

HIGH NET WORTH ESTATE PLANNING PRINCIPLES

Unique Challenges...
Unique Opportunities

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PRINCIPLE #1 – THE PRIMARY RULE OF GIFTING IS FIRST TO DETERMINE WHAT ASSETS YOU WISH TO KEEP FOR YOUR OWN USE AND PEACE OF MIND.

While there are many strategies that reduce estate taxes, our primary objective is to provide for your well being (not that of your children). There are significant tax savings that you can achieve by making gifts during your lifetime; however, even more important than saving taxes at your death is ensuring that you have whatever assets you need during your lives to provide for your support in your desired standard of living and to provide whatever other funds you may desire for peace of mind, gifting to charity during life, and any other purposes you desire.

Therefore, we could look at the amount you are spending annually on your support in your desired standard of living, and calculate based on that rate of spending, the amount of assets you need to retain to meet your future needs. Then, based on the calculation of the amount of assets to retain, we could determine how much of your estate you could gift away while still retaining enough assets to provide for your maximum security.




PRINCIPLE #2 – IT IS BETTER TO PAY GIFT TAX THAN ESTATE TAX.

The federal government imposes two types of transfer taxes: the gift tax and estate tax. There are two reasons that it is better to pay gift tax during life than estate tax at death.

First, the estate tax requires you to pay tax on the tax while the gift tax does not. When you make a lifetime gift, the gift tax is imposed upon the amount the recipient receives. However, when you make a transfer at death, the estate tax is imposed on all assets in your estate, including the assets that will be used to pay the tax. That is why the estate tax is said to require you to “pay tax on the tax.”

A short example will illustrate the importance of this difference. Let us assume that you have the sum of \$2,000,000 that you wish to transfer to your child and that your objective is to transfer as much as possible to your child after paying whatever taxes must be paid. We assume a 50% tax rate throughout this presentation. The following is the difference between a gift during life and a gift after death:

	<u>Gift During Life</u>	<u>Gift at Death</u>
(1) Total assets before taxes	2,000,000	2,000,000
(2) Less gift tax (i.e. 50% of line 4)	-666,667	
(3) Less estate tax (i.e. 50% of line 1)		-1,000,000
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(4) Amount of gift to child	1,333,333	1,000,000




This illustrates the significant advantage of paying gift tax over the estate tax. If you start with the same exact amount of money (\$2,000,000), your child will receive an additional \$333,333 if you give the money during life rather than at your death assuming you survive three (3) years after the gift.

Second, it is realistic to assume that if the \$2,000,000 used in our example is not gifted during life, it will increase in value prior to death. To make the above example more realistic, let us assume an annual growth rate of 10% per year and that your death occurs in five years. The calculations would then look like the following:

	<u>Gift During Life</u>	<u>Gift At Death</u>
(1) Total assets at beginning of Year 1	2,000,000	2,000,000
(2) Less gift tax (i.e. 50% of line 3)	- 666,667	0
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(3) Total assets after gift tax paid	1,333,333	2,000,000

Now, jump ahead five years with 10% annual growth. This is what it looks like at the end of year 5.

(4) Total assets at end of Year 5	2,147,346	3,221,020
(5) Less estate tax (i.e. 50% of line 4)	0	-1,610,510
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(6) Value of gift to child	2,147,346	1,610,510



Under the example, the gift during life transfers an additional \$536,836 to your children more than a transfer at death. This significant savings is possible because the making of a lifetime gift (as opposed to a gift at death) removes not only the asset itself from your estate but also all future appreciation and income of the asset.

Given the dramatic tax savings available from lifetime gifting, we usually recommend the lifetime gifting of some or all of the assets that are not needed for your support as discussed under Principle #1.



PRINCIPLE #3 – IN SELECTING ASSETS TO GIFT, IT IS PREFERABLE TO RETAIN APPRECIATED ASSETS AND TRANSFER DEPRECIATED ASSETS.

The income tax code contains a provision that upon the death of the owner of an asset, the basis of the asset is adjusted to its then fair market value. If an asset has a basis lower than its fair market value, this is a favorable result because the basis is increased. Conversely, if an asset has a basis higher than its fair market value, this is unfavorable because the basis is decreased.

The examples below illustrate the importance of this rule.

“THE APPRECIATED ASSET”

If Transfer to Heirs at Your Death

Tax basis of asset in your hands	100
Fair market value at time of death	300
Tax basis in the hands of your heirs	300
Sale by heirs for \$300	300

Capital gain equals (300 less 300) 0

If Gift During Life to Heirs

Tax basis of asset in your hands	100
Tax basis in hand of donees	100
(Value at your death irrelevant because of gift)	
Sale by heirs for \$300	300

Capital gain equals (300 less 100) 200

From an income tax standpoint, it is preferable to retain an appreciated asset until death rather than transfer it during life because your heirs can avoid paying capital gain tax on appreciation during your life.

“THE DEPRECIATED ASSET”

If Transfer to Heirs at Your Death

Tax basis of asset in your hands	500
Fair market value at time of death	300
Tax basis in the hands of your heirs	300
Sale by heirs for \$300	300

Capital loss equals (300 less 300) 0

If Gift During Life to Heirs

Tax basis of asset in your hands	500
Tax basis in the hand of donees	500
(Value at your death irrelevant because of gift)	
Sale by heirs for \$300	300

Capital loss equals (500 less 300) 200

From an income tax standpoint, it is preferable to gift a depreciated asset during life rather than retain it until death because you can preserve a capital loss for your donees.


Therefore, in selecting assets to gift, it is preferable from the perspective of income taxes, to gift depreciated assets and retain appreciated assets.



PRINCIPLE #4 – IT IS DESIRABLE TO GIFT ASSETS FOR WHICH A VALUATION DISCOUNT CAN BE TAKEN.

A gift of cash is easy to value because the value of the gift is equal to the amount of cash given. However, certain assets, like interests in privately held companies, are more difficult to value. For example, a 1% interest in a limited partnership or a privately held corporation is worth less than 1% of the net worth of the partnership or the corporation because of certain valuation discounts that apply. Discounts are generally appropriate for an interest that is a minority interest and for an interest for which there is not a ready market for resale. By gifting assets that can be discounted, you can “leverage” your gifts.

Or you can keep newly acquired assets out of your estate from the beginning.



One way to increase the discount and leverage of your gifts is to contribute assets, including closely held business interests to a family limited partnership (FLP). You would contribute the assets in exchange for a partnership interest in the FLP. The FLP interest you received could be a limited partnership interest or a general partnership interest. A limited partnership interest may provide for a greater discount, whereas the general partnership interest would allow you to retain control over the management of the assets. Then, you could gift limited partnership interests during your life using the discounted value, and the value of the FLP interest you still own at your death is included in your estate at a discounted value.

PRINCIPLE #5 – IF A PERSON HAS CHARITABLE INTENTIONS, THOSE INTENTIONS SHOULD BE FULFILLED, TO THE EXTENT POSSIBLE, THROUGH A GIFT OF QUALIFIED PLAN ASSETS, WHICH OTHERWISE WOULD BE LARGELY CONFISCATED BY TAXES.

A qualified plan, such as an IRA, is subject to multiple taxes that drastically reduce its value. First, at your death, the qualified plan is subject to estate tax, which as discussed above can be as high as 55%. Second, qualified plan assets are also subject to income tax whenever a withdrawal is made from the plan by your beneficiaries. Therefore, approximately 70% of the value of an IRA held at your death will be consumed by taxes.

One way to avoid these burdensome taxes is to gift the IRA to charity. When you gift an IRA to charity, both estate tax and income tax on the IRA are avoided, and the charity will enjoy the entire value of the IRA.

Next best is appreciated property to avoid paying tax on the gain.

PRINCIPLE #6 –AN ESTATE CAN RECEIVE AN EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX ATTRIBUTABLE TO AN INTEREST IN A CLOSELY HELD BUSINESS.

In order to help the decedent's family pay the estate tax on a family business, an estate can elect to receive an extension of time for payment of estate tax attributable to an interest in a closely held business, for up to five years; and thereafter, such estate tax can be amortized over as many as ten annual installments. The amount of tax that can be postponed is calculated as follows:

$$\frac{\text{Closely held business interest}}{\text{Adjusted gross estate}} \times \text{Net estate tax due}$$

The advantages of making such an election are the deferred payout of taxes and a special 2% interest rate on a certain part of the tax deferred.

Techniques and Strategies to Reduce/Freeze Estate Tax

- 1. Family Limited Partnership
- 2. Valuation Discount on business and investment interests
- 3. Grantor Retained Annuity Trust (“GRAT”)
- 4. Sale to an Intentionally Defective Grantor Trust (“IDIT”)
- 5. Self Canceling Installment Notes (“SCINs”)