

BASIC ESTATE TAX PLANNING TECHNIQUES:

FOCUS ON THE UNMARRIED COUPLE

Thomas Sciacca, Esq.
Law Offices of Thomas Sciacca, PLLC
44 Wall Street – Fl. 10
New York, NY 10005
(212) 495-0317
www.sciaccalaw.com

Part 1: Transfer Taxes

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- Planning for unmarried couples – it's more than just probate avoidance, especially when planning for wealthier clients facing estate tax liability.
 - What are the tax consequences posed upon each of the deaths?
 - Can the surviving partner afford to keep the inherited property?
 - Can the couple overcome these hurdles with proper planning?

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Part 1: Overview of Transfer Taxes

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FOUR (4) TYPES OF TAXES TO CONSIDER

- Estate taxes (Federal and State)
- Gift taxes (Federal only)
- Generation-skipping transfer taxes (Federal and State)
- Income taxes (Federal and State)

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Part 1: Overview of Transfer Taxes

A. Estate taxes

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- The gross estate of a Decedent is subject to taxation upon his death. What is included in the gross estate?
 - IRC § 2031(a):

The value of the gross estate of the decedent shall be determined by including ... the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated.
 - English: all property in which the Decedent possessed an interest upon his death will be included in his gross estate.

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A. Estate taxes

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- Some important elements of the Code definition:
 - “value at the time of his death”
 - “all property, real/personal, tangible/intangible”
 - “wherever situated”

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A. Estate taxes

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Some assets/interests require special mention:

- Life insurance: § 2042
 - Included to the extent Decedent retains the “incidents of ownership” over the policy:
 - OWNERSHIP OF THE POLICY
 - ABILITY TO CHANGE BENEFICIARIES
 - ABILITY TO BORROW AGAINST CASH VALUE
 - ABILITY TO SURRENDER FOR CASH VALUE

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□ Trusts with “strings attached”: §§ 2036 & 2038

- If the Decedent creates a Trust, or is given certain rights under the Trust, the full value of the trust will be included in his gross estate if he:
 - Retains an income interest
 - Retains the right to change beneficiaries, or is given that right by the Grantor of the Trust
 - Retains the right to direct the payment of income or principal in an individual capacity, or is given that right by the Grantor of the Trust

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A. Estate taxes

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□ Powers of Appointment: § 2041

- If the Decedent has a general power of appointment over the Trust, the full value of the Trust will be included in his gross estate
- What is a general power of appointment? The ability for a person to appoint assets to
 - Himself
 - His creditors
 - His Estate
 - The creditors of his Estate
- All other powers of appointment are limited powers of appointment.

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A. Estate taxes

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- Jointly held property: § 2040(a)
 - Where non-spouses own an asset as joint tenants with rights of survivorship, § 2040(a) creates a rebuttable presumption that the full value of the asset is fully includable in the gross estate of the first owner to die.
 - How to overcome the presumption? Must demonstrate contribution.

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A. Estate taxes

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Available estate tax deductions:

- Debts of Decedent
- Expenses of Administration
 - Caveat on deducting Executor's commissions
- Reasonable funeral expenses
- Charitable deduction
 - Unlimited, must be to a § 501(c)(3) charity
 - Don't waste it if you don't need it - bequests
- Marital deduction

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A. Estate taxes

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The applicable exclusion amount

- (f/k/a “the unified credit”)
- The applicable exclusion amount provides a threshold at which the Estate incurs estate tax liability – taxes are due on all amounts over the threshold.
- The applicable exclusion amount varies between Federal and state tax authorities

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A. Estate taxes

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- The Federal applicable exclusion amount:

Year	Exclusion amount	Highest tax rate
2008	\$2 million	45%
2009	\$3.5 million	45%
2010	N/A (repeal)	N/A (repeal)
2011	\$5 million	35%
2012	\$5.12 million	35%
2013	\$5.25 million	40%
2014	\$5.34 million	40%
2015	\$5.43 million	40%
2016	\$5.45 million	40%

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New York State:

Year	Exclusion amount	Highest tax rate
2000-2014	\$1 million	16%
Apr '14 – Mar '15	\$2,062,500	16%
Apr '15 – Mar '16	\$3.125 million	16%
Apr '16 – Mar '17	\$4,187,500	16%
Apr '17 – Dec '18	\$5.25 million	16%
2019 onward	Tracked to Federal	16%

NB: a portion of state estate taxes paid deductible on the Federal estate tax return

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A. Estate taxes

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Mechanics of the estate tax

- Filing thresholds
- Due dates
- Extensions of time to file
- Assessment of interest and penalties

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B. Gift taxes

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- The gift tax is imposed upon all taxable gifts made by a donor within a calendar year. The return is due April 15th of the following year
- NB: for NYS residents, there is only a Federal gift tax – NYS abolished its gift tax in 1994.
- Purpose of the gift tax
 - ▣ Prevent frustration of the estate tax
 - ▣ Prevent frustration of the income tax

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B. Gift taxes

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What is a “taxable gift”?

- In general, ALL gifts are taxable gifts unless they fall into one of the following exclusion categories:
 - ▣ Gifts to charities: § 2522 (unlimited)
 - ▣ Gifts to a spouse: § 2523 (unlimited)
 - ▣ Annual exclusion: § 2503(b)
 - Effective 1/1/2013: \$14,000 per beneficiary per year
 - ▣ Payment of tuition/medical expenses: § 2503(e)
 - Must be paid directly to provider to qualify

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B. Gift taxes

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- Lifetime credit against gift taxes matches estate tax exclusion – hence the “unified credit”
- Taxable gifts first use up part of the lifetime credit
- Gift tax returns required when making taxable gifts – even if no taxes are due
- NB: dollar-for-dollar reduction of the applicable exclusion amount for estate taxes

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C. Generation-skipping transfer taxes

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- One of the Code’s “best kept secrets.”
- Congress the generation-skipping transfer tax (GST) in 1986 to prevent wealthy families from avoiding estate tax payments by bypassing a generation: *i.e.* inheritance left directly to grandchildren
- GST tax paid simultaneously with filing of estate tax return or gift tax return

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Part 1: Overview of Transfer Taxes

C. Generation-skipping transfer taxes

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- Most common example of the GST tax – direct transfer to a “skip person”
 - Who is a “skip person”
 - Any relative with a common grandparent ancestor more than one generation away from the grantor/decedent (absent an intervening death)
 - Any non-relative at least 37.5 years younger than the grantor/decedent

Exemption amount available equal to the unified credit

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D. Income tax considerations

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- Cost basis of property transferring upon death: § 1014
 - Discussion of cost basis in computing gain/loss
 - Gifts & “carryover” basis: § 1015
 - Current rule: “stepped-up” basis to fair market value upon date of death: § 1014

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Part 2A: Fundamentals of estate tax planning

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- With advance planning, parties may minimize their potential estate tax liability. A brief overview of some of the most common techniques (in general).

1. *“Let your last check bounce.”*

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Part 2A: Fundamentals of estate tax planning

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2. *Be aggressive with lifetime giving*

- Maximize annual exclusion gifting
- Consider exhausting the entire unified credit by making lifetime taxable gifts. Benefits:
 - Excludes further appreciation from the taxable estate
 - Time value of money analysis to the donee
 - If done correctly, Grantor can maintain control without triggering estate tax inclusion:
 - Favorable Grantor trust status under Subchapter J and the “intentionally-defective” grantor trust (IDGT)
 - Example – Grantor retaining right to substitute assets

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Part 2A: Fundamentals of estate tax planning

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3. Maximize the marital deduction

- Where available, the marital deduction can defer payment of any taxes until the death of the second spouse
- Use of Trusts (bypass trust, disclaimer trust, etc.) will allow for the use of each spouse's applicable exclusion amount
- Marital deduction against gift taxes allows for asset allocation between spouses
- Use of Trusts can also "protect" against a second marriage

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Part 2A: Fundamentals of estate tax planning

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4. Look for the discount

- A Decedent is only taxed on the percentage interest he owns of an asset (absent joint ownership). Some ways to take advantage:
 - Transfers of real property retaining a life estate
 - Grantor Retained Income Trust (GRIT)
 - Qualified Personal Residence Trust (QPRT)
- BEWARE: § 2702 and retaining an interest when making a transfer to a "related party."

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Part 2A: Fundamentals of estate tax planning

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Example of a “Sexy” (but controversial) discount

- Creating a limited liability company (LLC) with one general partnership share and several limited partnership shares.
 - Limited partnership shares gifted gradually using annual exclusion gifting
 - Calculate gift of shares at a discount for minority ownership and lack of marketability
 - Give away the general partnership share before death
 - NB: “check-the-box” audit liability

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Part 2A: Fundamentals of estate tax planning

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Example of a More Vanilla discount

- The QPRT (previously discussed) has been blessed by the IRS – they now provide a sample form QPRT for practitioners
- Charitable Remainder Trusts
 - Grantor transfers assets to trust, retaining an income interest
 - Upon death of Grantor (or another party), remainder goes to charity
 - Charitable deduction against gift taxes minimizes the size of the taxable gift
 - Income tax deduction available upon funding of trust (charitable interest must be irrevocable)

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Part 2B: Obstacles & Solutions

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1. Complete loss of the marital deduction

- For purposes of the estate, gift, and GST taxes, no marital deduction for unmarried couples. This is a complete loss of the most valuable deduction.
- Remedy? Plan, plan, plan!
 - Lifetime transfers from the “monied” partner to the “non-monied” partner – use the gift tax exclusions and credits
 - Avoid the “fire sale” on the home if owned by only one partner:
 - Charitable remainder trust
 - Irrevocable Life Insurance Trust (ILIT)

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Part 2B: Obstacles & Solutions

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2. Some partners may be “skip persons”

- For purposes of the Federal GST tax, a spouse cannot be a “skip person” – however – unmarried couples are not spouses by definition
- Remember: for purposes of unrelated parties, a “skip person” is any party more than 37.5 years younger
- Remedy? Avoid direct skips. USE TRUSTS.

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Part 2B: Obstacles & Solutions

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3. *Unfavorable presumption for joint property*

- § 2040 of the Code creates the presumption that an asset owned jointly between non-spouses is included 100% in the gross estate of the first owner to die
- Remedy? PLAN FOR IT.
 - Have a frank conversation with clients as to whether they can demonstrate contribution. Look at the documents. Are they really all there?
 - Break the joint tenancy. Is probate really going to be that inconvenient? If so, give each of them a trust which holds a 50% tenants-in-common interest.

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