ESTATE TAX UPDATE 2021

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Estate Tax Update -2021

I. The Biden Tax Plan Estate Tax Provisions

A. Step Up in Basis - Eliminate Step up in basis.

B. Estate Tax Exemption

- Reduce the estate tax exemption to $3,500,000.
- Increase top rate to 45%.

II. The SECURE Act

A. Overview

Another bill in the Omnibus Act is the SECURE Act, an acronym for "Setting Every Community Up for Retirement Enhancement". The core intent of this Act is to update retirement rules for needed improvements and longer life expectancies. Most of these provisions begin in the year 2020.

B. Retirement provisions of the SECURE Act.

- The so-called "Stretch IRA" plan is eliminated for those dying after 2019. Beginning in 2020, IRA beneficiaries must spend the entire account within ten years of the death of the prior owner. Exceptions will remain for certain beneficiaries including spouses, those beneficiaries who are within 10 years of age of the deceased, those beneficiaries who are disabled or chronically ill, and minor children (but only while they are minors – then the 10-year clock will start).
- The Act removes the age 70-1/2 limit on contributing to an IRA. Beginning in 2020, no age limits will apply. All other requirements still apply, such as the requirements to have earned income.
- The Act creates a new exception from the 10% penalty for premature retirement distributions. This new one is for up to $5,000 for a birth or adoption. The distribution will still be subject to income tax – it's just the 10% penalty that is waived.
- The Act increases an employer tax credit for the establishment of a retirement plan to up to $5,000.
- The Act creates a new employer tax credit for adopting an automatic enrollment retirement plan.
- The Act requires that long-term part-time workers be included as eligible employees (those who work at least 500 hours for at least 3 consecutive years).

C. Non-retirement provisions of the SECURE Act.

- Retroactive to 1/1/2019, up to $10,000 annually of 529 plan funds can be used to pay expenses of student loans and apprenticeships.
- Before 2018, children with significant investment income were subject to the so-called "kiddie tax", meaning that the children were taxed at their parents' tax bracket. The Tax

Cuts and Jobs Act of 2017 changed this rule effective for 2018, providing that these children will use trust tax rates instead. The Act changes this rule back effective for the tax year 2020. Thus, beginning in 2020, the children are not subject to trust tax rates, but to the incremental rate of their parents.

– Further, taxpayers can elect to apply this new rule to 2019.

– Even further, the taxpayer can elect to apply this new rule to 2018 via an amended return. But it seems that it may be hard to generate sufficient tax savings to justify the expense of this effort.

III. Estate Tax Update

A. What's New for 2021

1. Estate Tax Exemption

On October 26, 2020, the Internal Revenue Service ("IRS") announced the official estate and gift tax limits for 2021. Currently, the estate and gift tax exemption equivalent is $11.58 million per individual (or $23.16 million for a married couple). For 2021, the exemption equivalent will increase to $11.7 million per individual (or 23.4 million for a married couple). With these exemptions, a married couple can give up to $23.4 million to heirs and pay no federal estate or gift tax.

2. Gift Tax Exclusion

The annual gift exclusion amount for 2021 stays the same at $15,000 per donor, per recipient. Each individual can give away $15,000 to any individual they desire with no federal gift tax consequences. Married couples can combine these amounts and make $30,000 gifts to each individual, doubling the impact. In addition to the $15,000 amount, each individual can make unlimited payments for medical and tuition expenses as long as such payments are made directly to the institution providing the service. It should be noted that these gifts are not limited to children, grandchildren, etc. but can be made to anyone you choose.

3. New Regulations Impacting Fiduciary Income Tax Issued.

Treasury and the IRS issued proposed regulations under Sec. 67(g) clarifying that certain deductions allowed to an estate or nongrantor trust are not and, thus, are not affected by the suspension of the deductibility of miscellaneous itemized deductions contained in the law under the Tax Cuts and Jobs Act.

4. Nelson

In *Nelson, TC Memo 2020-81*, the Tax Court held that the defined-value clause the husband and wife taxpayers used to transfer interests in a family limited partnership (FLP) did not prevent the IRS from imposing gift tax based on the percentage interests stated in the transfer instrument.

5. Estate of Jones

In *Estate of Jones*, *TC Memo 2020 -101*, the Tax Court held that tax-affecting the earnings of an S corporation and limited partnership was appropriate in determining their value under the discounted-cash-flow (DCF) method of valuation.

6. Loans Were Gifts.

In *Estate of Bolles, TC Memo 2020-71*, the Tax Court held that advances the decedent made to one of her sons over many years to support his struggling architecture business were more properly characterized as gifts and, therefore, were properly included in computing her estate tax liability.

7. Willing Buyer/Willing Seller

In *CCA 201939002*, the IRS determined that a future merger of a corporation whose shares were gifted should be considered for gift tax valuation purposes.

8. Family Limited Partnership Disregarded

In *Estate of Moore*, *TC Memo. 2020-40*, the Tax Court held that the value of a farm a decedent transferred to a family limited partnership (FLP) was includible in the decedent's estate because the decedent retained the possession and enjoyment of the farm until his death; a loan from the FLP to the decedent was not a bona fide loan; and the decedent's transfers to his children within the three-year period preceding his death were gifts rather than loans.

9. Transfers between Grantor Trusts

In *IRS Letter Ruling 202022002*, the IRS ruled that the sale between a trust from which the beneficiary had a general power of appointment and a grantor trust created by that beneficiary is not recognized as a sale for federal income tax purposes because the beneficiary is treated as the owner of both trusts.

10. Valuation of Beneficial Interests

In *Letter Ruling 201932001*, the IRS ruled that the termination of a GST tax-exempt trust and the proposed distribution of the trust assets to beneficiaries will not cause the trust, or any terminating distributions from the trust, to be subject to GST tax or gift tax. The IRS ruled that the proposed transaction, in substance, is a sale of the life tenant's and the life tenant's grandchildren's interests to the life tenant's children, requiring the recognition of gain or loss.

11. Valuation of LLC Interests

In *Estate of Grieve, TC Memo 2020 -71*, the Tax Court upheld the taxpayer's gift tax valuation of 99.8% nonvoting interests in two LLCs that the taxpayer had transferred in 2013 to a grantor retained annuity trust (GRAT) and an irrevocable trust, rejecting a valuation/methodology the IRS offered that assumed that a buyer of a 99.8% interest would start by seeking to purchase the 0.2% controlling interest.

12. Estate Tax Basic Exclusion Amount

The IRS issued final regulations (T.D. 9884, 84 Fed. Reg. 64995) addressing the effect that changes made by the law known as the Tax Cuts and Jobs Act (TCJA)2 have on the basic exclusion amount used in computing federal estate and gift taxes. The final regulations affect donors of gifts made after 2017 and the estates of decedents dying after 2025.

13. Modification – GST

In *Letter Ruling 201947004*, the IRS ruled that the modification of a trust would not cause the trust to lose its grandfathered status as exempt from GST tax, even when the period of trust is extended beyond its original termination date.

14. Trust Reformation

In *Letter Ruling 201941023*, the IRS allowed the reformation of six trusts reforming a beneficiary's withdrawal power from a trust to be applied retroactively because the specific provisions of the trust did not comply with the taxpayer's intent at the time the trusts were created. In addition, it ruled on the consequences of the reformation and certain mistakes made on gift tax returns reflecting the transfers to the trusts.

B. New Regulations Impacting Fiduciary Income Tax

The IRS on September 21, 2020, issued final regulations (T.D. 9918) clarifying that certain expenses incurred by, and certain excess deductions upon the termination of, an estate or nongrantor trust are not affected by the suspension of miscellaneous itemized deductions for tax years 2018 through 2025. The regulations also provide guidance on determining the character, amount, and allocation of excess deductions that are succeeded to by beneficiaries.

The final regulations adopt with few changes proposed regulations issued in May 2020. Sec. 67(g), enacted by the Tax Cuts and Jobs Act (TCJA), P.L. 115-97, disallows miscellaneous itemized deductions for any tax year beginning after Dec. 31, 2017, and before Jan. 1, 2026. Before the TCJA, miscellaneous itemized deductions were allowed to the extent that their aggregate amount exceeded 2% of adjusted gross income (AGI). They are defined as itemized deductions other than those listed under Secs. 67(b)(1) through (12).

Sec. 67(e) directs that the AGI of an estate or trust is computed in the same manner as for an individual, except that deductions are allowed for (1) costs paid or incurred in connection with the administration of the estate or trust that would not have been incurred if the property were not held in an estate or trust, and (2) deductions allowable under Sec. 642(b) (personal exemption amounts for estates and trusts) and Secs. 651 and 661 (distributions by trusts distributing current income and trusts accumulating income, respectively). In Notice 2018-61 issued in July 2018, the IRS announced it would issue regulations to clarify that Sec. 67(e) deductions are not suspended or eliminated by Sec. 67(g).

The proposed regulations amplified this position, along with addressing the treatment of excess deductions upon an estate or trust's termination under Sec. 642(h)(2). That provision allows beneficiaries succeeding to the property of a terminating trust or estate to take a deduction of any excess of certain deductions over gross income of the trust or estate in its last tax year. Prior regulations provided that

excess deductions were allowed by beneficiaries in computing taxable income and not AGI; thus, they were treated as a single miscellaneous itemized deduction.

In the proposed regulations, the IRS and Treasury recognized that excess deductions may in fact consist of (1) deductions allowable in arriving at AGI; (2) non-miscellaneous itemized deductions; and (3) miscellaneous itemized deductions. Only the third type is suspended under Sec. 67(g). Consequently, the proposed and final regulations provide rules for trustees to determine for a terminating estate or trust the character and amount of each deduction type and, therefore, their respective allocations to, and applicable limitations upon, the succeeding beneficiaries.

Here's an Example : Assume an estate's income and deductions in its final year are as follows:

Total income of $6,500

– Taxable interest of $500,

– Dividends of $3,000,

– Rental income of $2,000,

– Capital gain of $1,000,

Total Deductions of $17,500

– Probate fees of $1,500

– Estate tax preparation fees of $8,000,

– Legal fees of $2,500

Collectively, IRC §67(e) deductions – (i) personal property taxes of $3,500 (itemized deductions), and (ii) rental real estate expenses of $2,000.

There are two beneficiaries – A (75%) and B (25%).

Pursuant to the regulations under IRC §652, the $2,000 of rental real estate expenses are allocated to the $2,000 of rental income. The executor may, in his discretion allowed under the regulations, allocate the $3,500 of personal property taxes and $1,000 of the IRC §67(e) deductions to the remaining $4,500 of income (thus maximizing the amount of the excess deductions which are considered above-the-line deductions). Therefore, the excess deductions on the termination of the estate are $11,000, consisting entirely of IRC §67(e) deductions which are deductible when computing gross income.

Beneficiary A will be allocated $8,250 of above-the-line deductions, and beneficiary B will be allocated $2,750 of above-the-line deductions.

C. Estate Planning With an Elusive Estate Tax Exemption

1. Taking Advantage of the Current Exemption Amount

a. General Gifting Guidelines

The current federal estate and gift tax exemption for 2021 adjusted for inflation stands at $11,700,000 per individual, or $23,400,000, for a married couple. That exemption will under current

law revert to $6,000,000 in 2026. Under President elect Biden's tax plan, the exemption could revert to $3,500,000 even sooner. Gifts made during your lifetime reduce the exemption amount available to be applied against your estate. One might assume that you could take advantage of the higher exemption amount currently available simply by making gift of the "excess exemption amount", i.e., the excess of the current exemption amount of $11,700,000 over that which will be available in 2026 projected at $6,000,000 (the "base exemption amount)." That would be the case if the gifts made prior to 2026 reduced that excess exemption amount first, and the base exemption amount only when taxable gifts exceeded that amount. However, the increased exemption is structured in the opposite way so that a gift made in 2021 when the exemption is $11,700,000, will reduce the base exemption amount before it is utilizing the "excess exemption amount". To illustrate this further consider this example:

> *Example 1 - A has an estate with a value of $11,700,000. In 2021 he makes a gift of $6,000,000, leaving $5,700,000 of value in his estate. The gift will utilize $6,000,000 of his exemption amount and will incur no gift tax.*
>
> *If A dies in 2026, when the exemption amount has been reduced under current law to $6,000,000; his estate will have no exemption amount remaining. The $6,000,000, gift in 2021 being deemed to have offset that base exemption amount in full. Because A died in 2026 the excess exemption amount is lost. As a result, A's entire remaining estate of $5,700,000 will be taxable without an exemption and incur a federal estate tax of $2,280,000.*
>
> *From this we can reach the conclusion that to take advantage of the higher exemption amount of $11,700,000, available in 2021, an individual must either: (1) die before the exemption is reduced either by existing law or by future legislation or (2) make gifts with a value in excess of the base exemption amount. Three more examples will illustrate these concepts:*
>
> *Example 2 - Assume the much same facts as in Example 1, that is A has an estate with a value of $11,700,000. In 2021 he makes a gift of $6,000,000, leaving $5,700,000 of value in his taxable estate. Again, the gift will be deemed to have utilized the exemption amount to the extent of $6,000,000 of his available $11,700,000 exemption amount, and no gift tax will be incurred.*
>
> *One change in facts from Example 1: Assume that A dies in 2025, with a remaining estate of $5,700,000 and that the exemption amount remains as it does under current law at $11,700,000.*
>
> *If this is the case because A died before the exemption amount was reduced in 2026, A's estate will still have $5,700,000 of exemption amount remaining to offset the value of the estate, resulting in no taxable estate and no estate tax.*
>
> Two more illustrative examples:
>
> *Example 3 - B has an estate with a value of $11,700,000. If B dies in 2026, when the exemption amount has been reduced under current law to $6,000,000. B's entire $11,700,000 estate will be subject to estate tax offset by the reduced exemption of*

$6,000,000 resulting in a taxable estate of $5,700,000 and a federal estate tax of $2,280,000.

Example 4 – Again assume B has an estate with a value of $11,700,000. However, in this example assume that in 2021 she makes a gift of $9,000,000, leaving $2,700,000 of value in her estate. The gift will utilize $9,000,000 of her exemption amount, but no gift tax will be incurred by the transfer.

If B dies in 2026, when the exemption amount has been reduced under current law to $6,000,000. Her estate will have no exemption amount remaining - the gift in 2021 being deemed to have offset fully that amount. As a result, B's entire remaining estate of $2,700,000 will be taxable without an exemption. However, by reason of the $9,000,000 gift in 2021, her taxable estate has been reduced to $2,700,000, and the federal estate tax to $1,080,000. This represents a savings of $1,200,000, over what it would have been if she had not made the gift.

As a result, the following conclusion can be reached: To take advantage of the current federal estate tax exemption gifts must be made in excess of the base exemption amount applicable to the estate. Such gifts will effectively reduce the taxable estate, but only in the amount of the excess. The unknown of course is what that base exemption amount will be. The answer depends on when the person dies and whether the new administration with Democrats in control will accelerate the reduction of the exemption amount before 2026.

If law as currently on the books remains unchanged the following guidelines apply to gifts made before 2025:

– If an individual dies before 2025, pre 2026 gifts will effectively remove value from the taxable estate only to the extent they are "leveraged" and to the extent of post gift appreciation.

– If an individual dies before 2025, pre 2026 gifts will not increase or decrease the taxable estate except to the extent they are "leveraged" and to the extent of post gift appreciation.

– If an individual dies after 2025, pre 2026 will reduce the taxable estate, but only to extent they are in excess of the base exemption amount applicable to the estate.

– If an individual dies after 2025, pre 2026 gifts that are less than the base exemption amount will not reduce the taxable estate, i.e., such gifts will reduce the base exemption amount, and reduce the taxable estate by the same amount.

b. Spousal Lifetime Access Trust ("SLAT").

(1) Overview.

One planning option discussed in order take advantage of the higher estate exemption is the so-called Spousal Lifetime Access Trust, or "SLAT."

(2) What is a Spousal Lifetime Access Trust?

The Spousal Lifetime Access Trust ("SLAT") is an irrevocable trust where one spouse makes a gift into a trust to benefit the other spouse (and potentially other family members) while removing the assets from their combined estates.

One spouse may choose to fund a SLAT for the benefit of the other spouse or each spouse may choose to fund SLATs. For married couples, this may offer a way to take advantage of the federal lifetime gift and estate tax exclusion, which is currently $11.7 million per person in 2021, or $23.4 million per married couple, while retaining limited access to the assets, in the event such access is ever needed. Because a SLAT is funded with a gift made during the spouse's lifetime, any post-gift appreciation will take place in the trust and be excluded from the estate of both spouses for federal estate taxation purposes.

(3) How a SLAT works

Married couples may be interested in making large, permanent gifts to reduce the size of their estate. However, concerns can arise because many gifting strategies involve the loss of control of the assets during their lifetime and they may be unsure whether the assets will be needed in the future. A SLAT is an estate planning strategy that can perhaps address these conflicting objectives. This type of trust is created by one spouse (the "donor" spouse) who gifts property to an irrevocable trust for the benefit of the other spouse ("non-donor" spouse). They may also elect to include other family members (typically children and grandchildren) as beneficiaries. The donor spouse uses their federal exclusion when transferring assets to the SLAT.

Although the trust is irrevocable, the donor spouse may indirectly benefit from the property gifted to the trust, as long as the non-donor spouse is living and remains married to the donor. This indirect benefit is achieved because the non-donor spouse is the primary beneficiary of the trust and can request distributions from the trustee of the trust, if needed, during their lifetime. The trustee may approve this request and distribute income or principal to the non-donor spouse, typically to maintain their accustomed standard of living.

Upon the death of the donee spouse the remaining balance of the trust reverts to the heirs other than the donor spouse. Distributions to the non-donor spouse will be reintroduced into their taxable estate unless they are spent. The appropriate amount to gift to a SLAT should be determined through appropriate budgeting and planning, with the ultimate goal of the SLAT to be to let the trust assets grow outside the estate for future generations. Upon the death of the non-donor spouse, the trust assets are transferred to the remaining trust beneficiaries (e.g., children or grandchildren), either outright or in further trust.

(4) Potential benefits of a SLAT

The donor's transfer of assets to the SLAT is considered a taxable gift. If structured properly, the gift permanently removes the assets, as well as future appreciation on the assets, from the donor's taxable estate. Even though the non-donor spouse is a beneficiary of the SLAT, the trust is excluded from the non-donor's taxable estate as well.

SLATs are typically structured as grantor trusts for income tax purposes. This means the donor pays the income tax liability personally on the earnings generated in the trust, rather than the trust itself bearing the burden of income taxes. The grantor trust structure may also further reduce the taxable estate of the donor and allow the assets inside the trust to appreciate outside of the estate of the donor without being encumbered by income taxes.

The current estate tax environment also provides a benefit for those considering SLATs. While the exclusion is currently $11.7 million (in 2021) per person, this is scheduled to "sunset" in 2026 or could be changed sooner, so funding a SLAT prior to the exclusion being lowered enables a donor to effectively utilize the current historically high exclusion amount. Individuals who take advantage of the increased exclusion in effect until December 31, 2025 will not be adversely impacted after 2025 when the exclusion amount sunsets. In other words, there will be no clawback of previously gifted amounts on the individual's estate tax return.3

Like other irrevocable trusts, a SLAT can be an effective tool for multi-generational planning. A SLAT may be designed to benefit the next generation only or be structured as a dynasty trust, which is a long-term trust created to pass wealth from generation to generation without incurring transfer taxes, such as estate and gift taxes or generation skipping transfer tax.

c. Alternative – The Delaware Trust.

An alternative to the SLAT is the Delaware Asset Protection Trust. This is how this would work. You transfer assets to a Delaware Asset Protection Trust. Under the terms of the trust, you do not retain any absolute right to income and principal but do remain eligible to receive distributions in the discretion the trustee or trust advisor that you appoint. Assets transferred to the trust are subject to gift tax but are removed from the taxable estate. The advantage of the Delaware Trust is that it will allow you to take advantage of the higher estate tax exemption and still retain access to the value transferred to the trust. In addition, upon the death of the donor spouse the assets remaining in the trust may be held for the benefit it of the benefit of the surviving spouse before they revert to the benefit of the subsequent heirs.

In most states, the type of trust arrangement would allow your creditors to access the trust and also cause the trust to be included in your estate. However, in Delaware and other states such as Alaska, which provide the trust remain protected from creditors except in certain situations, the creator of the trust can remain eligible to receive distributions from at the trustee’s discretion and still have the trust assets remain out of the reach of creditors. This asset protection features of the trust together with the fact that access to trust income and principal is vested with a third party trustee or trust adviser the trust assets will be removed from your estate for tax purposes. As a result, the Delaware Trust allows you to “give” the assets away to the Delaware Trust, remove those assets from your taxable estate, yet be able to get payments from the trust at the trustee’s or trust adviser’s discretion.

Note: Not everyone agrees with this interpretation of the estate tax law, and the IRS has not ruled on it. In addition, it is not clear that the trusts will protect your assets from creditors. If a court in another state rules that your creditors are entitled to tap the trust, then under the Constitution, the Alaska or Delaware trust probably has to comply with that ruling. That also has not been tested. Using these new trusts for estate planning or asset protection is not a sure thing.

The only way to get certainty is to wait for IRS rulings and court decisions. Some asset protection specialists are saying that they will use Alaska trusts in combination with other devices or with an escape valve. For example, the Alaska trust might be automatically moved to a foreign country if a creditor gets a judgment against you. Or the trust might be combined with a family limited partnership. Or the Alaska trust might be created by an offshore trust that you create. But the cost of those strategies will be higher, so a lot of money must be at stake.

Note: One additional caveat in order to establish a Delaware trust you generally to have a Delaware trustee, which means that you must pay trustee's fees. However, even though you must appoint a Delaware trustee, the law allows the discretion to make distributions to you may be vested solely in a "trust adviser" that you appoint

2. Taking Advantage of "Leverage" Gift Techniques

a. Overview

As noted, the issue with gifts made to take advantage of the higher exemption amount currently available is that unless such gifts are in excess of the applicable exemption determined at the time of death such gifts will not reduce federal estate tax liability. This is because while such gifts remove value from the taxable estate, they also reduce the exemption amount available to the estate. An alternative is the so-called "leveraged gift." A "leveraged" gift is a gift transfer that is structured in such a way so that the taxable value of the gift is less than the value of the property actually transferred. For example, a leveraged gift can remove say $1,000,000 from the taxable estate at a gift value of $650,000, or even zero (-0-). The following are some of the leveraged gift options.

b. GRATs/GRUTS.

(1) How it Works

Grantor retained annuity trusts ("GRATs") and grantor retained unitrusts ("GRUTs") are often used to minimize the gift tax value of intrafamily transfers. Pursuant to this planning, an individual transfers his or her property to an irrevocable trust, i.e., a GRAT or GRUT, 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 remainder interest in the trust property generally passes to beneficiaries named in the trust, either outright or in further trust. If the requirements of IRC §2702 are met, the value of the gift 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 is set high enough, the value of the retained right to income can equal the value of the interest transferred. In that case, the value of the gift will be zero.

Under IRC §2702, retained income interests are valued at zero unless they are "qualified interests." IRC § 2702(b) defines three types of qualified interests: (i) 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) (i.e.; a "GRAT"); (ii) a unitrust interest (i.e., an income interest equal to the fair market value of the property transferred determined on an annual basis) (i.e., a "GRUT"); and (iii) any non-contingent remainder interest if all of the other interests in the trust consist of either

unitrust or annuity trust interests. For the GRAT or GRUT to realize the tax benefits described, the owner must survive for the period during which he or she has retained the qualified interest. If the owner dies within that period, the value of the interests held by the GRAT or GRUT is included back in his or her taxable estate, effectively reversing the tax benefit created by the GRAT or GRUT.

(2) Illustrative Planning

The transfer of $5,700,000 to a 10 year Grantor Retained Annuity Trust, which provides a 11.13% annual annuity will remove that amount from your taxable estate with a taxable gift value of zero (-0-).

c. Private Annuity/Intentionally Defective Trust.

(1) How it Works

The sale of property to an “intentionally defective grantor trust” (“IDGT”) in exchange for a lifetime annuity payment can serve as an alternative to a transfer by gift. Under this plan, an individual first establishes an irrevocable trust – the IDGT. The trust intentionally includes trust provisions which make the trust a “grantor trust” for income tax purposes. As a grantor trust, the trust is essentially ignored for tax purposes, and all of the income, deductions, and credits are taxable to the grantor of the trust, in this case, the individual establishing the trust.

After the IDGT is established and funded, the individual then "sells” a property interest to the IDGT in exchange for an annuity payable for life. Normally a sale would create taxable income to the seller based on the amount of gain realized. In the case of the IDGT, however, because the trust is a “grantor trust,” the sale is not considered taxable (the IRS essentially looks at the grantor trust and the trust creator as one taxpayer). As a result, the gain realized on the “sale” is not recognized for tax purposes. To avoid gift tax consequences, the private annuity must be set at a sufficient level that its present value at least equals the value of the property interest transferred. If that is the case, the exchange will be considered made for fair value in money and money’s worth, and no gift tax consequences will result from the transaction.

Upon the death of the individual seller, the private annuity terminates leaving nothing to be taxed in his or her estate. From an estate tax point of view, the property interest is removed from the taxable estate without gift or estate tax consequences. This is perhaps overstating the case, since the annuity payments, if retained by the individual seller, will be subject to estate tax.

(2) Illustrative Planning

The transfer of $5,700,000 to an Intentionally Defective Trust in exchange for a private lifetime annuity for an annual life annuity of $380,533 will also remove that amount from your taxable estate with a taxable gift value of zero (-0-).

d. Family Limited Partnership.

(1) How it Works

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" which will result in a discount of the value of the transferred property by as 35% to 40%.

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.

(2) Illustrative Planning

The transfer of $5,700,000 to a Family Limited Partnership followed by the transfer of a 99% limited partnership interest valued at a discounted value of $3,667,950, to a 10-year Grantor Retained Annuity Trust, which provides for an annual annuity of $422,389 will remove $5,700,000 from your taxable estate with a gift tax value of zero (-0-).

The transfer of $5,700,000 to a Family Limited Partnership followed by the transfer of a 99% limited partnership interest valued at a discounted value of $3,667,950, to an Intentionally Defective Trust in exchange for a private lifetime annuity for an annual life annuity of $244,873 will also remove that amount from your taxable estate with a taxable gift value of zero (-0-).

e. Qualified Personal Residence Trust.

(1) How it Works

A qualified personal residence trust ("QPRT") is a trust that is initiated by the transfer of the legal ownership of a primary residence to an irrevocable trust, i.e., the QPRT. The primary advantage of a QPRT lies in its potential for estate and gift tax savings. The QPRT works as a tax savings device by reducing the value of the gift to the value of the remainder interest, as opposed

to the value of the entire property interest. Under the terms of the QPRT, the transferor retains the right to live in and manage the residence transferred for the term of the trust. Also, the transferor remains primarily responsible for all costs associated with the property, including the mortgage, insurance, and taxes.

At the end of the trust term, assuming the transferor survives, the residence passes to the beneficiaries named in the trust, either outright or in trust. At that point, the transferor can continue to occupy the residence, but a lease arrangement must be made with the trust or the beneficiaries at a fair market rental.

(2) Illustrative Planning

The transfer of your residence valued $750,000 to a Qualified Personal Residence Trust will also remove that assets from your taxable estate with a taxable gift value of $97,994.