1-1-1999

Selected Estate Planning Strategies for Persons With Less Than $3 Million

Bridget J. Crawford
Elisabeth Haub School of Law at Pace University

Selected Estate Planning Strategies for Persons With Less Than $3 Million

Estate planning for the less wealthy is challenging because these individuals cannot easily afford to make large lifetime gifts that will reduce estate taxes. This article focuses on planning techniques of particular benefit to the modestly wealthy

JONATHAN G. BLATTMACHR, GEORGIANA J. SLADE, AND BRIDGET J. CRAWFORD, ATTORNEYS

Individuals in the "modest" wealth category face special hurdles in estate planning. This article assumes that the "modest" wealth category includes individuals whose net worth exceeds the amount that may be protected by the unified credit (for 1999, the equivalent of $650,000[1] and herein referred to as the "estate tax exemption," the "gift tax exemption" or the "applicable exemption amount"), but does not exceed approximately $3 million.

In general, people of modest wealth cannot easily afford to give up significant amounts of wealth during lifetime to achieve estate planning goals, although the lifetime transfer of wealth is one of the most useful techniques for reducing estate taxes. Unlike individuals whose wealth is small enough that it will most likely be protected from tax by credits or exemptions, or those whose wealth is so large that an achieved lifestyle almost certainly will continue regardless of how much is transferred during lifetime, individuals of modest wealth face a real tension between opportunities to reduce taxes and protect assets from other claims that may arise, on the one hand, and the need to preserve adequate wealth to ensure the maintenance of a current standard of living, on the other hand.

JONATHAN G. BLATTMACHR and GEORGIANA J. SLADE are partners, and BRIDGET J. CRAWFORD is an associate, in the New York City office of the law firm of Milbank, Tweed, Hadley & McCloy LLP. Mr. Blattmachr is also a fellow of the American College of Trust and Estate Counsel. The authors have written and lectured extensively on estate planning.

Assign life insurance and other non-income-producing assets

Many individuals even of somewhat modest net worth consume the income from their assets, but not their capital. This presents a planning opportunity. However, giving away property while retaining the right to income usually does not achieve any tax reduction or protection of assets from creditors' claims.[2] On the other hand, many people own assets that are likely never to produce income for themselves. A common example is life insurance.

Although life insurance in certain circumstances can be made to be an excellent income-producing asset (if it has a cash or investment component), most individuals do not "cash in" on that feature of the policy. Rather, they allow the investment element to be maintained within the policy because most policies are structured so that the investment component is constantly being substituted for an ever-decreasing term insurance component.[3] In such a case, an insurance policy may be an ideal subject of a gift by the insured.[4]

The purposes for which the insurance is being maintained (such as to replace earnings lost upon the death of the insured, to pay a debt that becomes due upon the death of the insured, or to fund estate taxes) usually can be as readily achieved if someone other than the insured owns the policy. If the insured holds no "incident of ownership" in the policy at or within three years of death, the proceeds should not be includable in the insured's estate for estate tax

purposes except to the extent they are payable to the estate of the insured.[5] If the insured does hold any incident of ownership at or within three years of death, the proceeds—even if paid to someone other than the insured's estate—may be subject to estate tax at rates of 50% or more, even if the total estate does not exceed $3 million.

The most effective way to avoid inclusion of insurance proceeds in the insured's estate is to have the insurance acquired initially by someone other than the insured. Alternatively, if the insured already holds an incident of ownership (e.g., because he or she currently owns the policy), it is generally most effective for the insured to assign all incidents of ownership to someone else at least three years before death. Usually, the simplest route is to have the policy initially acquired by or assigned to the individuals whom the insured wishes to benefit from the proceeds, such as children or grandchildren.

But having policies owned by one or more individuals may substantially complicate matters in the long run. That may occur, for example, if a child dies before the insured and the child's interest in the policy passes to someone whom the insured does not wish to own the policy, such as the surviving spouse of the predeceased child. The solution to this problem is to have the policy owned by a trust. If the trust is properly structured, the policy proceeds will be used for the purposes intended by the insured and will not be included in his or her estate.

Although there will be more expense involved, having the policy owned by a trust may be the most effective strategy. Ownership of the policy by a trust will permit the use of a so-called back-up marital deduction provision. This provision will allow the proceeds to qualify for the estate tax marital deduction if the insured is married and the proceeds are includable in insured's estate (because, for example, the insured dies within three years of assigning the policies).[6]

Arranging for another person (or a trust) to own insurance almost by necessity will result in the making of a taxable gift. The assignment of the ownership of a policy to another and the payment of premiums on a policy owned by another constitute gifts for gift tax purposes. Generally, these gifts can be made to qualify for the gift tax annual exclusion if the policy is assigned to individuals or to a trust. Many individuals of modest wealth do not make significant annual exclusion gifts because they feel they cannot afford to give up income-producing assets. But gifts of an insurance policy and the subsequent payment of premiums can be an excellent way of using annual exclusions if they will not otherwise be used.

Life insurance—unless it is a cash value policy and has been specifically acquired to fund estate taxes—often lapses prior to the insured's death. If that occurs, one can view the creation of the trust and the use of annual exclusions with respect to the transfer of the policy to the trust and payments of subsequent premiums as "wasteful." That probably is not a reasonable way to view the planning, though, because individuals of modest wealth who have gone to the trouble and expense of establishing such a trust likely will be vigilant in assuring that the policy does not lapse.

Another category of assets that may be appropriate to give away under the annual exclusion are items of tangible personal property which have significant intrinsic value and which the owner is willing to transfer before death. This may include jewelry, works of art, antiques, and collections. To remove the items from the donor's taxable estate, gifts must be "complete." For example, the items should no longer be stored in the donor's home or otherwise be under the control of their former owner (such as in a safe deposit box in the donor's name). The new owner should pay for the insurance on the items. If a donor wants to and does continue to use certain objects (such as jewelry), giving those items away will not improve the donor's estate tax situation.

Recreational real estate also may be an excellent type of property for a lifetime gift. Although the property may be too valuable to give away at one time under the annual exclusion, gifts of undivided interests in property can be made, and may be valued at a discount (i.e., the value of the fractional interest is worth less than an aliquot share of the value of the whole).[7]

---

1 This "exemption" will increase to $1 million for 2006 and later years

2 See, e g . Section 2036(a)(1); Restatement (2d) of Trusts. § 156 (1959)

3 See "Some Advanced Considerations and Uses of Life Insurance in Estate Planning," especially Chart 3. The Chase Review (Winter 1997)

4 For a wealthier individual, a gift of an asset other than an insurance policy may be more appropriate

5 Sections 2042 and 2035

6 Usually, it is best for the estate tax includable insurance proceeds to pass under the irrevocable life insurance trust agreement into a trust that can qualify for the marital deduction, via a QTIP election under Section 2056(b)(7) That way, the insured's executor can determine, by the election, how much should qualify for the marital deduction See generally, "Building an Effective Life Insurance Trust," 129 Trusts & Estates 29 (May 1990) Special considerations will arise if the surviving spouse is not a U S citizen Section 2056(d)

7 *Cf* Lefrak. TCM 1993-526

Continued use of the property should be consistent with the relative ownership of the property. Accordingly, if the original owner gives away an undivided 25% interest in the property, the recipients of that interest should pay a quarter of the cost of maintaining the property and should exercise ownership rights and use over a quarter of the property. In the case of recreational property that constitutes a residence, use of a qualified personal residence trust, discussed next, should also be considered.

Qualified personal residence trusts

Under Section 2702, for purposes of determining the value of a gift of a remainder in property to family members, the value of an income or use interest retained in that property generally is treated as zero, causing the entire value of the property to be treated as the gift. Section 2702(a)(3)(A) provides an exception if the remainder transferred is in a personal residence the use of which is retained.[8] This exception permits, for example, the owner of a personal residence to give a remainder interest to take effect after a term of years, and to value the remainder based on the normal "actuarial" principles of Section 7520. Usually, the gift of the remainder is made by transferring the home to an irrevocable trust from which the grantor retains the right to the exclusive occupancy and use of the home for a period of years. Such a trust is known as a "personal residence trust" (PRT) or a "qualified personal residence trust" (QPRT), depending on its terms.[9]

One "problem" with an effective QPRT is that the entitlement to use the property must end before the grantor dies. If death occurs during the retained term, the trust is includable in the grantor's estate under Section 2036(a). This means that the property will no longer be available to the remainderman, at least without cost. Finally, the client must be aware that once the retained term ends, he or she no longer has any right to occupy the property. The client must then be in a position where he or she can afford to vacate the property or rent it from the remainderman at a fair market rent.[10]

Effective use of the (balance) of annual exclusions

The annual exclusion may not have an enormous impact on reducing taxes for a person of extraordinary wealth. For such an individual, other gifts to family members (such as automobiles or payment for vacations) often absorb completely the available annual exclusions. Even if part of the annual exclusion is being used for other transfers by a person of more modest means (such as the payment of premiums on a life insurance contract owned by others), an unused portion of the annual exclusion may remain.

For instance, a married person with two married children and four grandchildren may give up to $160,000 to them each calendar year, using annual exclusions coupled with "gift splitting" under Section 2513 by the spouse (that is, $20,000[11] to each of these eight individuals). Over five years, this strategy would remove $800,000, plus the subsequent income and growth on the gift property, from the client's estate. That could represent a large percentage of the client's wealth. Hence, the use of annual exclusions can produce exceptionally effective estate planning results for persons of modest wealth.

On the other hand, that effectiveness highlights the tension which may arise when the client considers making such maximum use of his or her annual exclusions and when the client would have to make the gifts with income-producing assets because the individual does not own sufficient non-income-producing property with which to make the transfers. Neither the assets given away under the annual exclusions nor the income they produced usually may be made available to the donor. The individual simply may not be able to afford such a loss of income. The individual, however, might be able to continue to benefit indirectly from the income of the gift property without causing estate tax inclusion by transferring assets under the annual exclusion to a trust, the income of which the trustee is permitted to distribute to the grantor's spouse who could use it, in the spouse's discretion, for the grantor.

Although a spouse may not "gift split" with respect to gifts made to himself, herself, or a trust of which he or she is a beneficiary, the non-donor spouse can gift split transfers to a Crummey trust[12] for the benefit of others and in which the gift-splitting spouse is a beneficiary (but not a holder of a Crummey power), to the extent of the transfers to the holders of the Crummey powers.[13] Accordingly,

[8] The Clinton Administration has proposed the repeal of the personal residence exception under Section 2702(a)(3)(A)(ii)

[9] See Reg 25.2702-5

[10] See Ltr Ruls 9626041 and 9425028

[11] The annual exclusion of $10,000 ($20,000 if the sponsors "split gifts") is now indexed for inflation See Section 2503(b)(2)

[12] A trust, transfers to which qualify for the annual exclusion by reason of the power of the beneficiaries immediately to withdraw the property transferred, is often called a "Crummey trust" after the well-known case of *Crummey*, 397 F 2d 82, 22 AFTR2d 6023 (CA-9, 1968)

[13] Reg 25 2513-1

the grantor could continue to enjoy the trust property to the extent it is made available to his or her spouse. Of course, when that spouse dies, the property may no longer be available for the grantor.

Each spouse could also create a trust for the other spouse, although the trusts should be structured to avoid the application of the so-called reciprocal trust doctrine. Under this doctrine, the trusts may be "uncrossed" so that each spouse is treated as though he or she created the trust for his or her own benefit. This will cause estate tax inclusion to the extent that inclusion would have occurred if the spouse who is the trust beneficiary had created that trust.[14]

It might be possible to structure the trusts so that the benefits and controls granted to the spouses are sufficiently different that the reciprocal trust doctrine will not apply.[15] Nevertheless, it does mean that only one-half of the assets will remain in trust for the benefit of the surviving spouse when the first one dies unless the trust continues for the benefit of the spouse who created that trust. However, continuing the trust for the benefit of the spouse who created it typically will cause that trust to be includable in the estate of the grantor on account of the "creditors' rights" doctrine. Generally, the creditors of the grantor can attach trust assets to the extent the trustee must, or in the exercise of discretion may, distribute them to the grantor. Also, to that extent, the trust assets will be includable in the grantor's estate.[16]

The new Alaska option

A new law in Alaska provides another option.[17] This law, Alaska Stat. § 13.36.310 (1998), provides that an Alaska trust is not subject to claims of creditors of the grantor even if the grantor is eligible, in the exercise of the discretion of another person acting as trustee, to receive distributions from the trust, provided, among other conditions, that the transfer to the trust was not made to defraud creditors. Because the trust assets are not subject to the claims of the grantor's creditors, the Alaska trust should not be includable in the grantor's estate unless the grantor retains some other power over the trust that would cause it to be includable in the estate.[18] If, however, the grantor receives all the income of such an Alaska trust, or perhaps, regular distributions that are nearly equal to the trust's income, there may be a factual finding that there was a sufficient understanding that the grantor was to receive the income and the trust will be includable in the grantor's estate.[19]

Potential use of the gift tax exemption and the GST exemption

As indicated, many individuals of more modest wealth cannot afford to make large gifts, such as those equal to their entire gift tax exemption or GST exemption, because they cannot afford to give up the income from the assets that would be given away. The possibility of being able indirectly to benefit from the income through one's spouse or to remain at least eligible to receive distributions from gift property while nonetheless excluding it from the donor's estate raises the possibility of making gifts in excess of the annual exclusion amount, such as the amount of any remaining gift tax exemption (which generally can be as large as $650,000) or the remaining GST exemption (which can be as large as $1,010,00 in 1999, and is indexed for inflation[20]). Certain potentially attractive options may be available.

Reg. 26.2652-2 allows the immediate allocation of GST exemption to a lifetime QTIP trust described in Section 2523(f), even though by making the QTIP election for gift tax purposes no gift tax will be paid upon the transfer.[21] The QTIP Regulations provide that a QTIP trust which one spouse creates for the other will not be includable in the estate of the spouse creating the trust, even if that spouse retains a secondary income interest in it, unless the estate of the beneficiary spouse elects for any continuing trust to qualify for QTIP treatment in his or her own estate (or unless the spouse creating the trust otherwise held a general power of appointment described in Section 2041).[22]

Although the creation of such a lifetime QTIP trust will permit the effective use of the grantor's GST exemption, it will not permit the effective use of the grantor's gift tax exemption (unified credit): Because the trust property will qualify for the gift tax marital deduction, no use will be made of the grantor's unified credit. In planning, use of the unified cred-

14 Estate of Grace. 395 U S 316, 23 AFTR2d 69-1954 (S Ct. 1969)

15 Cf Estate of Green, 68 F 3d 151. 76 AFTR2d 95-7094 (CA-6, 1995)

16 Rev Rul 77-384, 1977-2 CB 198

17 Delaware has enacted similar legislation

18 Rev Rul 76-103, 1976-1 CB 293. See also Ltr Rul 9837007 and Estate of German. 7 Cl Ct 641. 55 AFTR2d 85-1577 (Cl. Ct. 1985)

19 See, e.g., Estate of Skinner. 197 F Supp 726. 8 AFTR2d 6073 (DC Pa. 1961)

20 See Section 2631(c)

21 If the donor's spouse is not a U S. citizen, the transfer cannot qualify for the gift tax marital deduction Section 2523(i)(1)

22 The Clinton Administration has proposed an amendment to Section 2044, which would provide that if the grantor spouse is allowed a marital deduction with respect to the QTIP, such trust must be includable in the estate of the beneficiary spouse

it may be more important than the use of the GST exemption.

Of course, the property owner could create a trust for his spouse which does not qualify for the marital deduction but which will not generate gift tax on account of the use of the unified credit. However, the grantor will not be able to retain a secondary income interest following the death of the spouse because the retention of such an interest will cause the trust to be includable in the grantor's estate under Section 2036(a)(1), effectively nullifying the grantor's use of his unified credit at the time the trust was created.

In virtually all American jurisdictions, the mere eligibility (as opposed to entitlement) to receive distributions from the trust will cause estate tax inclusion on account of the creditors' rights doctrine discussed earlier. That, in turn, again raises the Alaska (or Delaware) trust option: the property owner could transfer an amount equal to his or her unused gift tax exemption equivalent to an Alaska trust, remain eligible in the discretion of the trustee to receive distributions, and still make the transfer complete for estate and gift tax purposes. Making the trust an Alaska trust also will permit avoidance of the rule against perpetuities because Alaska has effectively repealed it. In addition, the trust will be subject to state income tax only to the extent the income is allocable to a grantor who is subject to state income tax (such as under the grantor trust rules of Section 671 et seq.) or to a beneficiary who is subject to state income tax.

Estate building and income tax sheltering with life insurance

Certain types of life insurance policies provide greater opportunities to build wealth while sheltering income from taxation. Specifically, so-called variable insurance contracts allow the policy owner to direct how the cash or investment value of the policy is to be invested among a variety of mutual funds. In some cases, these mutual funds may provide significantly better yields than the yields in traditional cash value policies.

As long as a policy is a life insurance contract under Section 7702, the earnings will accumulate income tax-free. Furthermore, as long as a policy does not constitute a "modified endowment contract" under Section 7702A (essentially, a single premium or limited premium payment policy), cash may be withdrawn free of income tax[23] up to the extent of basis,[24] before income is considered to be withdrawn, and even the income earned "inside" such a policy may be borrowed without income tax effect. In essence, this allows the insured to reach the income without paying any income tax. That can have the effect of increasing yield and thereby providing additional flexibility for estate and other financial planning.

By contributing an adequate amount of premium which is allocated to the cash or investment component, it is possible to have future term premiums paid with income earned under the policy. The effect of that is to pay for the term premiums with pre-tax income which will never be subject to income tax, even if the policy is canceled prior to death.[25]

If the insured has access to the cash or investment component of the policy, however, all the proceeds paid at death may be includable in the insured's estate, even if the insured has only an interest in the cash or investment component and someone else (such as an irrevocable life insurance trust) holds all incidents of ownership with respect to the term component of the policy.[26] Nevertheless, it is possible to structure the ownership of a policy through a split-dollar arrangement so that the insured may be able to benefit (at least indirectly) from the policy's cash value without causing the term insurance component to be includable in the insured's gross estate.[27]

Accessing income tax-free states

Only seven states have no income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington (state), and Wyoming.[28] Of course, an individual can move to one of those states and avoid income taxation, but that may not always be practicable or desirable. Moreover, if the individual's children or other objects of bounty live in states (or locations) with income taxes, income generated on inherited property will be subject to the state (and local) income tax once the beneficiaries have received the assets. However, by creating trusts under the laws of one of the above seven states, it may be possible to avoid income tax on income of the trust that is not currently distributed to such beneficiaries even if the beneficiaries live in a state (or locality) with an income tax.

It is not necessary that the trust be created, in all instances, in a

23 Although not all variable policies permit withdrawals, universal life policies usually do, but there may be "surrender charges" on amounts withdrawn.

24 Basis generally equals the sum of premiums paid, reduced by amounts previously withdrawn.

25 For more detail, see The Chase Review (Winter 1997).

26 Rev. Rul. 82-165, 1982-1 CB 117.

27 See, e.g., Ltr. Rul. 9636033.

28 Florida imposes a 2/10% intangible tax on wealth each year which is somewhat akin to an income tax, and some other states impose income tax only on certain types of income. See Fla. Stat. ch. 199.012 et seq.

state with no income tax. For example, New York is, in effect, a state income tax haven for trusts created by individuals who reside outside that state. Except for New York source income (essentially income derived by the operation of a business in New York), New York imposes an income tax on income retained in a trust only if the grantor was domiciled in the state when the trust became irrevocable.[29] New Jersey has a similar rule.[30] Delaware does not impose an income tax on income retained in a trust sited there unless the beneficiary is a Delaware resident.[31]

Some states, though, try to extend their reach of taxation so greatly that even creating the trust in another jurisdiction will not avoid state taxation. Certain states, for example, impose their income tax on a trust created by a nonresident if a trustee is a resident of that state.[32] California attempts to impose its income tax on income retained by a trust created by a nonresident of California if any beneficiary is a resident of that state, even if none of the trustees is a California resident.

Using a CRT to build wealth and generate income

Charitable remainder trusts (CRTs) described in Section 664 may provide two tax planning benefits. First, an income, gift, or estate tax deduction may be allowed for the actuarial value of the remainder interest committed to charity. The remainder interest must equal at least 10% of the initial fair market value (FMV) of all property placed in the trust. The second and often more significant benefit is that the trust is exempt from income tax for any year in which it does not have unrelated business taxable income (UBTI). This may, for example, allow for

The use of gift tax annual exclusions can produce exceptionally effective estate planning results for persons of modest wealth.

the contribution of appreciated assets to the trust and their sale by the trustee without imposition of income tax, *provided that*: (1) no UBTI is received in the year of sale by the trust, and (2) the gain is not attributed back to the grantor.[33]

The size of the annual payment to the recipient from a charitable remainder unitrust (CRUT) is directly proportionate to the value of the trust. By avoiding the imposition of tax on gain recognized and retained by the trust, a larger base of wealth is available to generate payments to the individual beneficiaries.

One common perception about CRTs is that they are used only for the grantor and, perhaps, the grantor's spouse. The reason is that all (or a significant part) of the trust will be includable in the estate of the grantor at his death because of the retained annuity or unitrust payments.[34] If the trust is only for the benefit of the grantor alone, the grantor's spouse alone, or the grantor and the grantor's spouse jointly, no gift or estate tax will be paid with respect to assets placed in the trust or includable in the grantor's estate at death.[35]

Besides continuing a CRT for the benefit of the grantor's spouse, the trust may be continued for the benefit of the grantor's descendants. By retaining the power to terminate the interests of all or any of the grantor's descendants by the grantor's will, no gift tax will be payable upon the creation of the trust.[36] The trust, however, will be includable in the grantor's estate. Where the grantor's spouse and descendants or the grantor's descendants are beneficiaries of the trust, estate tax is paid on the present value of the interest in the trust that is committed to such successor individual beneficiaries. (If the surviving spouse is the only beneficiary of the trust after the grantor's death, no estate tax would be payable.[37])

A net income (with or without make-up) CRUT, which pays the lesser of the unitrust amount or trust income,[38] can provide an opportunity for taxable income to accumulate, *in effect*, tax-free until the trustee decides to invest the assets to generate current trust income, which then can be distributed to the grantor or other beneficiaries of the trust. (If a CRT with a make-up provision is chosen, deficiencies are made up in subsequent years in which trust accounting income exceeds the unitrust amount.)

The tax-free build-up may provide an enhanced base of wealth for the grantor (and, if appropriate, the grantor's spouse and other family members). This enhanced base of wealth could provide a sufficiently improved degree of financial comfort for the grantor so that he or she will feel more financially secure in making gifts of other assets, which thereby can be removed from the grantor's estate. Nevertheless, because a CRT does involve the transfer of assets to charity at the end of the trust

---

29 N.Y. Tax Law § § 601 and 605(b)(3).

30 N.J. Stat. Ann. § § 54A:2-1.

31 Del. Code Ann. 30 § 1131 et seq.

32 See, e.g., Cal. Rev. & Tax Code § 17742.

33 See, e.g., Ltr. Rul. 9452026.

34 See, e.g., Rev. Rul. 82-105, 1982-1 CB 133.

35 Special rules apply if the spouse is not a U.S. citizen. See Section 2056A.

36 Regs. 1.664-2(a)(3), 1.664-2(a)(4), and 25.2511-2(c).

37 Sections 2056(b)(8) and 2055(a).

38 For more detail, see The Chase Review (July 1993).

term, this technique will likely appeal only to the taxpayer who is charitably inclined.

Medical care and tuition payments

Direct payments to a health care provider for the medical care of another person and direct payments of tuition to an educational institution for another person are not transfers for gift tax purposes.[39] For instance, a grandparent may pay all the college tuition for a grandchild free of gift tax. This amount is in addition to any annual exclusion gifts that the grandparent may make to the grandchild. Over time, these transfers for tuition and medical care can remove substantial amounts from the donor's gift and estate tax base, which may be especially important for estate planning for those donors of more modest wealth who feel they can afford to make these payments.

Furthermore, even though the payments for medical care and tuition must be made directly to the health care provider or educational institution, there are practical ways to effect such payments. For example, a property owner might open a joint checking account with each of his or her adult children, which is not considered a gift to the child even though the account is in joint name.[40] Only to the extent that the child draws on the account will the gift be complete. If the child draws

39 Section 2503(e)

40 Reg 25.2511-1(h)(4) In those states where the opening of a joint account may be a completed gift, it might be appropriate to have the joint tenants enter into an agreement that the non-contributing tenant may draw on the account only as an attorney-in-fact for the contributing tenant and only for purposes of paying medical care and tuition payments under Section 2503(e) Accordingly, there should be *no completed gift from* the contributing tenant to the non-contributing tenant on the opening of the account because withdrawals will only be for the benefit of the contributing tenant or should qualify for the exclusion under Section 2503(e)

on the account only by direct payment for medical care or tuition, the transfer—while complete—should be excludable as a gift under Section 2503(e). Any amounts reimbursed, such as by medical insurance, would be contributed to that account and could be withdrawn by the person who opened the account.

Limited liability entities for asset protection and tax planning

A family holding company—whether in the form of a limited partnership, limited liability company, business trust, or other entity—may provide asset protection and tax benefits for the property owner and his family. Contributing assets to such an entity changes the nature of what is owned. For instance, the contribution of real estate to a limited partnership in exchange for limited partnership units changes what is owned from real estate to partnership units. Such partnership units are generally less marketable than the underlying real estate is.[41] Hence, the partnership assets may be worth less, and, therefore, are less attractive to a creditor of the owner.

In addition, it appears that generally the partnership agreement may provide that anyone who attaches a partnership interest does not become a limited partner for purposes of voting and management decisions, but becomes only an assignee of the economic interests that the units represent. Yet it also appears that such an assignee probably will be taxed on a pro rata portion of the partnership's income as though he were a partner.[42] If regular partnership distributions are not made, the units may actually become a liability for the assignee (because income taxes will be due on income attributed to the assignee without a corresponding receipt of property from the partnership to pay those taxes).

Furthermore, the transmutation of the nature of what is owned into something less marketable almost certainly results in a reduction in valuation. Lower valuation typically means lower gift, estate, or GST taxation, but it usually also means a lower income tax-free step-up in basis under Section 1014(a) upon the transfer at death.

Handling interests in qualified plans, IRAs and other IRD

Despite the fact that the income tax basis of most property passing at death is equal to the estate tax value, a number of exceptions exist. The most common is for "income in respect of a decedent" (IRD).[43] IRD consists of income to which the decedent was entitled at death but which is not properly includable in the decedent's pre-death income tax return. Accrued interest on a bond, certain declared but unpaid dividends, the inherent profit in certain installment sale notes, and deferred compensation are common types of IRD. Interests in qualified plans and IRAs frequently represent a very significant portion of the worth of a person of modest wealth, and those interests almost always constitute IRD. As a consequence, they could be exposed to estate tax and income tax as well as other taxes.[44]

Often, 75% to over 100% of the value in such qualified plans and IRAs can be eroded by taxes. One of the more useful methods of reducing the overall tax burden on such an interest is to make it payable to a CRT on the death of the "owner" of such interest. That may effectively avoid the income tax on those interests, but will not avoid—or will probably only marginally reduce—the estate tax due on the interest. Hence, a source of paying those estate taxes, such as through life insurance proceeds, must be available to implement the payment of the qualified plan and IRA proceeds to the CRT. However, the payment of the proceeds to a CRT could be highly effective and often can result in a substantial increase in the net value of the economic benefit in such proceeds to which the decedent's beneficiaries will succeed.

> **Practice Notes**
> Carefully analyze which planning steps are most appropriate for the modestly wealthy person and what level of transfers he or she reasonably can afford to make. Different problems and potential solutions will arise for each individual, and the plan must be tailored to each person's unique circumstances and goals.

Conclusion

Estate planning for individuals of more modest wealth is challenging because they face significant death taxes but do not have such a large base of wealth that they can easily afford to make significant lifetime gifts or other transfers to reduce the taxes which will arise when they die. Nevertheless, careful planning, using techniques such as those analyzed here, often may help reduce these taxes. ■

[41] The Clinton Administration has proposed the elimination of valuation discounts for family limited partnerships and other similar entities, except for active businesses.

[42] Evans, 447 F 2d 547, 28 AFTR2d 71-5465 (CA-7, 1971); Rev. Rul. 77-137, 1977-1 CB 178, but see GCM 36960 (12/20/76).

[43] See Sections 691(a) and 1014(c).

[44] See "Selected Estate Planning Guidelines for Qualified Plans and IRAs," The Chase Journal (Vol. II, Issue 3, 1998).