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Estate Planning for Persons with Less than \$5 Million¹

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Individuals in the “modest” wealth category face special hurdles in estate planning. This article will assume that the “modest” wealth category includes individuals whose net worth exceeds the amount of taxable gifts that may be protected by the unified credit (the equivalent of \$1 million and herein referred to as the “gift tax exemption”), but does not exceed approximately \$5 million.

In general, people of modest wealth may not easily be able to afford to give up significant levels of their net worth during lifetime to achieve estate planning goals. However, the lifetime transfer of wealth is one of the most useful ways to reduce estate taxes. Unlike individuals whose wealth is small enough that it most likely will be protected from tax by reason of credits or exemptions (for 2007, for example, the federal estate tax exemption equivalent is \$2 million) 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 which may arise, on the one hand, and the need to preserve an adequate base of wealth to ensure the maintenance of a current standard of living on the other.

The advisor to these individuals should carefully consider which planning steps are most appropriate and what level of transfers the individual reasonably can afford to make. Certainly, different problems and potential solutions will arise for each individual, and the plan must be

tailored to each person's unique circumstances and goals. Nonetheless, such individuals need estate and financial planning as much as anyone else does, perhaps even more so. These individuals, in a real sense, cannot afford to "lose" as much of their wealth to taxes, professional fees, claims, and costs of administration as more wealthy people can. This article will focus on estate planning techniques that may be particularly useful to individuals in the modest wealth category.

ASSIGN LIFE INSURANCE AND OTHER NON-INCOME-PRODUCING ASSETS

A person of modest wealth faces a tension between making lifetime transfers of wealth which will reduce the taxes that will be imposed at death, and his or her desire to maintain a chosen lifestyle. Nevertheless, many individuals even of somewhat modest net worth consume their income but not their capital. This presents a planning opportunity, but 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 persons own assets that likely never will produce income. A common example is a life insurance policy. Although life insurance in certain circumstances can be made to be an excellent income-producing asset (where it has a cash or investment component), most individuals do not "cash-in" on that feature of the policy. Rather they allow the investment component 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 will become due or will be payable 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 federal estate tax purposes except to the extent they are payable to the estate of the insured.⁵ However, 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 substantial estate tax, even if the total estate does not exceed \$5 million.

The most effective way to avoid having insurance proceeds included in the estate of the insured is to have them acquired initially by

someone other than the insured (typically, a trust). 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 prior to death. Usually, the simplest route is to have the policy already owned or assigned to the individuals whom the insured wishes to benefit from the proceeds, such as children or grandchildren (or a trust for their benefit).

A more effective strategy may be to sell life policies the insured owns to a trust that would be excluded from his or her estate. If the trust is a so-called grantor trust for income tax purposes, if the insured's death is not imminent, and the policies are sold for their full fair market value ("FMV"), such a sale appears to avoid income tax recognition and the transfer-within-three-years-of-death rule of Section 2035.⁶

Having policies owned by one or more individuals may complicate matters in the long run. That may occur, for example, when a child of the insured who owns the policy dies before the insured person. The child's interest in the policy may pass to someone whom the insured does not wish to own the policy, such as a former spouse of the predeceased child. The solution to this problem is to have the policy owned by a trustee of a trust created by the insured. 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 initially may be more expense involved, trust ownership of the policy may be the more effective and, in the long run, most efficient method to avoid estate taxes on the proceeds and to guarantee that the proceeds will benefit only those selected by the insured.

For example, trust ownership of the policy 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 survived by his or her spouse and the proceeds are includable in the insured's estate (because, for example, the insured dies within three years of assigning them).⁷

On the other hand, it is appropriate to emphasize that unless the life insurance is a cash value policy that has been specifically acquired to fund estate taxes, it often lapses prior to the death of the insured. If that occurs, the creation of the trust and the use of gift tax annual exclusions with respect to the transfer of the policy to the trust and payments of subsequent premiums would be "wasteful." However, individuals of more modest wealth who have borne the transaction costs of establishing such a trust may be vigilant in maintaining the policy so that it does not lapse.

Arranging for another person or entity to own insurance almost certainly will require the insured to make a taxable gift. Both the assignment of the ownership of an insurance 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.⁸ Many individuals of modest wealth do not make significant annual exclusion gifts because they feel they cannot afford to give up income-producing assets; therefore, contributions to a life insurance trust are an excellent way of using annual exclusions that will not be used otherwise.

Another category of assets which may be appropriate to give away under the protection of the annual exclusion are items of tangible personal property that have significant intrinsic value and that the owner is willing to transfer before death. This may include, for example, jewelry, works of art, antiques, and collections. To remove the items from the donor's taxable estate, gifts need to be "complete" for estate tax purposes.⁹ For instance, the items should no longer be stored in the donor's home or otherwise be under the control of their former owner. Furthermore, the new owner should acquire and pay for the insurance on those items. Certainly, if the donor wants to continue to use certain objects (such as jewelry), the donor should not give them away.

Recreational real estate is another excellent example of the type of property that could be the subject of a lifetime gift. Although the property may be too valuable to give away at one time under the protection of the annual exclusion under Section 2503, smaller gifts of undivided interests in property can be made and, in fact, 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).¹⁰ However, continued use of the property should be consistent with the relative ownership of the property. For example, if the original owner gives away an undivided 25 percent interest in the property, the recipients of the 25 percent interest should pay for 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 in more detail below) also should be considered.

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. The fund alternatives usually include a blue chip stock fund, a government bond fund, an international stock fund, and so forth. In some cases, these funds may provide significantly better yields when compared to the yields in traditional cash value policies.

Yet as long as the policy is a life insurance contract under Section 7702, the earnings will accumulate income tax-free. In addition, as long as the policy does not constitute a “modified endowment contract” under Section 7702A (essentially, a single premium or limited premium payment policy), cash up to the extent of basis¹¹ may be withdrawn free of income tax.¹² Even the income earned “inside” such a policy may be borrowed without income tax effect. In essence, this allows the insured to access the income without paying any income tax. The policy’s yield thereby increases and thereby provides the owner of the policy with additional flexibility for estate and other financial planning. In addition, if an adequate amount of premium is allocated to the cash or investment component, it is possible to have future term premiums paid with the income earned under the policy. Essentially, then the term premiums are paid with pre-tax income that will never be subject to income tax, even if the policy is canceled prior to death.¹³

If the insured has access to the cash or investment component of the policy, all the proceeds paid upon death may be includable in the insured’s taxable estate, even if the insured has only an interest in the cash or investment component and someone else (such as the trustee of an irrevocable life insurance trust) holds all incidents of ownership with respect to the term component of the policy.¹⁴ It is possible, though, 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 taxable estate.¹⁵

Under a split-dollar arrangement, an irrevocable life insurance trust “owns” the term component, and the insured’s spouse or an investment company (such as a corporation) “owns” the cash (or investment) component. Upon the insured’s death, the proceeds attributable to the term insurance component should not be includable in the taxable estate of the insured. The insured might own no more than 50 percent of the voting stock of the corporate owner of the policy’s cash value component (even if the insured holds more than 50 percent of the total equity). In such a case, the incidents of ownership held by the corporation should not be attributed to the insured shareholder.¹⁶

Alternatively, the cash value owner might be a limited partnership of which the insured is a limited partner. The incidents of ownership

held by the partnership (which may be structured to be a disregarded entity for income tax purposes) should not be attributed to the insured limited partner.¹⁷ Although the corporation or the partnership could make tax-free withdrawals or borrowings from the cash value component of the policy (provided the policy was not a modified endowment contract), the distributions to the insured as a shareholder or partner may be subject to income tax.¹⁸

To avoid taxation of the tax-free withdrawal, an Alaska or Delaware (or other jurisdiction providing that self-settled trusts may be free of the claims of the grantor's creditors) trust could own the policy, including the cash value component. The trust should be structured so that no incidents of ownership held by the trust will be attributed to the insured even if the insured grantor is eligible to receive distributions (which may include cash withdrawn by the trustee from the policy) from the trust.¹⁹

QUALIFIED PERSONAL RESIDENCE TRUSTS

As a general matter, 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 is treated as zero, causing the entire value of the property to be treated as the gift. In other words, no reduction in the value of the gift is made on account of the retained interest because the entire value is attributed to the remainder. However, Section 2702(a)(3)(A) provides an exception when the remainder transferred is in a personal residence the use of which is retained.

This exception permits, by way of example, the owner of a personal residence to give a remainder interest that will take effect after a term of years expires 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 under which the grantor retains the right to the exclusive occupancy and use of the home as a personal residence for a period of years. Such a trust is known as a personal residence trust ("PRT") or qualified personal residence trust ("QPRT"), depending on its terms.²⁰

To illustrate, assume that a 70-year-old woman makes a gift to her child of a remainder interest in her \$1 million home. Assume also that the transfer is made through a QPRT that takes effect in ten years (*i.e.*, the current owner retains the right to use the property as a personal residence for ten years). The trust further provides that the property will revert to the estate of the donor if the donor dies during the retained ten-year term. If all these conditions are met, the gift the property owner

would be making upon the creation of the QPRT would be \$368,450, if the IRS interest rate used to determine the value of the interest of such a trust (determined under Section 7520) were 6 percent, as it was for September 2006. If the trust has been structured properly and the term-holder survives the ten-year retained term, the property automatically will be transferred to, or held in further trust for, the remainder beneficiaries without any additional gift tax and without any estate tax.

One “problem” with an effective QPRT is that the grantor’s entitlement to use the property must end before he or she dies. If death occurs during the retained term, the trust is includable in the grantor’s estate under Section 2036(a). That means that the transfer of the remainder will not be free from any additional tax liability. The client must also be aware that once the retained term ends, he or she no longer has any right to occupy the property. The client must be in a position, at the end of the fixed term, where he or she can afford to vacate the property or rent it from the remainder beneficiaries at FMV.²¹

Another possible application of the personal residence exception under Section 2702(a)(3)(A), is a “split-purchase trust”SM. This arrangement is a particular form of QPRT in which parents typically purchase life estates in a new home (such as a retirement home) and a generation-skipping trust that is a grantor trust with respect to one of the parents purchases the remainder interest in the home. Under this arrangement, the parents have the use of the home for life, need not pay rent and, it seems, do not have to survive for any particular time. Also, unlike a QPRT, a split-purchase trust arrangement can “leverage” the GST exemption of the parents.²²

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. In fact, for such an individual, other gifts to family members (such as automobiles, payment for vacations, and similar transfers) often absorb the entire sum of annual exclusions available for them. In the case of a person of more modest means, however, if the annual exclusion is being used for other transfers, 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 children, each of whom is married and has two children of their own, may give up to \$160,000²³ to them each calendar year under the protection of annual exclusions coupled with “gift-splitting” under Section 2513 by the spouse (that is to say, \$20,000 to each of these eight individuals). Over a five-year term,

such transfers would remove from the client's estate \$800,000 and the subsequent income and growth on the gifted property. If the property grew at 8 percent per year compounded annually, for example, a total of about \$930,000 would be removed from the client's taxable estate in just five years. 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 that may arise when the client may wish to make such maximum use of his or her annual exclusions, but the individual does not own sufficient non-income-producing property with which to make the transfers. If that is the case, a client would have to make annual exclusion gifts of income-producing assets. If the client does so, then neither the gifted assets nor the income they produced may be made available directly to the donor. The individual simply may not be able to afford such a loss of income, so gifts of income-producing property must be considered carefully.

However, the individual might be able to continue to benefit indirectly from the income of the gifted property without causing estate tax inclusion by transferring assets under the protection of the annual exclusion to a trust, the income of which the trustee is permitted to distribute to the grantor's spouse. The spouse in his or her discretion, then could use the assets for the benefit of the grantor. In fact, there is no reason that the grantor needs even to name the precise person who is a beneficiary of the trust. The grantor could define his or her spouse in such a trust "as the person to whom the grantor is married at the time such distribution is made."²⁴

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 trust²⁵ for the benefit of the gift-splitting spouse and others (as long as the other beneficiaries have Crummey powers).²⁶ The reason is that the gift to the Crummey trust is treated for gift tax purposes as made to the individuals who hold the power to withdraw the property transferred to the trust, rather than as a gift to the spouse, even though the spouse is a beneficiary of the trust. Hence, the grantor could continue to enjoy the trust property to the extent it is made available to (and through) his or her spouse. Of course, when that spouse dies, the property no longer would be available (via the spouse) for the grantor.

While it is true that each spouse could create such a trust for the other, the trusts should be structured so that the benefits and controls granted to the spouses are sufficiently different in order to avoid application of the so-called reciprocal trust doctrine.²⁷ Under that doctrine, the trusts may be "uncrossed," with the effect 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.²⁸

With careful drafting, it is possible to structure the trusts so that the benefits and controls granted to the spouses are sufficiently different so that the reciprocal trust doctrine will not apply.²⁹ Nevertheless, it does mean that upon the death of the first spouse, only one-half of the assets will remain in trust for the benefit of the surviving spouse, unless the trust continues for the benefit of the spouse who created that trust. However, that continuing benefit, as a general rule, 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.³⁰ To that extent, the trust assets will be includable in the grantor’s estate.³¹

SELF-SETTLED TRUST OPTIONS

A few states including Alaska, Delaware, Nevada, Oklahoma, Rhode Island, South Dakota, and Utah, as well as several “offshore” jurisdictions (subject to limitations in some cases and somewhat differing rules), have adopted legislation that provides that a trust created under that jurisdiction’s law is not subject to claims by 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, however, that among other conditions, the transfer to the trust must not have been for the purpose of defrauding creditors. Because the trust assets are not subject to the claims of the grantor’s creditors, an Alaska trust, for example, of which the grantor is a discretionary beneficiary should not be includable in the grantor’s gross estate for federal estate tax purposes unless the grantor retains some further right or power that otherwise causes the trust to be includable in his or her estate.³²

Under the laws of states that permit these types of self-settled trusts, an individual could make annual exclusion gifts to a discretionary trust for the benefit of family members and himself or herself, and yet still keep the assets out of his or her taxable estate. Estate tax inclusion can be triggered, though, if the grantor receives all the income or if the trustee makes regular distributions that are nearly equal to the trust’s income. In such cases, the IRS and the courts may find that there was an understanding between the grantor and the trustee to pay income to the grantor, and so the property will be included in the grantor’s estate on

the grounds that the grantor retained possession, income, or enjoyment of the property of the trust.³³

POTENTIAL USE OF THE GIFT TAX EXEMPTION AND THE GST EXEMPTION

Many individuals of more modest wealth cannot afford to make large gifts because they cannot afford to give up the income from the assets that would be given away. Yet a transferor can benefit indirectly (through a spouse) from the income from property transferred to the trust (by using the self-settled trust option in a state such as Alaska, the transferor can remain eligible to receive distributions from gifted property) and nonetheless exclude its value from his or her gross estate. Consequently, the grantor could make gifts in excess of the amount covered by the annual exclusion, such as the amount of any remaining gift tax exemption, without losing the benefit of that income. This opens up certain attractive estate planning options.

For example, the generation-skipping transfer (“GST”) tax regulations allow the immediate allocation of GST exemption to a lifetime qualified terminable interest property (“QTIP”) trust described in Section 2523(e), even though no gift tax will be paid on the transfer if the QTIP election is made on a timely-filed gift tax return.³⁴ A QTIP trust that one spouse creates for the other will not be includable in the estate of the grantor-spouse if the grantor-spouse retains a secondary income interest in the trust, 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). The creation of such a lifetime QTIP trust will permit the effective use of the grantor’s GST exemption.

Notwithstanding the GST tax benefits, creation and funding of a QTIP trust will not permit the effective use of the grantor’s gift tax exemption (unified credit). Transfers to a QTIP trust will qualify for the gift tax marital deduction, so will not make use of the grantor’s unified credit. In planning, use of the unified credit may be more important than the use of the GST exemption.³⁵ If so, the property owner could create a trust for his or her spouse which intentionally does not qualify for the marital deduction but which will not generate gift tax on account of the use of the unified credit.

In this case, the grantor should not retain a secondary income interest following the death of his or her 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 or her unified credit. In fact, in virtually all American jurisdictions (except those like Alaska, discussed above), 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.

The potential estate tax inclusion again points to the self-settled trust option. A property owner could transfer an amount equal to his or her unused gift tax exemption equivalent to, for example, an Alaska or Delaware trust, remain eligible in the discretion of the trustee to receive distributions, and still make a completed transfer for estate and gift tax purposes.³⁶ Additionally, Alaska, Delaware, and several other jurisdictions effectively have repealed the rule against perpetuities, thus permitting the trust to be unlimited in duration. In Alaska and certain other states, the trust generally will be subject to state income tax only to the extent the income is allocable either to a grantor who is subject to that tax (such as under the grantor trust rules of Section 671 et seq.) or to a beneficiary who is subject to a state income tax.³⁷ Otherwise, the trust will not be subject to the state income tax. This can result in substantial savings over the term of the trust.

ACCESSING INCOME TAX-FREE STATES

Only seven states have no income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington (State), and Wyoming. An individual can move to one of those states and avoid income taxation, but in many cases that may not be practicable, desirable, or even effective from a holistic perspective. If the individual's children or other chosen objects of bounty live in states (or locations) with income taxes, income generated on any property transferred to them will be subject to the applicable state (and local) income tax. However, by creating trusts under the laws of one of the seven listed states, it may be possible to avoid income tax on trust income that is not currently distributed to such beneficiaries even if the beneficiaries live in a state (or locality) with an income tax.

If a trust is created in a state with an income tax, careful planning may reduce or minimize the trust's and the beneficiaries' state and local income tax liabilities. For example, New York is effectively a state income tax haven for trusts created by individuals who reside outside of that state. Except for New York-source income (essentially income derived by the operation of a business in New York), New York imposes a tax on trust income only if the grantor was domiciled in the state at the time the trust became irrevocable.³⁸ New Jersey has a similar rule.³⁹ Delaware, in contrast, does not impose an income tax on

income retained in a trust sited there unless the beneficiary is a Delaware resident.⁴⁰

Of course, some states have far-reaching income tax rules that seek to tax trusts created in other jurisdictions. For example, California imposes income tax on a trust created by a nonresident if a trustee is a resident of that state.⁴¹ In fact, California attempts to impose its income tax on the retained income of a trust created by a non-resident if *any* beneficiary is a resident of California, even if none of the trustees is a California resident.⁴²

USING A CHARITABLE REMAINDER TRUST TO BUILD WEALTH AND GENERATE INCOME

In the case of clients who are charitably inclined, charitable remainder trusts (“CRTs”) described in Section 664 may provide two benefits for individuals in the modest wealth category. First, an income, gift, or estate tax deduction may be allowed for the actuarial value of the remainder interest committed to charity. Second, and often more significantly, the trust is exempt from income tax for any year in which it does not have unrelated business taxable income (“UBTI”).⁴³

This may, for example, allow for a grantor to contribute to a CRT appreciated assets that the trustee later sells 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 to the grantor.⁴⁴ Being able to sell assets without paying tax on the gain provides an enhanced base of wealth for the taxpayer. The size of the annual payment from a charitable remainder unitrust (“CRUT”) to the designated noncharitable beneficiaries will be directly proportional to the value of the trust. Hence, 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 may benefit only 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 upon his or her death because of the retention of the annuity or unitrust payments.⁴⁵ Moreover, if the trust is only for the grantor or the grantor’s spouse, then no gift tax will be owed with respect to the initial transfer to the trust and no estate tax will be owed with respect to assets includable in the grantor’s estate at death.⁴⁶

Yet just as a CRT can benefit the grantor’s spouse after the death of the grantor, the trust may also be continued for the benefit of the grantor’s descendants. If descendants are trust beneficiaries, it is necessary to structure the trust so that the remainder interest for charity is at

least equal to 10 percent of the initial net FMV of the property placed in the trust.⁴⁷ 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.⁴⁸ The trust, however, will be includable in the grantor's estate.⁴⁹ If the grantor's spouse and descendants or the grantor's descendants alone are beneficiaries of the trust, the grantor's estate pays tax on the present value (calculated as of the grantor's date of death) of the interest in the trust committed to such successor individual beneficiaries.

Whether the grantor will want to continue the trust after his or her death for the benefit of his or her descendants will depend on a variety of factors. For example, if the interest of the grantor's spouse in the trust is anticipated on an actuarial basis to be minimal (*e.g.*, if the grantor's spouse is older or the grantor is willing to make the grantor's spouse a mere discretionary beneficiary), continuing the trust for the benefit of the grantor's descendants may be advantageous from an economic perspective. Although estate tax will be payable upon the death of the grantor (because the successor interest of the grantor's spouse *and* descendants will be fully subject to estate tax and no marital deduction will be available), the interest for the benefit of the grantor's descendants in the trust is likely to be substantial. Furthermore, on a future-value basis, the descendants' interest likely exceeds what the descendants would have received if the value of the property had been bequeathed directly to them (after taking into account the estate tax liability and the future income tax liability on earnings from the transferred property).

However, if the grantor's spouse's interest in the trust is likely to be substantial (*e.g.*, the grantor has given the spouse a fixed interest in the trust and the spouse is young), it may not make economic sense to give the property directly to the grantor's descendants. The present value of the successor beneficiaries' interest in the trust property will be subject to estate tax, and all the property received from the trust by the surviving spouse (to the extent not expended by him or her) will be included in the surviving spouse's estate upon his or her subsequent death, and likely will be subject to estate tax. In this scenario, the grantor's descendants are unlikely to receive a substantial benefit from the trust, especially, in light of the 10 percent minimum value of the charitable remainder requirement.

A net income CRUT (with or without "make-up" provisions) that pays the lesser of the unitrust amount or trust income can provide an opportunity for taxable income to accumulate tax-free in effect, until such time as the trustee decides to invest the assets to generate current trust income that can be distributed to the grantor or other trust

beneficiaries.⁵⁰ 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 the grantor with a degree of financial comfort that will make the grantor feel more financially secure in making gifts of other assets to remove them from his or her estate.

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 subject to gift tax.⁵¹ This means that a grandparent, for example, may pay the tuition for a child, a grandchild, or any other individual from nursery school to post-graduate education free of gift tax. Combined with any annual exclusion gifts that such grandparent may make, these transfers over time can remove significant amounts from the donor's estate tax base.

Furthermore, even though the payments for medical care and tuition must be made directly to the health care provider or educational institution to fall under the exclusion, there are some convenient ways to effect such payments. For example, a property owner might open a joint checking account with each of his or her adult children. In many states, the creation of such account is not considered a gift to the child even though the account is in joint name.⁵² Only to the extent that the child draws on the account will the gift be complete. If the child draws on the account only by writing a check directly to the provider of medical care or the educational institution, the transfer should not be subject to gift tax under Section 2503(e). Any amounts reimbursed, such as by medical insurance, could be contributed to that account and 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 ("LLC"), business trust, or other entity, may provide asset protection and tax benefits for the property owner and his or her family. Contribution of assets to such an entity changes the nature of the assets. For example, the contribution of real estate to a limited partnership in exchange for limited partnership units changes what is owned from real estate to limited partnership units. Such limited partnership units are generally less marketable than is the underlying real estate. This reduction in marketability has two important effects.

First, partnership assets of lesser value are less attractive. As a general rule, a partnership agreement may provide that anyone who attaches a partnership interest does not become substituted as a limited partner for purposes of voting and management decisions (to the extent these rights are granted to the limited partners under the partnership agreement or local law), but becomes instead a naked assignee of the economic interests that the units represent. Such an assignee probably will be taxed on a pro rata portion of the partnership's income as though he or she were a partner.⁵³ If regular distributions are not made, the units could 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) with no corresponding economic benefit. Creditors therefore tend to stay away from limited partnership interests.

A second effect of the reduced marketability of partnership interests (in comparison with the underlying property) is an almost certain corresponding reduction in value. Lower valuation typically means lower gift, estate, or GST taxation. Unfortunately, it usually also means a lower income tax-free step-up in basis under Section 1014(a) upon the transfer at death, because the basis of most inherited assets is equal to their estate tax value.

SPECIAL CARE IN 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 its estate tax value, a number of exceptions exist. The most common one is for "income in respect of a decedent," or "IRD."⁵⁴ 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, which often represent a large portion of the worth of a person of modest wealth, are almost always IRD. As a consequence, they could be exposed to estate tax and income tax as well as other taxes.⁵⁵ In many cases, from 75 percent to over 100 percent of the value in such qualified plans and IRAs may be eroded by taxes.

Because of the significant income tax exposure, persons of modest wealth should consider the possibility of making qualified plans and IRAs payable to a CRT upon the death of the "owner" of the retirement account. Unfortunately for taxpayers, this may effectively avoid the *income* tax on the contributed property, but it marginally will

reduce or have no impact on the estate tax due to the inclusion of the interest in the descendant's estate. Hence, the ability to pay those estate taxes, such as with life insurance proceeds, must exist if one makes the qualified plan and IRA proceeds payable to a CRT. Use of a CRT can result in a substantial increase in the net value of the economic benefit in such plan and thus the interests to which the decedent's beneficiaries will succeed.

ENSURING FULL USE OF THE ESTATE TAX EXEMPTION

Not infrequently, a married couple in the modest wealth range will not have adequate assets to ensure that the taxable estate of the first spouse to die will be sufficient to use his or her entire federal estate tax exemption. That may be especially important because the exemption (\$2 million in 2007 and 2008, and in 2009, \$3.5 million) is significantly larger than the exemption that is scheduled for years after 2010 (\$1 million).

For example, if the couple now has \$3 million and the assets are owned equally between them, and the first spouse dies before 2010, his or her estate would underutilize the available exemption. If the survivor dies after 2010, the couple's property will be unnecessarily subject to estate tax. The "better plan" would have been for the first spouse to die to have at least \$2 million (rather than \$1.5 million) in his or her estate, leaving \$1 million to be included in the estate of the survivor, which would be entirely protected by the estate tax exemption even for years after 2010.

Fortunately, the IRS has approved an arrangement under which assets belonging to the surviving spouse can be added to the taxable estate of the first spouse to die so the full estate tax exemption of the first spouse to die can be fully used by each spouse creating a revocable trust (or a joint revocable trust) and as to which the spouse dying first would be granted a general power of appointment over assets in the trust belonging to the surviving spouse. The power would be over a sufficient portion of the survivor's assets to allow the deceased spouse to fully use his or her estate tax exemption, based on the conclusion that the general power causes these assets to be included in the deceased spouse's estate under Section 2041.⁵⁶

ELDER LAW CONSIDERATIONS

Although it is beyond the scope of this article, practitioners who represent individuals of mid-level wealth may also wish to consider the

appropriateness of so-called elder law matters, such as supplemental and special needs trust planning (to preserve or procure government entitlements), expanded powers of attorney, and burial-rights issues.⁵⁷

CONCLUSION

Estate planning for individuals of more modest wealth is challenging because these clients face significant estate taxes but do not have such a large base of wealth that they can “afford” to make large lifetime gifts or other transfers to reduce estate taxes. Nevertheless, careful planning using any number of the techniques described here often may help to reduce these taxes.

NOTES

1. © 2007. All Rights Reserved. This article appeared in the March 2007 issue of *Estate Planning* (Vol. 34 *Est. Plan.* No. 3 (Mar. 2007)).
2. See, e.g., Section 2036(a)(1); Restatement (3d) of Trusts, §§ 57–60; Willbanks, *Federal Taxation of Wealth Transfers* 241 (2004).
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 who is willing to make only limited level of lifetime gifts, a gift of an asset other than an insurance policy may be more appropriate for several reasons. First, often the policy lapses (e.g., is terminated by failure to pay premiums) before the death of the insured. In such a case, there will be no reduction of estate tax because the subject of the gift (i.e., the life insurance policy) will have lapsed prior to the death of the insured donor. Second, as a general matter, it is preferable to give those assets which have the greatest potential for growth. Many insurance policies are designed to emphasize preservation of value rather than high growth. These are just two of many reasons why an asset other than a life insurance policy may be a preferred subject of a gift by an individual of more substantial wealth. For a more detailed discussion of lifetime gifts of insurance policies and other estate planning with insurance, see Blattmachr, *The Complete Guide to Wealth Preservation and Estate Planning* 545–621 (1999).
5. Section 2042 and Section 2035(a).
6. See, e.g., Gans and Blattmachr, “Life Insurance and Some Common 2035/2036 Problems: A Suggested Remedy,” 139 *Tr. & Est.* 58 (May 2000).
7. Usually, it will be 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, by election under Section 2056(b)(7), as qualified terminable interest property (“QTIP”). That way, the insured’s executor can determine, by the election, how much should be made to qualify for the marital deduction. See generally Blattmachr and Slade, “Building an Effective Life Insurance Trust,” 129 *Tr. & Est.* 29 (May 1990). In addition, special considerations will arise if the surviving spouse is not a U.S. citizen. Section 2056(d).

8. See "Building an Effective Life Insurance Trust," *supra* note 6.
9. A gift is complete when, under the principles of Reg. 25.2511-2(c), the donor has given up dominion and control of the property. Even if the gift is complete under those principles, the property nonetheless may be included in the donor's gross estate at death on account of a retained interest or power. See Section 2036, Section 2037, and Section 2038.
10. Cf. Lefrak, TCM 1993-526.
11. Basis generally equals the sum of premiums paid, including that portion used to pay for the term insurance protection, reduced by amounts previously withdrawn.
12. Not all variable policies permit withdrawals. Universal type policies usually do. In any case, some insurance companies impose charges (called "surrender charges") on amounts withdrawn. It is important to consider whether commissions, premium taxes, and "management" fees are so significant that they offset the benefits of the income tax build-up "inside" the policy.
13. This technique is described in detail in the winter 1997 issue of *The Chase Review*.
14. Rev. Rul. 82-165, 1982-1 CB 117.
15. See, e.g., Ltr. Rul. 9636033 (not precedent).
16. Reg. 20.2042-1(c)(6).
17. Rev. Rul. 83-147, 1983-2 CB 158.
18. If the partnership is an entity that is disregarded for federal income tax purposes under Reg. 301.7701-3, the withdrawal will not otherwise be subject to income tax.
19. Cf. Ltr. Rul. 9434028 (not precedent) (incidents of ownership held by trust were not attributed to beneficiary who was not a trustee but whose life was insured under policy owned by the trust).
20. See Reg. 25.2702-5.
21. The IRS has ruled privately (not precedent pursuant to Section 6110(k)) that renting the home to the grantor after the retained use period ends will not cause the value of the home to be includable in the grantor's estate if the grantor pays full and adequate rent. Ltr. Rul. 9626041; Ltr. Rul. 9425028.
22. See generally Blattmachr, "Split-Purchase Trusts vs. Qualified Personal Residence Trusts," 138 *Tr. & Est.* 56 (Feb. 1999).
23. Although the annual exclusion under Section 2503(b) is \$12,000, the exclusion must cover not only what might be called "estate planning" gifts but holiday, birthday, and similar gifts. Hence, these examples assume only \$10,000 is available for the estate planning gifts.
24. See Rev. Rul. 80-255, 1980-2 CB 272; *Estate of Tully*, 41 AFTR2d 78-1477 (Ct. Cl. 1978).
25. 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).
26. Reg. 25.2513-1.
27. See Slade, "The Evolution of the Reciprocal Trust Doctrine Since *Grace* and Its Application in Current Estate Planning," 17 *Tax Mgt. Est., Gifts & Tr. J.* 71 (May-June 1992).
28. *Estate of Grace*, 395 U.S. 316, 23 AFTR2d 69-1954 (S. Ct., 1969).
29. Cf. *Estate of Green*, 68 F.3d 151, 76 AFTR2d 95-7094 (CA-6, 1995).
30. See Restatement (3d) of 'Trusts, §§ 57-60.

31. Rev. Rul. 77-384, 1977-2 CB 198.
32. See Rev. Rul. 76-103, 1976-1 CB 293; *Estate of German*, 7 Ct. Cl. 641, 55 AFTR2d 85-1577 (Cl. Ct., 1985); Ltr. Rul. 9837007 (not precedent).
33. See, e.g., Section 2036(a)(1); see also *Estate of Skinner*, 197 F. Supp. 726, 8 AFTR2d 6073 (D.C. Pa., 1961).
34. Reg. 26.2652-2. However, 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).
35. Because the GST tax usually can be postponed for a much longer period of time than can gift and estate tax, use of the GST exemption may be viewed as having less immediate benefit than use of the unified credit.
36. Rev Rul. 76-103, *supra* note 31.
37. Some states impose income tax on trust income if the grantor, trustee, or beneficiary resides in that state. See, e.g., N.Y. Tax Law § 605. Also, states with income taxes generally impose their income taxes on income earned in that state.
38. N.Y. Tax Law §§ 601, 605(b)(3).
39. N.J. Stat. Ann. § 54A:2-1.
40. Del. Code Ann. 30 §§ 1131 et. seq.
41. See, e.g., Cal. Rev. & Tax Code § 17742.
42. *Id.*
43. Section 664(c).
44. See, e.g., Ltr. Rul. 9452026 (not precedent) (gain recognized by the trust on appreciated assets contributed to the trust will be attributed to the grantor only if the trustee legally is obligated to sell the transferred assets).
45. See, e.g., Rev. Rul. 82-105, 1982-1 CB 133.
46. Section 2056(b)(8) and Section 2055(a). Special rules apply if the spouse is not a U.S. citizen. See Section 2056A.
47. Section 664(d)(2)(D).
48. Reg. 1.664-2(a)(3) and Reg. 25.2511-2(c).
49. Section 2038.
50. If a CRT with a make-up provision is chosen, then deficiencies are made up in subsequent years in which trust income exceeds the unitrust amount.
51. Section 2503(e).
52. Reg. 25.2511-1(h)(4). In 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 will be no completed gift from the contributing tenant to the non-contributing tenant on the opening of the account because withdrawals will be only for the benefit of the contributing tenant or will qualify for the exclusion under Section 2503(e).
53. *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) (distinguishing *Evans* and suggesting that a transferee is treated as a tax partner only if the transferee has "dominion and control" over the transferred partnership interest).

54. *See* Section 691(a) and Section 1014(c).
55. *See generally* Blattmachr and Gans, “Planning for IRD After Elimination of the State Death Tax Credit,” 33 *ETPL* 3 (Mar. 2006).
56. *See, e.g.*, Ltr. Rul. 20040394 and Ltr. Rul. 200101021. *See generally* Gans and Blattmachr, “Making Spousal Estate Tax Exemptions Transferable,” 19 *Prob. & Prop.* 10 (Nov./Dec. 2005).
57. *See generally* Regan, Morgan, and English, *Tax, Estate & Financial Planning for the Elderly*, Ch. 17 (Matthew Bender).