The Estate Planner

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Net gain for taxpayers

Tax Court approves net gift strategy

A net gift is a technique that potentially allows you to reduce your effective gift tax rate from 40% to 28.6%. It requires the donee to agree to pay the gift tax as a condition of receiving the gift. This reduces the gift's value for gift tax purposes.

Recently, the U.S. Tax Court approved a strategy that can reduce a gift's value even further: In addition to paying the gift tax, the donee can agree to assume the potential estate tax liability that would result if the donor dies within three years after making the gift.

How net gifts work

Here's an example that illustrates the net gift's tax-saving power. Kevin plans to make a $1 million gift to his daughter, Natalie. He's already used up his $5.34 million gift and estate tax exemption and wants to minimize the tax. At the current top gift tax rate of 40%, an outright gift would result in a $400,000 tax bill.

If Natalie agrees to pay the gift tax, the value of the gift — and, therefore, the gift tax liability — is reduced. There's a simple formula to calculate the tax on a net gift: Gift tax = tentative tax / (tax rate + 1). The tentative tax is the amount that would have been due if the gift hadn't been structured as a net gift (in this case $400,000). Applying this formula to the example, the gift tax would be $400,000 / 1.4, or $285,714 (for an effective rate of about 28.6%).

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To ensure that Natalie receives the full $1 million gift, Kevin uses a "financed net gift." He makes her a $285,714 loan to cover her tax obligation, bearing interest at the applicable federal rate (AFR) and documented by a written promissory note. Lately, AFRs have been extremely low (under 1% for a short-term loan and under 2% for a mid-term loan).

One caveat: The gift tax liability assumed by the donee constitutes consideration in exchange for the gift. If the gift consists of appreciated property, a net gift or financed net gift can result in capital gains tax liability for the donor.

How gifts reduce transfer taxes

Generally, funds used to pay *gift* taxes are removed from a donor's estate, escaping taxation, while funds used to pay *estate* taxes are included in the taxable estate. So if an estate is large enough that transfer taxes will be owed, paying gift taxes rather than estate taxes can reduce the overall tax liability.

Let's look at an example. (For simplicity, it assumes that the gift and estate tax exemption remains steady at $5.34 million.) Ann has an estate valued at $12 million. If she dies without having used any of her exemption on lifetime gifts, estate taxes will total $2,664,000.

Suppose, instead, that Ann makes $7 million in lifetime gifts to her children, paying $664,000 in gift taxes after her exemption. The gift tax payment is excluded from her estate, reducing it from $5 million to $4,336,000. This results in an estate tax of $1,734,400 at death, and combined gift and estate taxes of $2,398,400. The gifts would allow Ann to avoid more than $265,000 in transfer taxes.

But the tax savings aren't a certainty: Because of Internal Revenue Code Section 2035(b) (see main article), if Ann dies within three years of making the $7 million in gifts, the $265,000+ in tax savings will be lost.

Suppose, in the previous example, that instead of cash Kevin gives Natalie real estate with a fair market value of $1 million and a cost basis of $200,000. If Natalie pays $285,714 in gift tax, the excess of that amount over Kevin's basis ($85,714) is a taxable capital gain. One way to avoid capital gains tax is to enter into a financed net gift transaction with a grantor trust rather than the ultimate beneficiary.

Enhancing the benefits

You can enhance the benefits of a net gift by having the donee assume the potential estate tax liability that might arise under Internal Revenue Code Section 2035(b). This section provides that a gross estate is increased by the amount of gift tax paid on any gifts made during the three-year period ending on the date of death. It's designed to prevent people from using "deathbed gifts" to reduce transfer taxes. (See "How gifts reduce transfer taxes" above.)

Historically, the Tax Court has rejected this strategy, finding that the estate tax liability, which may or may not arise, is speculative. But in a recent case — *Steinberg v. Comm'r* — the court reversed its position, permitting taxpayers to reduce the value of gifts by the actuarially determined value of the donee's contingent obligation to pay any tax liability that might arise under Sec. 2035(b).

Put it in writing

If you wish to take advantage of net gifts to reduce your gift tax liability, have the donee (or the trustee in the case of a gift in trust) sign a written agreement at the time the gift is made assuming liability for gift and estate taxes. To ensure that the transaction passes muster with the IRS, it's also advisable for donees to seek the advice of separate counsel before signing the agreement. ✤

Wealth preserver

Use an ILIT to shield life insurance proceeds from estate tax

If you're concerned about your family's financial well-being after you're gone, life insurance can provide peace of mind. However, make certain that you don't own the policy at death. Why? The policy's proceeds will be included in your taxable estate and may be subject to estate taxes. To avoid this result, a common estate planning strategy is to set up an irrevocable life insurance trust (ILIT) to hold the policy.

ILIT benefits

Contributing an existing life insurance policy to an ILIT constitutes a taxable gift to the trust beneficiaries of the policy's fair market value (which generally approximates its cash value). With the combined gift and estate tax exemption currently at $5.34 million, now may be a good time to make such a gift.

Keep in mind that future ILIT contributions to cover premium payments will be taxable gifts. You may, however, be able to apply your annual gift tax exclusion (currently $14,000; $28,000 for married couples splitting gifts) to reduce or eliminate the tax — provided the ILIT is structured appropriately and certain other requirements are met.

To remove a life insurance policy from your taxable estate, simply transferring the policy to an ILIT isn't enough. You must also relinquish all "incidents of ownership," such as the power to change or add beneficiaries; to assign, surrender or cancel the policy; to borrow against the policy's cash value; or to pledge the policy as security for a loan.

To remove a life insurance policy from your taxable estate, simply transferring the policy to an ILIT isn't enough.

If you retain any incidents of ownership, the insurance proceeds will still be included in your estate. And they may be subject to estate taxes, depending on the size of your estate and your available estate tax exemption.

Also, be aware of the "three-year rule," under which the proceeds are pulled back into your taxable estate if you die within three years after transferring an existing policy to an ILIT. In light of this rule, the safest strategy is to establish the ILIT first and have it acquire a new insurance policy on your life. But if you already own a policy, the sooner you transfer it to an ILIT, the greater the chances that you'll successfully remove it from your estate.

ILIT drawbacks

An ILIT offers significant tax benefits, but it also has some significant limitations. As mentioned, after you transfer a policy to the trust, you can no longer

change or add beneficiaries; assign, surrender or cancel the policy; or borrow against or withdraw from the policy's cash value. In addition, you're not allowed to alter the ILIT's terms or act as trustee.

Nevertheless, there are some techniques available to build flexibility into an ILIT. For example, you can design the trust to adapt to changing circumstances, provide that children or grandchildren born after you establish the trust be automatically added as beneficiaries, and give the trustee the power to remove beneficiaries under certain circumstances (such as removing your daughter-in-law if she and your son divorce).

You can also establish conditions for distributing funds from the ILIT. For example, you might instruct the trustee to withhold funds from a beneficiary who drops out of school or develops a substance abuse problem.

Another strategy is to appoint a "trust protector." A trust protector is a sort of super-trustee who has the power to remove the trustee, amend the trust or take other actions to ensure that the ILIT achieves your objectives in light of changing laws or circumstances.

Ensure your policy works as intended

A life insurance policy can protect your family's financial future. Using an ILIT can help ensure the policy works as you intend by shielding the proceeds from hefty estate taxes. ✤

Estate planning for the young and affluent

How to hedge your bets

Events of the last decade have taught us that taxes are anything but certain. So how can young, affluent people plan their estates when the tax landscape may look dramatically different 20, 30 or 40 years from now? The answer is by taking a flexible approach that allows you to hedge your bets.

Conflicting strategies

Many traditional estate planning techniques evolved during a time when the gift and estate tax exemption was relatively low and the top estate tax rate was substantially higher than the top income tax rate. Under those circumstances, it usually made sense to remove assets from the estate early — through various trust and gifting strategies — to shield future asset appreciation from estate taxes.

Such lifetime asset transfers could result in higher income taxes for heirs. But in most cases, the estate tax benefits outweighed the income tax disadvantages.

Today, the exemption has climbed to $5.34 million and the top gift and estate tax rate (40%) is roughly the same as the top income tax rate (39.6%). If your estate's worth is within the exemption amount, estate tax isn't a concern and there's no gift and estate tax benefit to making lifetime gifts.

But there's a big *income tax* advantage to *keeping* assets in your estate: The basis of assets transferred at your death is stepped up to their current fair market value, so beneficiaries can turn around and sell them without generating capital gains tax liability. Assets you transfer by gift, however, retain your basis, so beneficiaries who sell appreciated assets face a significant tax bill.

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Unpredictable future

For young people, designing an estate plan is a challenge because it's difficult to predict what the estate and income tax laws will look like — and what their own net worth will be — decades from now. If you believe that the value of your estate will remain lower than the exemption amount, then it may make sense to hold on to your assets and transfer them at death so your children or other heirs can enjoy the income tax benefits of a stepped-up basis.

But what if your wealth grows beyond the exemption amount so that estate taxes become a concern again? What if Congress decides to reduce the exemption amount? If that happens, removing assets from your estate as early as possible is the better tax strategy. But by the time circumstances have changed, it may be too late to adopt that strategy.

Building flexibility into your plan

A carefully designed trust can make it possible to remove assets from your estate now, while giving the trustee the authority to force the assets back into your estate if that turns out to be the better strategy. This allows you to shield decades of appreciation from estate tax while retaining the option to include the assets in your estate should income tax savings become a priority.

For the technique to work, the trust must be irrevocable, the grantor must retain no control over the trust assets (including the ability to remove and replace the trustee) and the trustee should have absolute discretion over distributions. In the event that estate inclusion becomes desirable, the trustee should have the authority to cause such inclusion by, for example, naming the grantor (you) as successor trustee or giving the grantor a general power of appointment over the trust assets.

In determining whether to exercise this option, the trustee should consider several factors, including potential estate tax liability, if any, the beneficiaries' potential liability for federal and state capital gains taxes, and whether the beneficiaries plan to sell or hold onto the assets.

Consider the risk

This trust type offers welcome flexibility, but it's not risk-free. If you die unexpectedly, you may lose the opportunity to include the trust assets in your estate. Be sure to consider this risk as you determine whether this strategy is right for you. ✤

Estate Planning Red Flag

Your spouse's estate didn't make the portability election

Earlier this year, the IRS issued Revenue Procedure 2014-18, which permits estates to make a late portability election under certain circumstances. The rule change is of particular interest to same-sex married couples who were ineligible for portability and couldn't have made the election before the law was changed late last year.

Portability allows a surviving spouse to take advantage of a deceased spouse's unused estate tax exemption. But portability isn't automatic: It's available only if the deceased spouse's estate makes a portability election on a timely filed estate tax return. This return is due nine months after death, with a six-month extension option, regardless of whether any tax is owed.

Previously, if a deceased spouse's estate failed to make a timely portability election, the surviving spouse's only recourse was to request a private letter ruling from the IRS — a costly and time-consuming process. Rev. Proc. 2014-18 provides an *automatic* extension to file a portability election if:

- ✦ The deceased died after Dec. 31, 2010, and before Jan. 1, 2014,
- ✦ The deceased was a U.S. citizen or resident at the time of death, and
- ✦ The estate didn't file an estate tax return, and wasn't otherwise required to file one (because the value of the deceased's estate was less than the exemption amount).

If these requirements are met, the estate may make the election by filing an estate tax return no later than Dec. 31, 2014, with the following language at the top: "FILED PURSUANT TO REV. PROC. 2014-18 TO ELECT PORTABILITY UNDER SECTION 2010(c)(5)(A)."

In situations where the surviving spouse has subsequently died, his or her estate may be entitled to a refund of estate taxes that were overpaid without the benefit of a portability election made by the estate of the first spouse to die. If the deadline for filing a refund claim is approaching, Rev. Proc. 2014-18 permits the survivor's estate to file a protective claim pending the portability election.