TAX STRATEGIES

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JOSEPH R. POZZUOLO, ESQUIRE and
WILLIAM C. HUSSEY, ESQUIRE

Diversify Strategies For An Effective Estate Plan

DIVERSIFY STRATEGIES FOR AN EFFECTIVE ESTATE PLAN

By combining properly structured lifetime gifts with testamentary bequests—perhaps making use of trusts, and family annuities and partnerships—estate taxes can be reduced dramatically.

JOSEPH R. POZZUOLO and WILLIAM C. HUSSEY, Attorneys

The approach of the new millennium is an opportune time to reexamine clients' financial futures, including the prospect of death and the imposition of death taxes on accumulated assets in their estate. The ongoing aging of the baby boomer population and the passage of TRA '97, with its sweeping changes to many aspects of the estate tax system, further necessitates an examination of the needs of many families and the potential solutions to their estate planning problems. For those who have not yet looked into their and their families financial future, it is never too early (or too late) to begin the process of securing their legacies.

While death and taxes are the two certainties of life, with proper planning and the use of well-founded techniques, death taxes do not have to be punitive or impose a "penalty" on hard-earned accumulated family assets at death. Presented here is an overview of the many techniques that may be used to reduce (and for some individuals eliminate) federal and state death taxes on their estates.

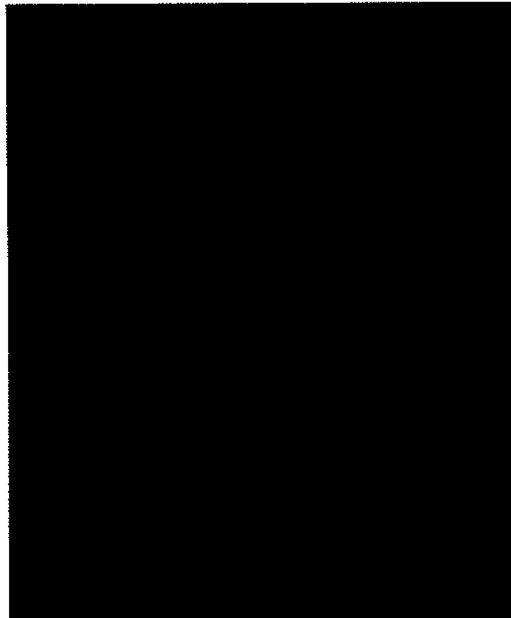
Testamentary devises

Of all the techniques and devices, proper estate planning necessarily begins with the drafting of a will for the individual and his or her spouse. While superstition and phobia prevent many from drafting this most basic of estate planning documents, it also prevents such individuals from taking advantage of several testamentary devices for reducing death taxes. For individuals with a gross estate valued at $650,000 or more who are subject to filing a federal estate tax return, the use of testamentary trusts can provide several distinct tax advantages.

Tax deferral trusts. The marital deduction, if properly used, offers an invaluable technique to reduce federal estate taxes. Any married individual may leave an unlimited amount of the adjusted gross estate tax-free to the surviving spouse.[1] A marital bequest trust, structured to be the primary vehicle for receiving marital deduction assets, can provide much needed flexibility in the combined estate plans of spouses.

The marital deduction trust should be funded with that part of a taxable estate of the first to die, which when added to all qualifying assets passing to the surviving spouse is exactly enough (and no more) to reduce the

JOSEPH R. POZZUOLO *is a senior member, and* WILLIAM C. HUSSEY *is an associate of Pozzuolo & Perkiss, P.C., in Philadelphia, Pennsylvania.*



federal estate tax payable, after application of the entire applicable credit amount (also known as the "unified credit")[2] remaining at the death of the first spouse, to the lowest possible figure. This strategy emphasizes the deferral of death taxes until the death of the survivor. Alternative testamentary strategies include the tax-rate equalization and surtax avoidance formulations.

The marital deduction trust would direct that the income be distributed to the surviving spouse and permit the trustee to use the principal for the surviving spouse's health, support, maintenance, and education and to maintain the surviving spouse's accustomed standard of living. Additionally, the surviving spouse may be given the right to terminate the trust at any time or to make gifts from the trust to himself or herself, children, and grandchildren. In essence, the surviving spouse would have the opportunity to deplete this trust, the property of which is includable in the surviving spouse's estate for death tax purposes.

In many instances (such as a second marriage), a spouse may wish to provide for the surviving spouse during the survivor's lifetime but still be able to direct the ultimate disposition of the assets to other remainder beneficiaries, such as his or her own children or grandchildren. Moreover, the spouse may also wish to provide for continuing professional financial management of the family assets for the survivor's benefit and be certain that on the survivor's death, the other beneficiaries of the estate are provided for as well. This result may be achieved by the executor's designation of the marital deduction trust assets as a qualified terminable interest property (QTIP) bequest.[3]

Under a QTIP marital deduction trust, the trustee would be directed to pay all the income from the trust to the surviving spouse at least annually (or at more convenient intervals) during their lifetime.[4] In addition, the trustee would be authorized to pay as much of the principal as is necessary to maintain the same standard of living and for the health, support, maintenance and education of the surviving spouse. At the survivor's death, however, although the remaining portion of this trust would be included in the surviving spouse's estate for death tax purposes, the balance of the trust fund can be paid over automatically to the children or co-mingled with other trusts for the children under the client's will and other established trusts for the children's benefit.

Besides the tax advantages, one of the most important nontax advantages of a QTIP trust is that it assures that the assets are carefully invested by the trustee, thereby protecting the entire family from unsound investment policies. The assets in the trust may also be protected from family creditors and will not be subject to the administration costs in the surviving spouse's estate, which may result in substantial administrative savings. Finally, on the surviving spouse's death, there is absolute assurance that the remaining assets of the trust will be distributed according to the decedent's wishes. Subject to certain exceptions, the authors generally wholeheartedly recommend the use of QTIP trusts to their clients.

Non-marital deduction trust. In conjunction with the marital bequest trust, a non-marital deduction trust (also known as a "unified credit trust," "non-marital trust," "residual trust," "bypass trust," "B trust," "family trust," "children's trust," etc.) using the unified tax credit offers an invaluable technique to reduce the federal estate death taxes at the death of the first-to-die to avoid a double estate tax.

The unified credit is a dollar amount allotted to each taxpayer that can be applied against the gift tax and the estate tax. For 1999, the unified credit offsets the tax on the first $650,000 of assets. The credit is scheduled to increase incrementally to offset aggregate asset transfers of $675,00 in 2000 and 2001, $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005 and, ultimately, $1 million in 2006.[5] Therefore, the unified credit trust

should be funded with $650,000 of assets for decedents dying in 1999.

The trust can be structured such that the surviving spouse will receive the income in quarterly or other convenient installments during his or her life. Further, the trustee can be directed to use as much of the principal of this trust to provide the surviving spouse with whatever is necessary for the surviving spouse's health, support, maintenance, and education. The surviving spouse may also be given the right to draw from the principal of this trust an annual payment of the greater of $5,000 or 5% on a noncumulative basis.

Both estates may avoid a sizable federal estate tax on the property being placed in these trusts. In many larger combined estates, the survivor's estate may be taxed at a marginal federal rate of 55% plus the 5% percent surcharge on the $650,000 dollars of property which would otherwise be placed in this trust, resulting in a saving of approximately $390,000 in federal estate tax (plus administrative fees and probate costs at the survivor's death).

In short, a zero tax marital bequest trust (sheltered by the marital deduction) containing the minimum amount necessary to eliminate the need to pay federal estate tax, coupled with a unified credit trust containing the maximum amount which can be sheltered from estate tax by the available credits (including without limitation, the applicable credit amount), results in the largest marital bequest fund of all the alternative testamentary dispositive plans and gives the surviving spouse maximum use of the family's economic wealth. It eliminates all federal estate tax on the estate of the first to die and decreases the cumulative total federal estate tax liability on both spouses' estates.

Generation skipping transfer tax

Another consideration in the testamentary and overall estate plan is avoidance of the generation skipping transfer tax (GSTT). Without using exemptions, the GSTT is applied as a flat rate equal to the highest current estate tax bracket (currently 55%) on every generation skipping transfer.[6] A generation skipping transfer is any transfer of property by gift or at death to any individual who is of a generation, as determined by the Code, that is two or more generations below that of the transferor. Thus, it affects such potential beneficiaries as grandchildren, great nieces and nephews, and younger generations.[7] The tax applies to outright transfers and to transfers in trust, estates for years, insurance and annuity contracts, and other transfers involving life estates and remainders.

Exemptions. Since every individual is allowed to make wholly GSTT exempt transfers, in the aggregate, of up to $1 million (indexed for inflation beginning in 1998[8]), either during lifetime or at death, and with estate planning encompassing proper allocation of these exemptions, up to $2 million can be transferred free of this burdensome surtax by the spouses. Furthermore, certain transfers do not trigger the imposition of the GSTT; if they had been made by gift, they would qualify as free from gift tax (such as direct payments made for the donee's educational or medical expenses, Section 2503(c) trusts, and some transfers that pass gift tax free under the annual exclusion rules). Thus, careful timing and substantive allocation of gifts and bequests can minimize or eliminate the impact of GSTT on the spouses' estates.

For succession planning purposes, a GSTT trust may provide the ability to remove estate tax on the death of the children by passing those assets through to the succeeding generation, the decedent's grandchildren. A GSTT trust may be used in conjunction with the marital

bequest (including QTIP) trust and unified credit trust discussed above. In addition, the children may have the right to receive the income of the trust and, subject to the discretion of the trustee, principal from the GSTT trust for their health, maintenance, support and education. Moreover, if the GSTT trust is funded properly, any appreciation in the principal of the trust will also be exempt from the GSTT, even if it exceeds the $1 million exemption on eventual distribution to the grandchildren and other skip persons.

A close examination of the family's assets and needs will usually indicate the proper combination of testamentary trusts needed, when used in conjunction with lifetime planning techniques discussed below, which are appropriate to protect the family assets and effectuate the testator's desires.

Lifetime gifts

Lifetime gifts, either directly or in trust, should be considered an important part of the estate plan. Gift giving generally should also be structured to avoid gift tax, which would reduce the unified credit available at death.[9] As discussed above, the unified credit is the dollar amount allotted to each taxpayer that can be applied against the gift tax and the estate tax. Application of the unified credit against the gift tax reduces (by the amount used) the credit otherwise available against any estate tax later imposed on transfers at death.[10] The annual gift tax exclusion, however, provides that outright gifts of up to $10,000 (with this limit indexed for inflation, in incremental increases of $1,000, beginning in 1998[11]) may be made during each donor's lifetime (resulting in a total of $20,000 from both spouses) to each donee (such as a child or grandchild) in each calendar year without incurring gift tax and without using any portion of the unified credit. Such gifts have the effect of reducing the donor's gross estate while also shifting the income earned and the appreciation on the transferred gifts to the donees.

Tax advantage. Even taxable lifetime gifts have the advantage of being made on a tax-exclusive basis, rather than on the tax inclusive basis (as are transfers occurring on death). Basically, this means that in a lifetime gift transfer, there is no tax on the tax.

Example. Betty transfers $1 million worth of assets as a lifetime gift. The gift tax rate is 55%. Thus, the transaction reduces Betty's wealth by $1,550,000 ($1 million in assets plus $550,000 gift tax). In contrast, a $1 million transfer at death would take $2,222,222 ($1 million assets transferred plus $1,222,222 in estate tax) of her assets, a difference of over $670,000 (all of which must be liquid funds).[12]

Many estate planning devices take advantage of the annual exclusion and the time value of money to further "leverage" the beneficial use of lifetime giving.

Lifetime transfers to minors

Special consideration should be given to transfers to children and others who are under age 21 at the time of transfer. Generally, a gift must be of a "present interest" (i.e., the ability to enjoy the economic benefit of the property at the time of transfer) in order to qualify for the annual exclusion.[13] Certain transfers, however, may be made that delay the receipt of the property by a minor, but still qualify for the annual exclusion.

THE MARITAL DEDUCTION, IF PROPERLY USED, OFFERS AN INVALUABLE TECHNIQUE TO REDUCE FEDERAL ESTATE TAXES.

Under Section 2503(c), a gift for the benefit of a minor will qualify if the principal and income therefrom are available for the use of the minor prior to age 21, and payable outright to the minor on attaining age 21.[14] A trust may be structured to meet these requirements so that additions to the trust will also qualify for the annual exclusion.

Also, a gift made to a custodian for the benefit of the minor under either the Uniform Gifts or Transfers to Minors Act enacted by most states will qualify for the annual exclusion.[15]

The donor may also want to consider the transfer of assets to children and grandchildren, if any, under Section 2503(e). A Section 2503(e) qualified transfer of funds may be made directly to an educational institution as a tuition payment for a donee without being subject to gift tax. This transfer must be made directly to the institution for tuition expenses only. Payments, however, may be for the full tuition without depletion of the $10,000/$20,000 exclusion or the unified credit. Therefore, the spouses can annually give each child and grandchild (or other person) $20,000 and full tuition to a qualified educational institution without incurring gift tax or diminishing

the available unified credit. Similarly, Section 2503(e) provides that a transfer of funds may be made directly to a provider of medical care as payment for such care, without gift tax consequences or using the donor's unified credit or annual exclusion.

Irrevocable life insurance trust

Under existing laws, proceeds of insurance policies on the life of a decedent are included in the decedent's estate if any of these occur:
1. The proceeds are payable to or for the benefit of the decedent's estate.
2. The decedent held an incident of ownership in the policies at the time of his death.
3. Having transferred the policy during lifetime, the decedent dies within three years after the transfer.[16]

Irrevocable life insurance trust. Under the existing rules, an irrevocable trust can purchase and pay for life insurance policies without the proceeds of such policy being included in the taxable estate of the deceased. Also, the client can assign the ownership of any existing insurance policies on his or her life to an irrevocable trust. Then, if the client survives the transfer by three years, the arrangement will not be deemed a transfer in contemplation of death.[17] The provisions of an irrevocable life insurance trust can be the similar to those under the unified credit trust discussed above or the client may elect to have alternative dispositive provisions (such as to provide for the special needs of a child or other family member).

The primary goal of such a trust is to shift the ownership of the policies on the life of the insured (i.e., divest the insured of "incidents of ownership"), thus removing the policy proceeds from the federal taxable gross estate at the death of the insured or the spouse of the insured.

During the lifetime of the surviving spouse, this estate planning technique will afford the economic benefit of the proceeds of the insurance policies on the life of the insured while allowing the proceeds to escape death taxation in both estates with the potential maximum federal estate tax savings of 55% to 60%. Also, by providing the family with a cash fund that can be used to loan money to or purchase assets from the estate at the discretion of the trustee, an irrevocable life insurance trust can provide the necessary liquidity for the payment of death

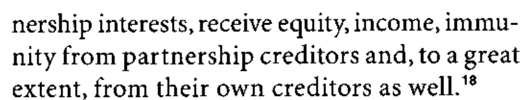
taxes without subjecting the proceeds of the policy itself to depletion by those taxes.

If and when additional insurance is needed or desired, it can and should be purchased by the trustee directly, without ever becoming a part of the spouses' respective estates and eliminating the three year "contemplation of death" rule involved when transferring existing policies under Section 2035.

FLPs

The family limited partnership (FLP) can be a valuable estate planning tool because it can provide:
1. A mechanism for permitting experienced family members to manage family assets.
2. Protection of assets from the claims of creditors.
3. A form of ownership that facilitates the making of gifts because it permits indirect transfers of a pro rata interest in the partnership assets.

A limited partnership is an ideal form of business entity to indirectly transfer interests in family assets to younger family members because older family members (or an entity controlled by them) can serve as the general partners and continue to manage the assets while the younger family members, who will receive limited part-



nership interests, receive equity, income, immunity from partnership creditors and, to a great extent, from their own creditors as well.[18]

An FLP may be used to fractionalize a married couple's interest in business assets, real estate, or even marketable securities, to create valuation discounts by giving or selling such assets to other family members. Generally, a fractional interest may be subject to three discounts and two premium adjustments to arrive at the proper value of the limited partnership interest:

1. Minority interest discount (reflecting the lack of control of such interest).
2. Lack of marketability discount (lack of liquidity of the asset).
3. Blockage discount (increased availability of the asset drives down price but rarely applied).
4. Control premium (applicable to a majority owner who may exercise unfettered control of the entity).
5. Swing vote premium (based on the ability of a fractional share to carry a majority proposal).[19]

The limited rights of a limited partner to obtain a pro rata share of the partnership assets can justify a substantial reduction in the value of a gift of limited partnership interest via a lack of marketability discount. The fair market value of both the retained and transferred interests may also be discounted to reflect the difficulty of selling fractional, not readily marketable, interests in businesses or properties (even though all of the FLP interests are still retained by the family).[20] Furthermore, when the surviving spouse dies, the estate may claim such discounts in the value of the retained interests due to the fact they are fractional interests and not readily saleable to a third person.

An FLP established in accordance with state law may also be treated for federal income tax purposes as a genuine partnership. Finally, gifts of such an interest in a family partnership qualify for the $10,000 dollar annual gift tax exclusion ($20,000 for married couples).[21]

An FLP is a vehicle that may be used to transfer ownership of assets to other members of the family, thereby reducing the size of the estates during the client's lifetime, without loss of control. The ability to control the management and operations of the underlying assets may be of utmost concern when the underlying asset requires professional management for which the limited partners (i.e., the children and grandchildren) are not yet prepared. Of course, by transferring some assets into an FLP and giving limited partnership interests to children and grandchildren, for each dollar of assets so transferred, the client may save up to 55% in estate tax, 5% percent more in surtax avoidance, and take advantage of the discounted fair market value to leverage the gift tax exemption.

LLCs and other entities

The limited liability company (LLC), like the FLP, may offer the client the benefit of transferring assets (at a discounted rate) to younger family members while retaining control over the investment of the family assets. As most states have now enacted legislation providing for the LLC form, the use of an LLC has gained greater popularity in the estate planning area. Significant differences in those enacting statutes, however, call for a close examination of the family's personal needs and the benefits and detriments of selecting the particular form of entity.

Corporate and other business interests, particularly closely held entities, are also candidates for lifetime transfers to younger generations. Unlike the FLP or LLC however, transfers of fractional interests, if made in the form of voting securities, in such corporations may eventually cause the transferor to eventually lose voting control of the entity.

Transfers by gift of these fractional business interests may have several additional advantages:

1. The gross estate is reduced by the present value of the interest.
2. Appreciation of the interest and the future income stream are also removed from the gross estate.

3. The transfer may motivate a younger family member to take greater interest in the management of the business or other assets and, thus, provide a greater chance those assets will be properly managed after the client's death.
4. A written agreement among the stakeholders in the entity (e.g., a limited partnership agreement, or a shareholders' agreement) can provide the family with many different options as to the management of the entity and provide that the interests will remain in the family through the use of buy-out and redemption clauses. (These agreements may also serve as evidence supporting the valuation discounts discussed above.)

Grantor retained interests

Substantial estate tax savings may be effectuated through the use of a personal residence grantor retained income trust (GRIT) or qualified personal residence trust (QPRT) for either a primary residence or one secondary residence, such as a summer home, or both. For example, this type of trust would allow the client to transfer a summer home to a trust while retaining the right to use the residence for a specified term of years and reducing estate taxes by eliminating the asset from their gross estate.[22]

In addition, GRITs can substantially discount the value of the transferred asset for gift tax purposes. The fair market value of the gift in a GRIT is reduced by the term interest retained by the grantor (i.e., the cost of the donee's wait to receive it). Thus its gift tax value is lowered, and the gift tax incurred or unified credit depletion is minimized.[23] Furthermore, 100% of the post-transfer appreciation in the transferred property's value will escape both estate and gift taxes, making it an excellent "estate freezing" device.

Where the transfer is made to a close family member, however, the requirements of Chapter 14 of the Code must be met.[24] The sections contained in Chapter 14 effectively value the retained interest at $0, such that the gift tax is imposed on the full fair market value of the asset. In order to avoid this harsh result, the retained interest must be either of three types:

1. An annuity payment (i.e., a "GRAT").
2. A unitrust payment computed annually on the fair market value of the trust assets (i.e., a "GRUT").
3. A remainder interest following an annuity or unitrust interest.

Each of these interests is intended to reflect the appropriate valuation of the annuity tables used and to prevent abuse of the GRIT by the placement of non-income producing, high capital growth assets in the GRIT. Even so, appropriately structured GRITs, GRATs, GRUTs, and QPRTs, which meet (or avoid) these requirements, are a viable and highly useful planning technique.

A grantor retained unitrust (GRUT) is an estate planning device through which the client can transfer an asset other than a personal residence into a trust while retaining an annuity payment for a term of years (i.e., a fixed percentage of the trust assets' value each year). A GRAT differs from a GRUT in that it is an irrevocable right to receive a fixed amount at least annually, payable to or for the benefit of the holder of the term interest. A GRAT or GRUT can remove the value of the asset from the gross estate, and thereby, will eliminate the federal estate tax on that asset and its appreciation in value, and will leverage the gift tax exemption through discounting the valuation of the taxable gift by the value of the retained interest.

THE GSTT APPLIES TO OUTRIGHT TRANSFERS AND TO TRANSFERS IN TRUST, ESTATES FOR YEARS, INSURANCE AND ANNUITY CONTRACTS, AND OTHER TRANSFERS INVOLVING LIFE ESTATES AND REMAINDERS.

Appropriate assets. This may be an effective estate planning device for assets such as an ownership interest in a closely held business or investment properties, which are likely to appreciate significantly and have the self-generated cash flow to support an annuity (or unitrust) payment.

If the GRAT or GRUT donor outlives the specified term, none of the trust's assets will be included in the donor's gross estate. If, however, the donor predeceases the annuity term, the value of the assets in the GRIT and GRAT will be includable in the donor's gross estate, and any used unified credit or gift tax paid will be restored to the estate. The net effect of such recapture is the same as if no transfer had occurred. To ameliorate such consequences, the beneficiary can purchase insurance on the donor's life and carry that life insurance during the period of time in which the donor's death would cause estate tax inclusion.

CRTs

A charitable remainder unitrust (CRUT) and charitable remainder annuity trust (CRAT) can allow the grantor/client to make an immedi-

ately deductible gift in trust to a charity, but keep (or give to another beneficiary) the right to receive regular payments from the trust for life or a period of years (not to exceed 20 years) before the charity receives the remainder interest of the trust.[25] The advantages of this estate planning technique are as follows:

- The grantor may take an immediate charitable income tax deduction for the fair market value of the remainder interest that passes to the charity.
- If appreciated assets are used to fund the trust, capital gains taxes will go unrecognized on the sale of the assets by the charitable remainder trust (CRT) until actual distribution of the proceeds to the beneficiary. (The CRT is not taxable unless it has unrelated business income.[26])
- Without the capital gains tax, all of the proceeds of the sale of assets are available for reinvestment, which increases the income the noncharitable (and charitable) beneficiary can receive.
- The assets contributed to the CRT will escape death taxes even if the grantor retained an annuity for their lifetime.

CRUT. The trust instrument in a CRUT must provide to the noncharitable beneficiary a variable payout based on the annual valuation of the trust assets. This payout must be paid at least annually and must be a fixed percentage of not less than 5% of the net fair market value of the trust assets (and generally limited to not more than 15% percent to prevent abuse of the CRT form by the grantor, but statutorily capped at 50%[27]), or the payout may be limited to the net income of the trust with the deficiency to be made up in later years (a "NIMCRUT"). The payout period may extend for a term of up to 20 years or for the life or lives of the beneficiaries.[28] Since the trust assets are valued annually, the grantor may make additional contributions to the trust subsequent to the initial funding. Following the termination of payments to the beneficiaries, the remainder interest is transferred to the designated qualified charity or retained in the trust for the charity's benefit.

If the noncharitable beneficiary of the CRUT is not the donor or the donor's spouse, the donor will be subject to gift tax only on the value of the income interest passing to the beneficiary, calculated as the present value of the beneficiary's right to receive the fixed annuity for the life of the beneficiary or terms of years. Moreover, the IRS has determined that this type of interest will qualify as a present interest gift for gift tax exemption purposes. Thus, the grantor and spouse are entitled to a $10,000/$20,000 dollar annual exclusion for each beneficiary if the trustee is required to make annual distributions to the beneficiary.

CRAT. Similar to a CRUT, the CRAT provides a *fixed annuity* to the grantor for a period of years (not to exceed 20 years) or for the life or lives of the grantor or his designated beneficiaries.[29] The annual annuity payment must be valued at a minimum of 5% of the *initial* fair market value of the transferred property (and not to exceed 50% of such value). Unlike a CRUT, however, no further contributions may be made to a CRAT. Finally, following the termination of the individual beneficiary's income/annuity interest, the remainder interest will pass to or in trust to the qualified charity.

Both the CRUT and CRAT provide the advantages discussed above. The subtle distinctions between the two, however, allow the client to select the CRT that best suits that client's needs.

Retirement plan distributions

Any qualified retirement plans and IRAs maintained for the client's benefit must be appropriately integrated within the comprehensive estate plan. Although income taxes are deferred on the contributions and earnings of such retirement plans, they are not structured for perpetual

tax sheltered wealth accumulation. Thus, there are numerous rules regarding distributions and significant penalties for noncompliance. Some penalties are as great as 50%.[30] Therefore, all qualified plan and IRA death benefits must be coordinated into the estate plan to minimize or avoid penalty taxes, maximize funds available for the ultimate beneficiaries, defer distributions from the plan as long as possible, and provide flexibility after death.

Post-mortem strategies are significant in distribution planning because tax laws affecting retirement plans change frequently, and there are many key variables impossible to predict with complete accuracy—such as health, life expectancy, order of death, and investment earnings. One of the most important considerations is the proper structuring and designation of a lifetime or testamentary trust as the recipient of the proceeds on the death of the qualified retirement plan or IRA owner. Therefore, a detailed discussion should be held by and among the client and his or her advisors regarding the incorporation of retirement plans and IRAs into the total estate plan to simultaneously achieve optimal income and estate tax savings and flexibility.

Private annuity

A private annuity is an estate planning technique that can be used to transfer a sizable asset, such as real estate or a business from the estate for federal estate tax purposes. The client can convey the complete ownership of an asset to a transferee, who is the natural object of his bounty (i.e., a child), who promises to make unsecured periodic payments to the client for a period (usually for his or her lifetime or a joint and survivor annuity for the lives of both spouses). Any type of property may be transferred in this manner, such as real estate, stocks, or a business interest. The optimal assets to transfer are ones that are income producing or will rapidly appreciate and will not be subject to debt, depreciation, or investment credit recapture.

In a private annuity arrangement with the client as the sole annuitant, the annuity payments will cease at the client's death, and the transferred asset is not includable in his or her gross estate for federal estate tax purposes. Furthermore, there will be no gift tax implications if the annual payments made to the client by the transferee are actuarially determined to be equivalent to the fair market value of the asset so transferred.[31]

The advantages to be gained from a private annuity are:

1. A stream of income for life.
2. The (legal) avoidance of gift tax.
3. The removal of the transferred asset (including any appreciation in its value) from taxable gross estate, thereby eliminating up to a maximum of 55% federal estate tax on the value of the asset.

Stepped-up basis

In selecting a dispositive estate plan, consideration should also be given to the Section 1014 basis adjustment. The surviving spouse receives a new income tax basis for property included in the marital bequest trust, and the bypass trust receives a new income tax basis for the non-marital property (i.e., a stepped-up—or, perhaps, a stepped-down—basis to the property's value at the decedent's date of death).

When the surviving spouse dies, a further income tax basis adjustment would be made for the marital trust, which is includable in their gross estate. In contrast, bypass trust property does not receive another basis adjustment because it is not included in the surviving spouse's gross estate. These basis adjustments can be favorable because they produce a "tax-free elimination of capital gain income tax" when the assets are eventually sold. Thus, before lifetime gifts are made to deplete a portion of the taxable estate, some consideration must also be given to the type of asset being transferred and the step up in basis for income tax purposes which occurs at death.

CERTAIN TRANSFERS MAY BE MADE THAT DELAY THE RECEIPT OF THE PROPERTY BY A MINOR, BUT STILL QUALIFY FOR THE ANNUAL EXCLUSION.

Compare taxes. The key element is to balance the ultimate payment of income and capital gains taxes versus the toll imposed by the estate tax. The types of assets transferred should be examined for growth rate, basis, and holding period and a rough calculation made of the probable tax consequences if transferred currently. It is possible through discussion that a more appropriate asset may be identified for transfer during life. Given the current marginal tax brackets however, it is probable that for high

net-worth individuals, any transfer will be better than none at all.

Springing durable power of attorney

As a final nontax consideration, a comprehensive estate plan should provide for the continuing management of family assets and administration of affairs in the event of the physical or mental incapacity of either or both spouses. Through the execution of a power of attorney, the client can delegate to another, referred to as the attorney-in-fact, the authority to take acts on behalf of the principal.

Some of the benefits of preparing a power of attorney are:

1. The client can enjoy the security of knowing that his or her financial and health care needs and concerns will be handled in a manner that is consistent with his or her own intentions.
2. The client, rather than a court, appoints the person he or she believes is the most competent to manage the principal's affairs. This may include the power to continue to make estate planning decisions on the client's behalf, such as the continuation of a gift-giving program begun by the client prior to incapacity.
3. The client will circumvent the expense and delay of a court appointed committee, conservator, or guardian. The management of an individual's assets through judicial intervention requires establishing, to the satisfaction of the judicial tribunal, that a person whose assets are to be administered has reached a level of diminished capacity. This procedure involves levels of scrutiny and due process that, in the final analysis, result in both delays and substantial financial costs—including ongoing expenses for court accountings, as well as separate applications to the court whenever a major transaction is to be undertaken.

Definition. A durable power of attorney is one that is not terminated by subsequent incapacity or disability of the principal, but will cease on the principal's request, or discontinue automatically on death.

Many individuals, however, are uncomfortable with immediately vesting the power to manage their financial or health affairs to an attorney-in-fact. One method that circumvents these concerns is the "springing" durable power of attorney. The springing power is simply a grant of authority that does not go into effect until a disability occurs. Once the principal becomes disabled or incompetent, the attorney-in-fact is vested with all the authority he would have had under an immediate appointment as an attorney-in-fact. The advantage of the springing power is that no control is transferred over the assets until there is an actual need. This type of appointment requires a statement in the instrument that specifies when the power will arise.

The critical issue with the springing power is determining a "triggering" event that properly defines when a disability has occurred. Often, the solution is to require that one or more physicians or other trusted persons certify that the individual is incapacitated. In all instances, there must be clear and precise language in the instrument that defines the triggering event and creates an objective mechanism for determining when such an event has occurred.

Conclusion

The conservation and distribution of the client's estate to efficiently and effectively accomplish his or her tax and nontax objectives is one that requires coordination of substantial assets with the components of a sophisticated estate plan. Unless such a plan is properly formulated, federal estate tax can consume over half of the value of the taxable gross estate. Through the integration of testamentary trusts together with the appropriate family limited partnerships, life insurance trusts, GRITs, CRTs, and private annuities, a client can reduce the size of the taxable estate, eliminate the estate surcharge, minimize combined estate tax liability, and optimize the leveraging of the unified credit.

Furthermore, even the most perspicacious estate planning strategies are subject to change along with the tax laws. As a result, regular review of an estate plan is necessary to ensure that the latest available planning options are being used. ■

NOTES

1 Section 2056.

2 Section 2010(c).

3 Section 2056(b)(7).

4 Section 2056(b)(7)(B)(ii)(I) See Streer and Strobel, "Review Wills for Recent QTIP Changes," 60 Tax'n Acc'-tants 138 (March 1998).

5 Section 2010(c).

6 Section 2641.

7 Sections 2611 and 2651.

8 Section 2631(c).

9 See Zaritsky, "Adapt Gift-Giving Strategies to Fit Special Circumstances," 62 PTS 348 (June 1999).

10 See Sections 2010, 2012, and 2504.

11 Section 2503(b)(2).

12 Compare Sections 2001(b) and 2502.

13 Section 2503(b).

14 Section 2503(c).

15 See Rev. Rul. 59-357, 1959-2 CB 212. See also West, "Gifts to Minors Can Be Tied Up With More Than Pretty Ribbons," 60 Tax'n Acc'tants 353 (June 1998).

16 Sections 2035(a) and (d)(2), and 2042(2).

17 *Id.*

18 See, e.g., the Pennsylvania Revised Uniform Limited Partnership Act (15 Pa. Cons. Stat. ch. 85).

19 See, e.g., In re Estate of McCormick, TCM 1995-371; Moore, TCM 1991-546; In re Estate of Berg, TCM 1991-279; In re Estate of Wildman, TCM 1989-667.

20 *Id.*

21 But see Adler, "Wrong Wording Kills Exclusion for Limited Partnership Interest," 61 Tax'n Acc'tants 80 (August 1998).

22 But see Regs. 25.2702-5(b) and (c).

23 But see Section 2702.

24 See Section 2702; Reg. 25.2702-3.

25 See Section 664.

26 Section 664(c).

27 Section 664(d)(2)(A).

28 *Id.*

29 Section 664(d)(1)(A).

30 See, e.g., Section 4947.

31 See Webel, "Private Annuity Passes Wealth to Family Members—Other Than Uncle Sam," 61 Tax'n Acc'tants 68 (August 1998); Ayers and Streer, "Declining Interest Rates Enhance Appeal of Private Annuities," 62 PTS 144 (March 1999).