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FEDERAL GIFT AND ESTATE TAX LAWS

There have been no significant changes to the gift and estate tax laws this year. In 2005, the gift tax exemption will remain at $1 million, the gift tax annual exclusion amount will remain at $11,000, and the estate tax and generation-skipping transfer tax exemptions will remain at $1.5 million. The estate tax and generation-skipping tax exemptions are, under current law, scheduled to increase again in 2006.

With the gift tax exemption "frozen" at $1 million, the estate tax exemption increasing, and the possibility of a permanent repeal of both, many clients are unsure of what kind of estate planning is appropriate, if any. Below we suggest some basic estate planning that everyone should do, as well as some additional techniques that might be appropriate for some clients and do not carry a high gift tax cost.

ESTATE PLANNING TECHNIQUES TO CONSIDER

Wills. Regardless of the tax laws, everyone needs to have a Will that operates to dispose of your property in accordance with your wishes. We recommend that clients review their Wills every five years or so to ensure that they still reflect your wishes regarding the distribution of your property, and to ensure that the individuals that have been named as executors and trustees are still the appropriate choices for those positions. The very significant increase in the estate tax exemption over the last few years, combined with the continued availability of the unlimited estate tax deduction for gifts to a spouse, provides additional opportunities for those who wish to make significant gifts to those other than a spouse. We also recommend that you have in place updated versions of Durable Powers of Attorney, Medical Powers of Attorney, and Directives to Physicians. If your powers of attorney are more than five years old, it would be a good idea to do new ones.

Annual Gifts. Recall that in addition to the $1 million dollar lifetime gift tax exclusion, there is also an $11,000 per donor per donee exclusion for gifts of a "present interest". In addition, payment of medical expenses and tuition directly to the provider (i.e., the doctor, hospital, school or university) are also exempt, regardless of the amount.

Grantor Retained Annuity Trusts. This technique, referred to as a "GRAT", allows an individual to transfer property to a trust for a certain term of years, while retaining the right to receive a stated amount (the "annuity" component) each year during the term of that trust. When the GRAT terminates, the property remaining in the trust becomes the property of those named as the remainder beneficiaries in the trust agreement (often times the donor's children or trusts for the children). This technique can work very effectively with assets expected to appreciate significantly. The amount of the donor's retained annuity and the term of the trust can be determined so that no little gift taxes result. This technique is specifically authorized by the Internal Revenue Code.

Qualified Personal Residence Trusts. Another technique that is specifically authorized by the Internal Revenue Code is the qualified personal residence trust (a "QPRT"). Unlike many techniques, this one is particularly advantageous as interest rates increase. To utilize this technique, a donor transfers his residence to a trust. The trust agreement provides that the donor has the exclusive right to live in the residence during a set number of years which is the term of the trust. When this term expires, the residence passes to the remainder beneficiaries of the trust, typically the donor's children. Because the IRS imputes a value to the donor's retained right to live in the house for a number of years, the gift to the children is reduced by that imputed value. The imputed value is determined by prevailing federal interest rates at the time the trust is created. Therefore, the longer the trust lasts, the "cheaper" the gift to the children. Also, the higher the applicable interest rate is at the time the trust is created, the greater the imputed value of the donor's retained interest, which also reduces the value of the gift to the children.

Irrevocable Life Insurance Trusts. Many of our clients have created irrevocable trusts to hold policies of insurance on their lives. One of the primary purposes, and advantages, to creating such a trust is removing the proceeds of the insurance policy from the insured's taxable estate upon his or her death. Generally, if you die owning a policy of insurance on your life, the full amount of the proceeds from that policy will be included in your estate for estate tax purposes when the policy matures upon your death. If, however, you do not possess what the IRS refers to as "incidents of ownership" over the policy at your death, the proceeds of the insurance policy will not be included in your estate and will pass on to your beneficiaries estate tax free and income tax free. "Incidents of Ownership" include certain powers over the insurance policy, including the right to assign ownership of the policy, the right to change the beneficiary of the policy, and the right to pledge the policy or borrow against its value. With a life insurance trust, you give up these rights in favor of the trustee of the trust. In many cases, there are no gift taxes resulting from the creation of such a trust, depending upon the initial value of the policy transferred to the trust and the annual premiums.

Limited Partnerships. Limited partnerships continue to be attractive to many clients. They make sense for those who own property that may be effectively managed in an entity to provide consolidation, centralized management, management succession mechanisms, protection from creditors, a means to keep property within a family through the use of purchase option provisions, as well as other benefits. Despite these benefits, setting up and maintaining a limited partnership involves a significant amount of time and money, so this technique is not for everyone.

In some cases, the value of interests in limited partnerships that are transferred by gift or at death is subject to significant discounts for marketability and liquidity. As always, cases in this area continue to illustrate the importance of setting up a partnership properly and maintaining it in the manner appropriate to this type of business entity. In previous newsletters we have outlined some of the administrative steps that every partnership should take upon formation, as well as some of the business practices it should maintain which are consistent with the identity of the partnership as a separate entity and its assets as partnership, rather than personal use, property. If you have any questions about your family partnership and its operations, it might be a good idea to schedule a meeting with us to talk about these issues.

The above are just a few of the estate planning techniques that may be useful to some of our clients at this time. Although each has benefits, each also has disadvantages. If you are interested in hearing more about any of them or discussing which might be right for you, please contact us.

HAPPY HOLIDAYS!