another change implemented by the Tax Relief Act is the concept of "portability." Portability allows the Basic Exclusion Amount which is unused by the estate of the first of a married couple to die to be carried over and used, with an interesting twist, by the surviving spouse's estate. In addition, it should be pointed out that like the estate tax, the gift tax exemption is also portable. Therefore, if an individual dies after December 31, 2010, the surviving spouse of that individual will potentially have a Basic Exclusion Amount of $10,000,000, which can be utilized to offset the estate and gift tax.

2. The Applicable Exclusion Amount

Under the concept of "Portability," the Basic Exclusion Amount that is not utilized when the first of a married couple passes away is available or "portable" to reduce the federal estate tax of the surviving spouse. Specifically the Act provides that in the case of the estate of the surviving spouse assets with a value equal to the "Applicable Exclusion Amount" are allowed to pass free of the estate tax. That amount is equal to the sum of (i) the "Basic Exclusion Amount" (i.e., $5,000,000 adjusted for inflation) and (ii) the "Deceased Spouses Unused Exclusion Amount."

3. The Deceased Spouses Unused Exclusion Amount

The Deceased Spouses Unused Exclusion Amount is defined as the "unused exclusion amount" of the "last deceased spouse," in other words, the Basic Exclusion Amount available to the husband or wife who was of the survivor spouse before they died. This definition makes irrelevant how much property the surviving spouse actually inherited from that husband or wife, or whether the surviving spouse inherited any property from that spouse at all. The only question is how much of the Basic Exclusion Amount was utilized in by that spouse's estate when they died.

Example - Assume that Bill dies first in 2011 and leaves his entire estate of $5,000,000 to his wife Ruth outright. Ruth would inherit Bill's assets without federal estate tax. This is because his estate passes to a surviving spouse, and by reason of the marital deduction, the property in his estate is not taxed. As a result, Bill's Basic Exclusion is not used and the Deceased Spouse's Unused Exclusion Amount is $5,000,000. Provided Ruth does not remarry upon Bill's death the Applicable Exclusion Amount available to her estate is $10,000,000 (i.e., the sum of the Deceased Spouses' Unused Exclusion Amount of $5,000,000, and the Basic Exclusion Amount of $5,000,000 available to her estate).

As alluded to above, one problem with "portability" is that amount of the Unused Exclusion Amount available to the surviving spouse's estate is dependent upon the unused exclusion amount of the "last deceased spouse." The planning issues with this requirement are obvious.[13] Consider this example:

[13] Another issue with "portability" is that in order to claim the Unused Exclusion Amount, an estate tax return must be filed on a timely basis by the estate of the first spouse to die. The amount of the exclusion considered "unused" will be dependent upon the values stated on that return, and the statute of limitations is suspended. This raise the question of whether all estates no matter what their size should file a federal estate tax return or risk not having the Unused Exclusion Amount of the first spouse to die being available to the surviving spouse's estate. Suppose for example at the time of Bill's death the combined estate was only $4,000,000, and no estate tax return was filed when Bill died. By the time Ruth dies the estate is now worth

Example - Assume the same facts as the preceding Example above.

Assume that Ruth remarries after Bill's death to Harry. Harry has his own children to whom he wishes to leave his entire estate. Harry predeceases Ruth and in his will leaves his entire estate of $5,000,000, to his surviving children. His executor claims Harry's entire Basic Exclusion Amount of $5,000,000. In this case Ruth's Applicable Exclusion Amount is only $5,000,000. She gets no benefit from Bill's Unused Exclusion Amount of $5,000,000, even though she inherited less than $5,000,000 from his estate.

As it relates to the gift tax, the Basic Exclusion Amount is also portable. If in Example above Ruth chose to make lifetime gifts prior to Harry' death Ruth's Applicable Exclusion Amount would still be $10,000,000. Bill remains Ruth's "last deceased spouse," even after her marriage to Harry. So what if Harry transfer assets to Ruth who in turn transferred them to Harry's children. If Ruth would agree she could in fact take advantage of Bill's Unused Exclusion Amount, even though she is remarried to Harry, Bill is still *her "last deceased spouse."*

C. The "Clawback"

Another factor to consider is the so-called *"clawback issue*." Because of the way the gift tax is calculated, some commentators are concerned that if the Basic Exclusion Amount drops to a lower level after 2012, and a person dies after that point, the gift tax savings can be recaptured in the form of additional estate taxes. This recapture is sometimes termed a *"clawback."* The recapture potential exists because the estate tax is imposed upon the decedent's taxable estate as increased by the decedent's lifetime adjusted taxable gifts, which is offset by the applicable exclusion amount at the time of the donor's death. As a result because the donor's taxable gifts were sheltered from a gift tax exclusion that is larger than the applicable exclusion amount at the time of the donor's death, such gifts will create additional estate tax for the donor's estate.

Example - Waldo has a $15 million estate. He makes a $5 million gift in 2011, paying no gift tax because he has his full unified credit (equivalent to a $5 million exclusion amount) available. Two years later, Waldo dies, leaving a $10 million taxable estate. The 2010 Tax Relief Act and EGTRRA sunset on December 31, 2012, leaving Waldo with a $220,550 unified credit, equivalent to a $1 million applicable exclusion amount, and a 55-percent top estate tax rate. Waldo's estate will owe $7,795,000 in estate taxes on a $10 million taxable estate, determined as follows:

Taxable estate	$ 10,000,000
Adjusted taxable gifts	$ 5,000,000
Tentative tax base	$ 15,000,000
Tentative tax	$ 8,140,800
Gift taxes payable	$ -0-

$6,000,000. Can her estate still claim Bill's Unused Exclusion Amount to shelter estate tax? The answer is no since, as stated, a timely filed estate tax return is required.

Example - Assume the same facts as in the preceding Example, except that Waldo made only $1 million of lifetime taxable gifts. Waldo dies in 2013, leaving a $14 million taxable estate. Waldo's estate tax liability will still be $7,795,000, determined as follows:

Taxable estate	*$*	*14,000,000*
Adjusted taxable gifts	*$*	*1,000,000*
Tentative tax base	*$*	*15,000,000*
Tentative tax	*$*	*8,140,800*
Gift taxes payable	*$*	*-0-*
Unified credit on date of death	*$*	*345,800*
Estate tax due	*$*	*7,795,000*

This can create a serious problem if the deceased has made lifetime taxable gifts significantly disproportionate to the decedent's remaining taxable estate. In such cases, the estate tax due could exceed the entire taxable estate.

Example - Waldo has a $6 million estate. Waldo lives largely on the income he receives from a trust created by his great-grandfather, and which is exempt from estate taxes. Waldo makes a $5 million gift in 2011, paying no gift tax because he has his full unified credit (equivalent to a $5million exclusion amount) available. Two years later, Waldo dies, leaving a $1 million taxable estate. The 2010 Tax Relief Act and EGTRRA sunset on December 31, 2012, leaving Waldo with a $345,800 unified credit, equivalent to a $1 million applicable exclusion amount, and a 55-percent top estate tax rate. Waldo's estate will owe $2,595,000 in estate taxes on a $1 million taxable estate, determined as follows:

Taxable estate	$	1,000,000
Adjusted taxable gifts	$	5,000,000
Tentative tax base	$	6,000,000
Tentative tax	$	2,940,800
Gift taxes payable	$	-0-
Unified credit on date of death	$	345,800
Estate tax due	$	2,595,000

Although a $2,595,000 tax on a $1 million taxable estate sounds unreasonable, it reflects that Waldo took advantage of a $4 million gift tax exclusion that did not exist on the date of her death.

D. Conclusions

The question of whether to make gifts with 2012 is complicated by the fact that the changes to the Federal Estate tax and Gift Tax will expire at the end of this year. If Congress does noting the Exclusion amount will revert to $1,000,000, and the highest tax rate will revert to 55%. To further complicate the issue is the potential for the "clawback" discussed above. On the one hand one could simply decide to make gift this year in order to take advantage of the higher Basic Exclusion Amount and the lower tax rates. However if the clawback recaptures the tax savings – the transfer may have resulted in little estate tax advantage. In addition the loss of basis step up may actually result in a net negative tax effect.

Whether Congress will allow clawback is not a settled question. So th question is simply is the risk of clawback and loss of step up in basis worth the potential reward of significant estate tax savings. That is risk is of course less if the estate exceeds $5,000,000. The deferential in the effective tax rates is reduced to the difference between 55% and 35%. If the Basic Exclusion falls to $1,000,000, the potential tax savings gift that reduce the taxable estate to that level is the difference between 0 and 55%; but if the Basic Exclusion falls to only $3,500,000, gifts that fall below would result in no real estate tax reduction, and also potentially result in the loss of basis step up.

What to do? Gift high basis assets – the cost of basis step up will be reduced. Don't to the point that the estate is reduced below $3,500,000. This is the most likely level at which the Basic Exclusion Amount will fall below that level is taking a risk without potential benefit. Finally, use the Method off Analysis to determine whether gifts should be made at all and what method of transfer should be employed.

Appendix – Case Study

Case Study

a. Facts: Assume Mr. Big has a total estate with a current fair market value of $20,000,000. He wishes to transfer $8,000,000, of his assets to his son by lifetime gift. Assume the both the assets retained and those transferred will appreciate at an annual rate of 5%. For simplicity assume the assets of estate produce no income, and his adjusted basis in the assets transferred is -0-

b. Alternative One – Retain the Assets in the Estate

***Step One** – Start with a determination of the Fair Market Value of the Assets to be Retained - $20,000,000.*

***Step Two** – Then determined the Fair Market Value of Assets to be Transferred -$10-*

***Step Three** - Determine the Gift Tax on Transferred to be Transferred -0-.*

***Step Four** - Subtract the Gift Tax determined in Step Three from the Current Fair Market of the Assets Retained -0-*

***Step Five - Determine the Total Future Value of Value Retained**.*

<u>Determine the Future Value of Assets Retained</u> - $32,577,893

<u>Determine the Future Value of the Net After Tax Income Earned by the Assets Retained</u> -0-

<u>Determine the Future Value of the Add Backs</u> – No Add Backs

The total of the three figures equals the Total Future Value of Value Retained.- $32,577,893.

Step Six - Determine Estate Tax on Assets Retained

Determine the Federal Estate Tax on the Total Future Value of Value Retained, determined under Step Five, above. $9,608,512

Step Seven – Determine the Net Value of the Assets Retained

Subtract the amount determined under Step from the amount determined in Step Six.- $22,969,381.

***Step Eight - Determine Future Value of Assets Transferred** -0-*

***Step Nine - Determine Value of Basis Step Up -** $4,886,683*

Step Ten - Add the total of Steps Seven, Eight and Nine.

This is the Total Net Value $- $27,856,064.

c. *Alternative Two – Make a Gift of $8,000,000 – Retaining $12,000,000.*

Step One *– Start with a determination of the Fair Market Value of the Assets to be Retained - $12,000,000.*

Step Two *– Then determined the Fair Market Value of Assets to be Transferred - $8,000,000*

Step Three *- Determine the Gift Tax on Transferred to be Transferred $1,006,250.*

Step Four *- Subtract the Gift Tax determined in Step Three from the Current Fair Market of the Assets Retained $10,993,750.*

Step Five - Determine the Total Future Value of Value Retained*.*

Determine the Future Value of Assets Retained - $17,907,660.

Determine the Future Value of the Net After Tax Income Earned by the Assets Retained -0-

Determine the Future Value of the Add Backs – No Add Backs

The total of the three figures equals the Total Future Value of Value Retained.- $17,907,660.

Step Six - Determine Estate Tax on Assets Retained

Determine the Federal Estate Tax on the Total Future Value of Value Retained, determined under Step Five, above. $6,267,681.

Step Seven – Determine the Net Value of the Assets Retained

Subtract the amount determined under Step Six from the amount determined in Step Five - $11,639,979.

Step Eight - Determine Future Value of Assets Transferred *-$13,031,157.*

Step Nine - Determine Value of Basis Step Up - *$2,686,149*

Step Ten - Add the total of Steps Seven, Eight and Nine.

This is the Total Net Value to be Transferred - $27,357,285 – without the Basis Step $24,671,136, compared to $22,969,381 for estate.

d. Alternative Three – Make a Gift of $8,000,000 using 10 year GRAT -$400,000 qualified income interest.

***Step One** – Start with a determination of the Fair Market Value of the Assets to be Retained - $12,000,000.*

***Step Two** – Then determined the Fair Market Value of Assets to be Transferred - $8,000,000 – Gift Value $4,587,920.*

***Step Three** - Determine the Gift Tax on Transferred to be Transferred Gift Value $4,587,920 – Gift Tax -0-.*

***Step Four** - Subtract the Gift Tax determined in Step Three from the Current Fair Market of the Assets Retained $12,000,000*

***Step Five - Determine the Total Future Value of Value Retained**.*

<u>Determine the Future Value of Assets Retained</u> - $19,546,736.

<u>Determine the Future Value of the Net After Tax Income Earned by the Assets Retained</u> -0-

<u>Determine the Future Value of the Add Backs</u> – Qualified income interest of $400,000, will on a compounded basis add $651,558, back to the estate of the transferor

The total of the three figures equals the Total Future Value of Value Retained.- $20,198,293.

Step Six - Determine Estate Tax on Assets Retained

Determine the Federal Estate Tax on the Total Future Value of Value Retained, determined under Step Five, above. $6,881,425.

Step Seven – Determine the Net Value of the Assets Retained

Subtract the amount determined under Step Six from the amount determined in Step Five - $13,316,869.

***Step Eight - Determine Future Value of Assets Transferred** -$13,031,157.*

***Step Nine - Determine Value of Basis Step Up -** $1,9975,530.*

Step Ten - Add the total of Steps Seven, Eight and Nine.

This is the Total Net Value to be Transferred - $28,345,556 – without the Basis Step $26,248,026, compared to $22,969,381 for estate.