Estate Planning Insights

A Quarterly Publication of

Karen S. Gerstner & Associates, P.C.

Attorneys at Law
5615 Kirby Drive, Suite 306
Houston, Texas 77005-2448
(713) 520-5205

Vol. 7, No. 2 **April 30, 2010**

WHY EVERY IRREVOCABLE TRUST SHOULD BE "DEFECTIVE" – PART 1

We use a lot of devices in estate planning with negative-sounding names, such as "Crummey Trusts" (discussed somewhat in this newsletter). Another device that has been used a lot over the past several years is an "Intentionally Defective Irrevocable Trust"--also sometimes known as an "Intentionally Defective Grantor Trust". We use a lot of acronyms in estate planning, too. Thus, the type of trust just referred to is an "IDIT" or an "IDGT". We submit that most irrevocable trusts created today should be in the form of an IDIT or IDGT–in other words, they should be intentionally "defective". To understand why, we will first need to review the estate and gift tax rules and then some income tax rules. Because of the highly technical nature of this discussion, we will break it into two parts.

Background: Transfer Tax Overview. The federal estate tax (also called the "death tax") and federal gift tax are *transfer* taxes. They are basically *excise taxes* on the "privilege" of transferring something you own to someone else. If you transfer something you own during your life, then the gift tax applies. If you transfer something you own when you die, then the estate tax (death tax) applies.

Some people believe that if they merely transfer assets they own while they are still living, they will avoid the estate tax (death tax) when they die. This is a misunderstanding of the transfer tax rules. A transfer made during life implicates the other transfer tax–the gift tax. *Taxable gifts* made during life must be reported to the IRS and use up some of a person's exemption from transfer taxes, thus reducing the amount of exemption available at death to reduce estate taxes. The two work together. In other words, the Internal Revenue Service ("IRS") doesn't care whether people transfer assets they own during their life or upon their death–either way, the transfer tax rules apply.

Estate and gift taxes are taxes imposed on *the person making the transfer*, not on the recipient of the gift. The transfer tax rules are implicated any time a person makes a transfer of something she owns to someone else, whether the transfer occurs during life or at death.

Some people also mistakenly think that if they transfer assets at death through a living trust instead of a Will they will avoid the estate tax. This is another common misunderstanding. The IRS also doesn't care what *method* you use to transfer assets when you die. All assets being transferred at death are subject to the estate tax, no matter what method is used to make the transfer. Assets owned by a person who dies (decedent) may be transferred by Will, pursuant to a living trust, via beneficiary designation form (e.g., life insurance or an IRA), and/or due to the way an account is titled (such as JTWROS, POD, TOD, etc.). The *method* used to make the transfer is irrelevant as far as the IRS is concerned. If you own something and someone else becomes the owner of it because of your death, a transfer subject to the estate tax has taken place.

Value of Transferred Asset. The value of whatever you transfer must be determined following principles set out in the Internal Revenue Code and Treasury Regulations. Basically, for transfer tax purposes, whatever you transfer must be valued at its *fair market value*. Fair market value is what the asset is actually worth on the date of the transfer (and not what you originally paid for it). It's what a theoretical willing buyer, with knowledge of all relevant facts, would pay to purchase the asset. Cash is easy to value. So are marketable securities (i.e., stocks and bonds that are sold on a public exchange). Some assets are difficult to value, such as real estate, minerals, and interests in closely held businesses. Appraisals are usually needed to determine the fair market value of assets that don't have a readily ascertainable value.

Some people who want to transfer something to a family member, but don't want to make a gift, attempt to structure the transfer as if it were a sale. First, to be a valid sale, the asset must be sold at its fair market value. If the asset is "sold" at a below market or bargain price, the difference between its fair market value and the price used in the deal is a gift, despite what the parties involved call the transaction. Second, the *terms* of the sale must be commercially reasonable. The legitimacy of the deal is based on the actual circumstances. In other words, it may not be justifiable to sell something to a person with little or no net worth for no down payment and an unsecured note for 100% of the purchase price. No one would structure a deal like that in the business world. Often, such a deal would require a guarantee by a person of means. If a parent has to guarantee something for a child, the guarantee has a value and the parent is making a gift to the child.

A lot of people enter into "questionable transactions" during their lifetime. Some know they are making unreported taxable gifts and some don't. When the person dies, however, the Executor of the person's estate (or the successor Trustee of their living trust) will have a legal obligation to report all of these unreported taxable gifts to the IRS. An Executor (or living trust Trustee, if applicable) is *personally liable* for all unpaid taxes of the deceased person whose estate he represents, so do some due diligence before agreeing to serve as Executor or Trustee!

Gift Tax Annual Exclusion and Lifetime Exemption. The annual gift tax exclusion amount for 2010 is $13,000. Thus, the *donor* (maker of the gift) can give to each *donee* (recipient or beneficiary of a gift) cash or other assets during 2010 having a total value of $13,000 or less, free of federal gift tax, as long as the gift qualifies as a "present interest". Basically, a *present interest* gift is a gift made directly to an adult or a gift made to a custodial account or 529 plan for a minor. In the case of a married couple, since that makes two (2) donors, the total amount that can be given away tax-free in 2010 would be $26,000 per donee. If a married couple uses community property to make a gift and the amount given away comes within the gift tax annual exclusion (i.e., $26,000 or less per donee), no federal gift tax return has to be filed since both spouses are deemed to be giving away half of the total (i.e., $13,000 or less, apiece). If separate property belonging to just one spouse is used to make a gift in 2010 and the value of the separate property given away is greater than $13,000 but less than $26,000 and the couple wants the gift to be treated as tax-free, a federal gift tax return must be filed with the IRS to "split the gift" for federal gift tax purposes. When split gift treatment is elected, it means that each spouse is treated as giving away half of the total amount given to the donee. A gift tax return has to be filed to obtain this treatment, however, since, otherwise, the spouse whose separate property is used to make the gift will be "over the limit" (since 100% of the gift would be considered to be coming solely from that spouse).

Reminder About Gifts Made To Trusts. Gifts made to most irrevocable trusts do not automatically qualify for the annual exclusion from the gift tax because most gifts to trusts are gifts of "future interests" and not present interests. If it is desired that gifts made to a trust qualify for the annual exclusion, then the trust must be drafted a certain way. The most typical way of drafting a trust so that gifts made to the trust will qualify for the gift tax annual exclusion is to give one or more beneficiaries of the trust a *Crummey* withdrawal power (a trust like this can be referred to as a *Crummey* trust). With a *Crummey* trust, every time the donor makes a gift to the trust, the beneficiary (or beneficiaries) must be given the right to withdraw the money placed in the trust for a certain period of time (called a *Crummey* withdrawal power). The beneficiary must also be provided with written notice of his or her withdrawal right to make the gift a tax-free gift (called a *Crummey* withdrawal notice). Failure to meet the *Crummey* rules produces a "crummey" tax result: gifts to the trust are not tax-free gifts.

Gifts that do not qualify as tax-free gifts are *taxable* gifts. Thus, the amount or value of a gift to a donee above the annual exclusion amount is a taxable gift. Further, a gift of any size (even as small as $100) to a trust that wasn't drafted or administered properly is a taxable gift. All taxable gifts must be reported to the IRS on a U.S. Gift Tax Return (Form 709). There is no statute of limitations on *unreported* taxable gifts, meaning that, even upon the donor's death, the value of unreported taxable gifts (often influenced by hindsight) is added to the donor's estate tax base for federal estate tax purposes.

Note that, when a person makes a *taxable gift*, she is using up some of her $1 million lifetime gift tax exemption amount. In years when there is also an estate tax (which would be the case for every year in modern history except this year), taxable gifts simultaneously use up a portion of the person's federal estate tax exemption amount, too. Thus, for two reasons, the IRS requires all taxable gifts to be reported (so that they can be tracked by the IRS): (i) once a donor makes taxable gifts totaling, in the aggregate, $1,000,000, she must pay a gift tax on all taxable gifts made thereafter, and (ii) to the extent of taxable gifts made during life, the donor will have less estate tax exemption available to shelter transfers made at death from the estate tax.

Taxable Gifts Should Be "Smart Gifts". If a person wants to go beyond making tax-free gifts to making gifts that actually use up some or all of his $1 million lifetime gift tax exemption, these taxable gifts should be "smart gifts". Here's an example. Suppose a wealthy donor, with many different assets to choose from, decides to give $1 million to his child. He can write a check to his child for $1 million and that will use up his lifetime exemption amount (and, in a "normal" year, use up $1 million of his estate tax exemption amount at the same time). Suppose his child takes the $1 million and loses it all in a gambling spree in Las Vegas. That's not the only bad thing about a $1 million cash gift. It would be better for the donor to give his child something that will either grow in value or produce a lot of income *after* the child receives it. That's because all of the appreciation in value and earnings that occur after the gift is made *will escape estate and gift* *taxes in the donor's estate*. So, instead of giving $1 million cash, the donor gives his son $1 million of Acme stock. If the stock goes up in value after the gift, none of that post-gift appreciation will be subject to future transfer taxes imposed on the donor. Further, all of the dividends paid to the son by Acme after the gift is made will be owned by the son and not the donor. If the gift hadn't been made, the donor's estate would continue to increase in value due to the appreciation in value of the stock and the dividends paid to the donor instead of to the son, most likely increasing the estate taxes on the donor's estate at death. Thus, at a minimum, when using any part of one's $1 million lifetime gift tax exemption, the asset chosen to give away should be something that will grow in value after the gift is made or produce a lot of earnings after the gift is made (or, better yet, both).

There are other gifts that are even smarter than simple gifts of appreciating and/or income producing assets. These gifts come within the category of "leveraged gifts". When a donor makes a *leveraged* gift, the donor is able to treat the gift as having a lower fair market value than it would otherwise seem to have. For example, suppose the donor owns an undivided 50% interest in a piece of real property having a total value of $2 million. The donor's 50% share of the property is not worth $1 million (50% of $2 million) due to some economic principles that apply. When two or more people share ownership of a single piece of real property, no single co-owner has complete control over the property and yet, one co-owner can be liable for 100% of the property taxes and expenses of the property if the other co-owner(s) don't pay their share. This negative aspect of co-ownership of real estate often results in a discount from the proportionate value of the whole property. In very general terms, a typical discount for an undivided interest in real estate could be around 20%. Thus, if the donor gives his son his undivided 50% interest in the piece of real estate, he will only be treated as making a gift to his son of, say, $800,000, and not $1 million due to the undivided ownership discount that applies. This is a simple example of leverage. While it might look like the donor is making a $1 million gift to his son, he is only treated as making an $800,000 gift to his son and he still has another $200,000 remaining of his $1 million lifetime gift tax exemption.

Other types of assets lend themselves to much larger discounts. For example, gifts of limited partnership interests in a family limited partnership can have a fair market value that is reduced below a straight proportionate value by two discounts: (i) lack of marketability and (ii) lack of control. A lack of marketability discount applies because a person who receives a limited partnership interest cannot go out into the real world and sell it to anyone he wants to because of restrictions on transferability of limited partnership interests under state law and/or in the partnership agreement. Further, the limited partners have no control over what the family limited partnership ("FLP") does. The general partner of the FLP controls the FLP and decides how the partnership's assets are invested and if and when distributions are made to any of the partners. Depending on the type of assets held in the FLP and various structural components, typical discounts in the value of a limited partnership interest (above a straight proportionate value) are usually in the range of 20% to 50%. Thus, if the donor has 1,500 limited partnership units in an FLP that would have a "straight" proportionate value of $1,500,000, but, according to the opinion of value by the qualified appraiser who reviewed all applicable factors, an appropriate discount in value in the particular case would be 33%, the donor can give all 1,500 LP units to his son and the value for federal gift tax purposes would be $1 million ($1,500,000 - 33% of $1,500,000, or $500,000). This is an *extremely oversimplified example*, but is meant to explain the idea of making a leveraged gift.

Besides leveraged gifts, there are leveraged gifting techniques available to give a donor "more bang for the buck" when it comes to using all or any part of his $1 million lifetime gift tax exemption. Some leveraged gifting techniques that have been used over the years include a Qualified Personal Residence Trust (QPRT), a Grantor Retained Annuity Trust (GRAT), a Charitable Remainder Unitrust (CRUT), sometimes coupled with an Irrevocable Life Insurance Trust (ILIT), a Charitable Lead Annuity Trust (CLAT), and a sale to an intentionally defective grantor trust (IDIT or IDGT). It is the last technique that we will discuss in detail in Part 2 of this series.

Vintage Cadillac Available. We are assisting the Executor of a decedent's estate that owns a vintage Cadillac. Specifically, it's a 1982 Cadillac Eldorado Coupe (2 door). We believe the car has less than 70,000 miles on it. The car hasn't been driven in years. The key to the car has been lost and a new one needs to be made. The car will need some work to get it into operating condition–sounds great, doesn't it?! If anyone knows someone who might be interested in buying a vintage Cadillac on very favorable terms, please have them call us.

Publication of Article by Karen S. Gerstner. We are pleased to report that Karen Gerstner's article, *Advising a Client Who Has Won the Lottery*, has been published in the April/May issue of GP Solo Magazine, a national publication of the American Bar Association for general practice and solo lawyers and small law firms. Ms. Gerstner has represented over three dozen lottery winners to date.

KAREN S. GERSTNER & ASSOCIATES, P. C.
A Professional Corporation
Attorneys at Law
5615 Kirby Drive, Suite 306
Houston, Texas 77005-2448

Telephone: (713) 520-5205
Fax: (713) 520-5235

ADDRESS CHANGE REQUESTED

To download back issues and learn more about estate planning, visit our web site at www.gerstnerlaw.com

PRINTED ON RECYCLED PAPER

Karen S. Gerstner & Associates, P.C. **April 30, 2010**

Summer Trips and the Need to Come in "Early". Every year about this time, and continuing until September, we get calls from dormant clients and prospective clients who want to make changes to their estate planning documents because they are about to go on a trip. Please keep in mind that the *normal time frame* to complete an estate planning project is 6-8 weeks. If clients are really motivated and will review their draft documents promptly upon receipt, the time frame can be cut to 4-6 weeks. We always have a number of estate planning clients "in the pipeline". These are clients who have started the process of obtaining new estate planning documents but have not yet completed it. When someone calls us "in a rush" because they forgot to allow sufficient time to change their estate plan and they want us to "drop everything" and put them first, we won't ordinarily do that. It doesn't seem fair to bump other clients out of line who are already in the pipeline. Besides, most of the people in a rush knew for quite some time they were going on vacation, but failed to plan ahead. Someone once said, "Your failure to plan is not my emergency". Of course, we will make exceptions for clients who are "on their death beds", but, even then, there is no reason to procrastinate when it comes to your estate planning. It is best to be thoughtful and diligent about one's estate plan and not obtain such important legal documents "in a rush". Plus, errors are more likely to be made when work is done speedily. So, if you are planning a trip this summer and think you might need to change your estate plan before you go, please call now to get on the calendar.

Welcome to Sharon. We are very pleased to announce the newest member of our team: Sharon Riccucci. Sharon comes to us from a similar type of law firm in Florida (she and her husband moved here to be closer to their daughter, a high school science teacher who is getting married later this year).

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown below.

You can also reach us by email addressed to:

Karen S. Gerstner*	karen@gerstnerlaw.com
Jill Gary Hughes	jill@gerstnerlaw.com
Sharon Riccucci	sharon@gerstnerlaw.com
Biljana Salamunovic	biljana@gerstnerlaw.com
General Delivery	info@gerstnerlaw.com

*Board Certified, Estate Planning & Probate Law, Texas Board of Legal Specialization