

# H G & G U P D A T E

Hofheimer Gartlir & Gross, LLP

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## *The Importance of Gifts in Estate Planning*

DID YOU KNOW that between Federal and state estate taxes, the tax man can take 60% or more of your estate on your death? A well-designed gift program can produce significant tax savings and thereby operate to transfer more of your assets to younger family members.

### **Goals**

#### *Estate and gift tax*

A gift program should remove property from your estate without generating a large gift tax bill.

#### *Income tax*

A gift of income-producing property may lower your income tax bracket as well as remove the property from your estate.

#### *Transfer Taxes*

Federal law imposes three separate "transfer" taxes (they are imposed on the transfer of property by gift or at death). Many states impose a death tax as well.

cumulative lifetime gifts and taxable estates above \$3,000,000.

■ **Generation-skipping transfer tax.** This tax, at a flat rate of 55%, is imposed on transfers which have the effect of "skipping" a living generation (e.g., from grandparents to grandchildren).

### **Gifts to Family Members**

*In general* The value of gifts made during life is taken into account in determining the estate tax when the donor dies. *But post-gift income and appreciation in value of the gifted property are not included in determining the estate tax.*

*Early gifts* The earlier a gift program is undertaken the better. An early gift means that more income and appreciation may be shifted to the next generation free of transfer tax. This is especially true for property (such as real estate) whose value is depressed but may increase in the future.

*Basis step-up* Transfers at death generally receive a step-up in basis for income tax purposes (assuming the property has appreciated in value). The result—when the property is sold by the estate or beneficiary— income tax is either eliminated or greatly reduced. However, there is no basis step-up for gift transfers, so the donee may pay income tax on the subsequent sale of the gifted property.

### **Family Giving Strategies**

■ **Annual Exclusion gifts.** You may give up to \$10,000 each year to an individual without

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Early gifts promote tax savings by shifting income and appreciation away from the donor.

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■ Gift tax—on property given away during life.

■ Estate tax—on property owned at death.

These taxes are integrated so that without proper planning, the estate tax cannot be avoided

by giving away property during life.

The gift and estate tax rates are progressive and increase very quickly to 55% on

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being subject to gift tax. There is no limit on the number of annual exclusion gifts that you can make. If you are married, you and your spouse can elect to treat your gifts as made one-half by each.

For Example: Husband and Wife have five children. They may give each child up to \$20,000 per year, or a total of \$100,000 to all the children.

The annual exclusion doesn't generally apply to gifts in trust unless the trust is properly structured.

■ **Medical and education expenses.** There is an additional exclusion (not subject to the \$10,000 ceiling) for payments directly to providers of medical services or payments for tuition directly to educational institutions.

■ **Unified Credit gifts.** An individual is entitled to shield up to \$600,000 of taxable gifts, or a \$600,000 taxable estate, from transfer tax<sup>1</sup>. Any portion of the Unified Credit used during life will be unavailable at death<sup>2</sup>.

"Gift-splitting" makes it possible for a married person to transfer up to \$1,200,000 in value of property, rather than \$600,000.

■ **Transfers to spouse.** There is no gift tax on property transferred to one's spouse. (For transfers in trust, certain requirements must be met.) However, the full value of that property at the date of death of the surviving spouse will be taxed when that spouse dies. The bunching of assets in the estate of the surviving spouse may expose assets to higher tax brackets.

■ **Gifts of minority interests in business and real estate investments.** Substantial discounts may be available in valuing gifts of minority interests. (We are aware of transactions in

which discounts of 35% have been approved.) An additional discount for lack of marketability may be available if the interest cannot be readily sold.

■ **Qualified Personal Residence Trust ("QPRT").** A homeowner may transfer ownership of a personal residence to a trust, retain use of the residence for a term of years and provide that at the end of the term ownership will pass to the children. The children's right to receive the residence in the future is a present gift. The amount of this gift is determined by subtracting the "value" of the parent's right to use the residence from the value of the residence at the time of transfer to the trust.

For Example: A 65-year old parent transfers a vacation home worth \$750,000 to a QPRT with a 12-year term. If the applicable IRS interest rate is 9.6% (the rate for February, 1995), the value of the gift would be \$167,000, and a portion of the parent's Unified Credit would shelter the transfer from gift tax. If the parent lives at least 12 years, he or she would have succeeded in transferring a \$750,000 asset to the children at a gift tax value of \$167,000.

Any appreciation in value after the transfer to the QPRT will escape gift and estate taxation.

■ **Grantor Trusts.** A gift in trust may be designed so that the trust assets will not be subject to estate tax at death but the income of the trust will be taxed to the grantor during the trust term. Generally, the Unified Credit of the grantor (and, frequently, the grantor's spouse) is utilized to shield the original transfer from gift tax. Payment of income taxes by the grantor avoids diminution of the trust and is a benefit to the trust, but should not be a taxable gift for gift tax purposes.

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Available exclusions and credits make it possible to transfer significant assets free of tax.

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<sup>1</sup> A bill may be introduced in Congress this year which would raise this amount to \$700,000 in 1996, \$725,000 in 1997 and \$750,000 in 1998 (thereafter to increase with inflation).

<sup>2</sup> The Unified Credit and graduated rates are reduced for taxable estates over \$10 million.

■ *Grantor retained annuity trusts ("GRATS") and grantor retained unitrusts ("GRUTS").* Clients frequently ask if they can make a gift to their children but retain the income from the gift property for a period of years. GRATS and GRUTS are the approved ways of doing this.

In a GRAT or GRUT, an individual transfers property to a trust and retains the right to receive payments for a fixed term. At the end of the term, the assets pass to children without further transfer taxation (provided that the transferor outlives the term). When the GRAT or GRUT is established, the transferor is considered to have made a gift of the children's right to receive the trust assets in the future. This gift is valued using

the applicable IRS interest rate for the month in which the trust is established.

For Example: 65-year old parent transfers a \$750,000 securities portfolio (producing an annual 7% return) to a GRAT with a 12-year term and retains the right to receive an annuity of \$52,500 (7%) per year. If the applicable IRS interest rate is 9.6%, the value of the gift would be \$417,750, and the gift may be sheltered from gift tax by the parent's Unified Credit. If the securities appreciate in value by 4% annually, the value of the portfolio would be \$1,211,000 at the end of the GRAT term, when it would pass to the children free of any further gift tax.

■ *Family Limited Partnerships.* A family limited partnership ("FLP") is a convenient

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GRATs and GRUTs can be used to pass property to future generations.

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### ■ **Legislation Affecting New York Statutory Powers of Attorney and Spousal Right of Election**

#### *New York Powers of Attorney*

As of October 1, 1994, individuals who wish to grant a power of attorney to another individual as "attorney-in-fact" should use the new statutory short form power of attorney. Unlike the old form, the new short form requires that the individual initial each power given to the attorney-in-fact. The new law also provides a statutory short form "springing" power of attorney that would take effect at a later time, for example, upon the individual's disability. Statutory short form powers executed prior to October 1, 1994 remain effective.

#### *Spousal Right of Election*

In New York, decedents cannot disinherit a surviving spouse. The surviving spouse has a right to an "elective share" equal to the greater of \$50,000 or one-third of the deceased spouse's estate (in addition to certain family property worth up to \$56,000). If the decedent's Will and certain property passing outside of the Will provide less than

the elective share to the surviving spouse, the surviving spouse may take the elective share. As of September 1, 1994, individuals can no longer satisfy the elective share by placing property in trust for the surviving spouse, since the surviving spouse has the right to receive the elective share outright. Individuals who wish to preserve an estate plan that includes a trust for a spouse might wish to obtain a waiver from the spouse of the right of election.

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### ■ **NBC Case**

Our client leased a building to NBC under a lease which contained a complex rent escalation formula. NBC contended that the maximum annual rent under the lease formula was \$2 million; our client maintained that the maximum rent should be \$5 million. When NBC disputed the rent, our litigation department won a judgment for the client in New York Supreme Court for the full rent (\$12 million total).

way to transfer interests in various kinds of property to future generations, thus shifting the future appreciation away from the estate of the parent or grandparent.

Here are some of the reasons why FLPs make sense in the right circumstances:

- > The donor may retain control over the property by being, or retaining control over, the general partner;
- > Substantial valuation discounts are available for minority interest and lack of marketability;
- > An FLP lends itself to annual exclusion gifts. The FLP simplifies gift-making since (in the case of real property) multiple deeds are not required and only simple assignments of limited partnership interests do the trick;
- > The partnership agreement may provide restrictions on the transfer of limited partnership interests, thus enhancing the ability to keep property "in the family";

*continued in next column*

**■ New Members**

We are pleased to announce that Allan D. Mantel and Richard G. Klein have joined the firm as partners. Allan practices in the field of matrimonial and family law and Richard practices corporate and securities law. Howard N. Gorham has become of counsel. He practices in the fields of real estate and real estate financing.

**■ Partner Lecture**

In December, Herb Fixler addressed over 75 members of the Chief Executives Organization at its annual investment seminar held at the Lotus Club in New York City. Herb spoke on sophisticated estate planning techniques for business owners.

- > Assets of the FLP are insulated from the claims of creditors of the partners; and
- > The FLP agreement may be amended.

■ *Insurance Trust.* Life insurance proceeds are subject to estate tax if the insured owns the policy or the proceeds are payable to the insured's estate. If the proceeds are paid to the surviving spouse or to a qualified trust for the spouse, the proceeds would be free of estate tax by reason of the marital deduction.

However, the proceeds paid to the surviving spouse would be subject to estate tax at the spouse's death to the extent the proceeds are not spent during life.

An Insurance Trust may make it possible for the proceeds of life insurance policies to escape estate taxation in the estate of the insured and the estate of the spouse while still making such proceeds available for the family and for payment of debts, administration expenses, death taxes and other needs.

■ *Family loans.* An individual may make a loan to a family member. The loan proceeds may be invested by the borrower who agrees to repay the loan with interest. Appreciation on investments made by the borrower will escape transfer taxation as will income earned (less interest payable to the lender).

A gift program makes sense for many individuals. If you would like to discuss or design a gift program, please call your attorney at the firm, or call Herb Fixler or Bob Howard.

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A future issue of the Update will discuss charitable giving techniques in the context of income tax and estate tax planning.

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About Hofheimer Gartlir & Gross, LLP

*The firm conducts a general commercial practice. Our principal practice areas are:*

- real estate
- corporate and securities law
- general business and commercial law
- cooperative and condominium matters
- financial institutions (loan transactions, leasing, acquisitions, credit restructuring, workouts and foreclosures
- estate planning
- trust and estate administration
- general litigation
- matrimonial and family law
- taxation

*Clients of the firm range from major financial institutions and public corporations to closely-held businesses, individuals and families.*