2001

A Dozen Things Not to Assume in Gift Planning

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A DOZEN THINGS NOT TO ASSUME IN GIFT PLANNING

By

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I. LIFETIME GIFT PROGRAM

A. Annual Exclusion Gifts – *Don't Assume the Client Tells You All You Need to Know.*

1. Clients do not view many of the things they do for family members as gifts, and certainly not gifts for federal gift tax reporting purposes. Typical examples are automobiles for college, wedding gifts, use of rented vacation property, and family holiday trips.

2. Some gift tax return preparers merely record the information provided by the client, but others pick up on signals from the client and ask the right questions.

3. Many clients consider annual exclusion gifts ($10,000 in 2001, increasing to $11,000 in 2002) to be free gifts on top of all other donative transfers and benefits during the year.

4. Failure to disclose all purported annual exclusion gifts means the statute of limitations protection offered by the adequate disclosure rules is not available.

B. Unified Credit Gifts – *Don't Assume You Know the Maximum Amount the Client Can Give Tax Free.*

1. The increase in the unified credit exclusion amount from $675,000 to $1,000,000 on January 1, 2002 does not necessarily mean a client can give away an extra $325,000 tax free.

2. Marginal brackets and pending rate reductions influence the maximum tax-free gift that can be made.

3. Pre-1977 gifts are considered for gift tax purposes although they are not taken into account for estate tax purposes except for those made during the last quarter of 1976.

C. <u>Disclaimers – *Don't Assume a Disclaimer of Part of a QTIP Trust is Better Than a Taxable Gift by the Surviving Spouse.*</u>

1. Because the estate tax is a tax-inclusive tax, paying a gift tax on a tax-exclusive basis can make good sense even in the face of possible estate tax repeal, particularly for an older client.

2. The disclaimer is usually not a leveraged transaction and either uses unified credit exclusion amount on a dollar-for-dollar basis or causes estate taxes to be paid on a dollar-for-dollar basis.

3. If part of the marital deduction share passes outright to the surviving spouse or is subject to withdrawal or distribution from a marital trust, the spouse will be able to structure a leveraged transaction (for example, using valuation discounts).

4. In a gift transaction, the spouse can make the gift to a defective grantor trust for added after-tax benefits for the donees.

5. If gift taxes are incurred, and assuming the spouse lives at least three years thereafter, the result means that transfer taxes have been paid at a discount by reason of the tax-exclusive nature of the gift tax.

II. COMMUNITY PROPERTY

A. <u>Making a Gift – *Don't Assume Only One Signature is Required to Make a Gift.*</u>

1. The nondonor spouse's signature may be needed for community property purposes as well as for augmented estate purposes.

2. The community property states are Alaska (elective), Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

3. Many corporate executives and retirees coming to Virginia from separate property states may have lived and worked in community property states earlier in their careers and bring community property with them.

4. The key is to determine and trace domicile and the source of the funds used to acquire the property.

B. Purchase of Property – *Don't Assume Property Purchased While in Virginia is Separate Property.*

1. If domicile is not established in Virginia, assets acquired during the marriage while in Virginia could be community property.

2. Proceeds from the sale of community property continue to be community property unless and until the property is converted to separate property.

3. Income from a spouse's separate property is community property in Idaho, Louisiana, Texas, and Wisconsin but is separate property in the other community property states.

4. A couple domiciled in Virginia their entire marriage can own community property (and thus able to obtain a double basis adjustment at the death of the first spouse to die), for example, by one spouse's purchase of a condominium in Arizona or an interest in an oil well in Texas.

III. LIFE INSURANCE

A. Crummey Gifts – *Don't Assume Everything is Being Done According to the Original Plan.*

1. Clients and many trustees become lax in the handling of notices and in maintaining the proper documentation.

2. Failure to abide by the usual formalities gives the Internal Revenue Service the opportunity to treat the transfers to the trust as future interest gifts instead of present interest annual exclusion gifts.

3. For trusts having taxable income, the income tax returns are often prepared incorrectly.

4. Particular attention must be given to the allocation of GST exemption, and under the 2001 Tax Act an election out of the automatic allocation regime may be required in order to carry out the overall plan.

B. Transfers of Existing Policies – *Don't Assume Policy Transfers are Simple Matters.*

1. Determining the fair market value of a policy can be a very uncertain exercise. Cash surrender value is not the proper measure for gift tax purposes, and interpolated terminal reserve value may be inappropriate depending upon the insured's health condition.

2. The regulations say that interpolated terminal reserve only approximates value. The proper tax value equals replacement cost for a "comparable contract."

3. To avoid the three-year contemplation of death estate inclusion rule, consider selling the policy for full and adequate consideration instead of a transfer by gift in a transaction designed to avoid the transfer for value rule.

4. Because there may be delays in having the transfer of ownership forms recorded with the insurance carrier, the use of a separate assignment form by the parties may be desirable to document the effective date of the transfer.

C. Split-Dollar Arrangements - *Don't Assume You Can Rely on the Initial Policy Illustrations.*

1. The tax treatment of split-dollar arrangements is in a state of flux as a result of Notice 2001-10, 2001-5 I.R.B. 459.

2. The economic benefit amounts shown on the illustrations provided by the insurance broker are unlikely to be the proper measure thereafter.

3. The carrier's actual yearly term rates may differ from what is shown on the initial illustration.

IV. LEVERAGED TRANSACTIONS

A. GRATs and QPRTs - *Don't Assume GRATs and QPRTs Offer the Best Leveraged Benefits.*

1. Death during the GRAT or QPRT retained-interest period results in estate inclusion of the entire trust property.

2. By contrast, the leveraged benefits of a CLAT or CLUT are obtained even if death occurs shortly after the trust's creation. In fact, the charitable period can be measured by the donor's life without estate inclusion.

3. GRATs and QPRTs must be created in taxable years for which the spouses will not elect split-gift treatment.

4. QPRTs do not have as much leverage as a transaction using marketable securities because historic averages show that a portfolio of equities will achieve a greater rate of after-tax total return than a personal residence.

5. Because of the ETIP rules, GRATs and QPRTs are not the best tool for multi-generational planning.

B. Family Limited Partnerships – *Don't Assume the Benefits are Always Worth the Cost.*

1. If funded with securities, a gain on contribution could be triggered unless the investment company rules are avoided.

2. A good appraisal for valuation discount purposes is not inexpensive.

3. The client should be prepared to do battle with the Internal Revenue Service.

4. For a somewhat charitably inclined client, a CLAT or CLUT may provide the desired leverage with less cost and more certainty of results.

C. Intrafamily Sales – *Don't Assume Triggering a Capital Gain is Bad.*

1. Selling an appreciating asset to a family member or trust is a way to freeze the seller's estate because the note will not grow in value beyond any interest that is accrued and compounded.

2. Triggering a future capital gain or other income tax cost may be less costly than a current gift tax or a future estate tax assessed against an appreciating asset.

3. Sales can be made in exchange for private annuities or self-canceling notes.

D. Sales to Grantor Trusts – *Don't Assume a Sale to a Grantor Trust is Without Risk.*

1. Because sales to grantor trusts are not statutorily sanctioned in the same manner as GRATs, QPRTs, CLATs, and CLUTs, there is significantly more tax risk to be assumed by the client.

2. If the donor/seller dies before the note issued by the trust has been paid in full, the tax results are uncertain.

3. The primary nontax risk is the potential lack of cash to complete payment of the purchase price.