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EstatePlanning101

What Every CPA Should Know

Most clients assume their CPAs are experts in all things financial, especially as related to tax matters. They believe that if there is anything important for them to plan for, their CPAs will raise the matter. One particular area that many clients neglect, however, is estate planning. Some do not want to deal with mortality issues, others do not want to confront family issues and still others think that the estate plan they made 20 years ago is fine.

Moreover, clients are generally unaware of the state of the estate tax laws. For example, despite repeated efforts by Congress to repeal the "death tax," no agreement has been reached. The current law is effective until the end of 2010, then we revert to a prior estate tax law that, unless modified, will result in a big increase in both the amount of wealth subject to tax and the rate of tax applied.

Clients often do not realize that the estate tax, like the gift tax and generation-skipping transfer tax, impose a tax on the transfer of wealth. While clients bemoan the amount of *income tax* they pay, they are often in denial over the fact that they (or their estates) will be subject to a separate tax as their assets are *transferred*. However, there are exceptions to the imposition of transfer taxes.

Another factor to keep in mind is that estate tax reduction planning should first consider the long-term effects on the donor's financial planning status. After all, you don't want clients making gifts they can't afford.

Enter the CPA to help clients with these matters. CPAs are usually aware of the scope of their client's assets and often know something about their client's family relationships.

The following primer on federal estate tax rules can help provide CPAs with the tools needed to conduct a meaningful conversation with their clients about their estate planning.

The Common Exceptions

Basic estate planning involves using one or more techniques to reduce the tax cost of transferring assets to family members and other beneficiaries. Which techniques to use depends upon many factors, tax and non-tax related. Also, not every tax-free transfer should be made in all circumstances. Further, estate planning honors the client's wishes as to the ultimate transfer of their property. For example, charitable giving is often employed because of the client's love for the charity, not always with intent to reduce costs.

From an income tax perspective, it may not be advantageous to make any lifetime transfers. Assets that pass to a beneficiary upon death frequently receive an increase in tax basis for income tax purposes, which can provide additional depreciation or amortization deductions when applied to depreciable or amortizable assets.

Similarly, the increased income-tax basis can reduce the subsequent gain on the sale of such assets by the beneficiary. Therefore, if the amount of the potential estate in question is small enough that there will be no estate tax, a tax-free transfer taken during the client's lifetime may not be a tax benefit.

Instead, the client may wish to transfer all assets upon death so the beneficiaries will receive an income-tax basis in the assets equal to the fair market value as of the date of the client's death.

With that caveat, here are some common estate planning techniques:

Annual Gift Tax Exclusion. The law allows an annual tax-free transfer of property or cash up to $12,000. These transfers are exempt from gift tax and are not counted toward the amount that can be transferred free of tax as part of the lifetime exemption.

Annual gifts can be made to an unlimited number of people every year and the same people can receive the gift each year. Far better, for married couples, the amount of the annual gift tax exclusion for each gift is $24,000 since each spouse can gift $12,000. Even if all of the property comes from one spouse, an election can be made on a gift tax return to treat it as if made by both, thereby allowing annual gifts by one spouse of $24,000.

Each of these gifts reduces the value of the estate's remaining assets. If the estate is going to be a taxable estate, then the savings from these gifts is measured by the highest estate tax rate (currently 45 percent) since these transfers come off the top of the estate.

Further, the gifts carry any future appreciation on the property transferred. Thus, the estate is reduced by the amount of the gift and by all earnings and growth attributable to the property transferred.

Most important, the annual exemption applies on a "use it or lose it basis." Gifts not made in one year cannot be made up by increased gifts in other years when such gifts were not made. For example, you can't gift $24,000 in one year and claim $12,000 for the previous year.

It's not just about gifts of cash, however. Some gifts increase the value of the property transferred. For example, a gift of an interest in a limited partnership that is valued at $12,000 will often have a value on liquidation that is substantially greater.

Gifts can be made outright or in trust. However, most gifts made in trust will not qualify for the annual exemption unless the trust includes special language to create a "present interest" in the beneficiary, often referred to as "Crummey provisions." These provisions are derived from *Crummey v. Commissioner*, in which the Ninth Circuit U.S. Court of Appeals held that a right of withdrawal granted to a beneficiary made a gift in trust a present interest gift so that it qualified for the annual exclusion.

Payments for Qualified Education and Health Care Expenses. Another gift that is not a gift for tax purposes is a payment made for qualified education (tuition for everything from preschool to grad school) or health care. Here, payments are made directly to the education or medical services provider and are not a

reimbursement to the person who incurred the expenses.

The treatment of these items as tax-free transfers reflects a policy consideration to encourage such personal charitable acts.

Lifetime Exclusions. The estate and gift tax systems are unified in the sense that the tax-free transfers available lifetime and upon death work in tandem. IRC Sec. 2505 provides a credit for an "exclusion amount" for cumulative lifetime transfers of taxable gifts of up to $1 million. Thus, every transfer made during a lifetime that does not qualify for one of the exceptions, such as annual exclusion or qualified education and medical expenses, uses part of the lifetime exclusion amount to avoid gift tax.

All transfers constituting taxable gifts in excess of $1 million are subject to the gift tax of a rate of 45 percent. Any portion of the lifetime exemption that is not used is available for transfers made upon death. The cumulative exclusion amount for transfers made during lifetime and upon death is $2 million, increases to $3.5 million in 2009 and increases again to an unlimited amount in 2010, but only for 2010. Thereafter, unless amended, the exclusion amount will reduce to $1 million.

The main reason to use the lifetime exclusion is that all income and appreciation of the transferred property are removed from the transferor's estate. Thus, a lifetime transfer of $1 million can result in estate tax savings on hundreds of thousands (or millions) of dollars of earnings, and appreciation on the $1 million that would be included in the transferor's estate if no gift were made.

As with all other transfers, there may be more important non-tax reasons to make or not make the gift. It is important to recognize that tax savings alone should not motivate important financial decisions, particularly those infused with family relations.

For example, gifts may result from the transfers required to provide support for a parent or an adult child. While transfers of property may be tax efficient, many potential parents won't approve of how gifts, particularly of cash, would be used by the donee.

Transfers to a Spouse. There is no tax on transfers of property to a spouse—who is a U.S. citizen—whether made outright or in trust, during lifetime or upon death. The estate of a deceased spouse is generally entitled to a "marital deduction" for certain transfers to a surviving spouse. Trusts that qualify for the tax-free transfer between spouses are often referred to as qualifying terminal interest property (QTIP) trusts.

However, for transfers in trust for a spouse to qualify as tax free, the trust must, at a minimum, distribute all income to the spouse for life. Thus, a trust that provides distributions of income to a spouse until the spouse remarries, or until a house is sold, will not qualify.

A transfer to a spouse who is not a U.S. citizen is not eligible for a marital deduction unless the transfer is made to a qualified domestic trust, which is generally referred to as a QDOT.

Why use a QTIP trust? First, like any transfer of assets to a spouse, no estate tax applies on the transfer. Ultimately, an estate tax will apply upon the death of the spouse, as the assets in the trust will be includible in the spouse's gross estate and potentially subject to estate tax. However, a QTIP trust can achieve a deferral of estate tax for an unlimited amount of property.

Second, the use of a QTIP trust assures that assets that remain upon the death of the surviving spouse are owned by the deceased spouse and will pass to the beneficiaries designated by the deceased spouse. In contrast, if the deceased spouse's assets are left outright to the surviving spouse, there can be no assurance that those assets will end up with those beneficiaries selected by the deceased spouse.

Finally, the QTIP trust can provide a measure of asset protection for the surviving spouse. Assets in a QTIP trust can be used for

the benefit of the surviving spouse, but are not generally recoverable by the surviving spouse's creditors.

Lifetime Exemption and QTIP Trust

Here is a case study that demonstrates how the QTIP trust and lifetime exemption can be used together in a typical estate plan.

Husband ("H") and wife ("W"), both age 60, have three children. They have a combined net worth of $6 million and live in a community property state. H and W want their descendents to have full use of their assets upon their deaths, to minimize the potential estate tax liability. They also want to assure that their children eventually will receive all of the assets remaining after they both die. H and W have made no taxable gifts during their lifetimes.

Assume that H dies in 2007 and that W dies in 2009. Upon W's death, the fair market value of their combined assets has declined to $5.5 million.

What are the options? In the simplest of plans, H and W can each provide that all of the assets of the deceased spouse pass outright to the surviving spouse. Because of the unlimited marital deduction, there would be no estate tax on the transfer of H's asset to W. However, upon W's death in 2009, her gross estate of $5.5 million would exceed her then available exemption amount of $3.5 million. As a result, the estate tax due upon her death would be $900,000.

H, by leaving everything outright to spouse, did not take advantage of his own exemption amount. He could have left up to $2 million in a trust for their children, (typically referred to as a bypass trust) so that these assets would not be includible in W's estate upon her death.

A bypass trust can provide substantial benefits for the surviving spouse, while still excluding the assets in the trust from the surviving spouse's estate. Thus, the surviving spouse can receive all of the income of the bypass trust and may invade principal for purposes defined as subject to an ascertainable standard, meaning the health, support, maintenance and education of the surviving spouse.

Therefore, instead of leaving $3 million to W, H could leave $2 million to a bypass trust for W's benefit and the remaining $1 million to W. Both transfers would be exempt from estate tax. As a result, W's gross estate would be only $3.5 million, an amount equal to the exemption amount available in 2009. Accordingly, no tax would result upon the death of both H and W and their children would divide the $5.5 million upon W's death, assuming that W did not alter her estate plan after H's death.

But what if one or both spouses are concerned about the final disposition of the assets that passed to the surviving spouse. In this example, H and W have the same children, so there may be less concern that the surviving spouse would change his or her plan to alter what their children would receive. However, if the children were all H's from a prior marriage, he may want to make sure that his remaining assets, after W's death, pass on to his children, and not to W's children or to W's new spouse.

Accordingly, by transferring all of his assets to the bypass trust and the QTIP trust, H can provide for W during her lifetime and, at the same time, provide, irrevocably, that his children will receive the remaining assets upon W's death. Therefore, instead of leaving all of his assets in excess of what can pass tax-free in the bypass trust outright to W, H may provide that the excess go to a QTIP trust for W's benefit.

Since many of the basic concepts of estate planning are tax driven, at least in part, many clients expect their CPAs to be well versed in the subject.

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