JOURNAL OF ACCOUNTANCY

Estate Planning: Time for a Tuneup

What's the state of your clients' estates?

BY WILLIAM M. WEINTRAUB AND MICHAEL B. ALLMON
JANUARY 5, 2009

A CPA is in an excellent position to help clients address the issues of estate planning. CPAs are usually aware of the scope of their clients' assets and often know something about family relationships, recent marriages, children, grandchildren and other key facts. They see their clients annually in connection with the preparation of income tax returns. Therefore, clients will not be surprised when a CPA raises the issue of estate planning, particularly when an estate tax could be substantial. In fact, a good CPA would be remiss for failing to address these issues. For all the hand-wringing over income tax planning that occurs prior to April 15 each year, the potential estate tax savings that can be achieved with basic planning will often dwarf a lifetime of potential income tax savings. Therefore, every discussion of estate planning should include a review of the common exceptions to gift and other transfer taxes.

Clients also need to be aware of the currently unsettled state of the estate tax laws. This year, the size of an estate exempt from estate taxes stands at $3.5 million, with a top tax rate of 45%. Barring further action by Congress, the exemption in 2010 will be unlimited, only to return to the pre-2001 level of $1 million and a top rate of 55% thereafter.

Whether any or all of the techniques for transferring assets to family members and other beneficiaries should be used also depends on many factors besides tax, such as whether the client can afford to or is willing to transfer assets before death. It may be disadvantageous to heirs' income tax liabilities to transfer appreciated property that they stand to inherit after the donor's death, since at death such assets typically receive a stepped-up basis for income tax purposes (modified for 2010 only). Therefore, if the estate appears likely to fall under the exemption amount, there may not be a tax benefit by taking advantage of a tax-free transfer during the client's lifetime. Nonetheless, the strategies to reduce estate tax should be reviewed with clients.

ANNUAL GIFT TAX EXCLUSION

Currently, gifts of up to $13,000 may be made to an unlimited number of donees every year. For married couples, the amount of the annual gift tax exclusion for each gift is $26,000, since each spouse can join in the transfer. Even if all of the property comes from one spouse, an election can be made on a gift tax return to treat the gift as if made by both, thereby effectively permitting annual gifts by one spouse of $26,000.

If the estate will be taxable, the savings resulting from these gifts are measured by the highest estate tax rate (currently 45%). Further, the gifts also carry out of the estate with them any future appreciation on the property transferred. Thus the estate is reduced not only by the amount of the gift, but also by all anticipated earnings and growth. While gifts are often made in cash, those of property can be advantageous. For example, a gift of an interest in a limited partnership could have a value on liquidation that is substantially greater than at the time of the gift. Gifts can be made outright or in trust. However, most gifts made in trust will not qualify for the annual exemption unless the trust includes language to create a "present interest" to the beneficiary, often referred to as "Crummey provisions." Named for the 1968 court decision *Crummey v. Commissioner* (22 AFTR2d 6023), such provisions typically allow a trust beneficiary to demand distribution of any additional property transferred to the trust by the donor during the year, up to a specified amount.

PAYMENTS FOR QUALIFIED EDUCATION AND HEALTH CARE EXPENSES

Another type of gift that is not a gift for tax purposes is a payment for qualified education (tuition) or health care expenses under IRC § 2503(e). This exclusion is unlimited, but in all cases, the payment must be made directly to the provider of the education or medical services and not as a reimbursement to the person who incurred the expenses. Contributions to a section 529 qualified tuition program are counted against the annual gift tax exclusion, but any excess may be taken into account ratably over five years (section 529(c)(2)(B)).

The treatment of these items as tax-free transfers reflects a policy consideration to encourage such acts of personal charity. Imagine the outcry if after children paid thousands of dollars for an elderly parent's medical care, the government stepped in to collect a gift tax on the payment as a taxable transfer of wealth. Therefore, where a client is able, the payment of education and medical expenses on behalf of another can involve substantial tax-free transfers of wealth. Tuition, from preschool to graduate school, can cost hundreds of thousands of dollars. Think of the tax savings when a grandparent uses funds that would be subject to estate tax to pay for the education of grandchildren or great-grandchildren.

LIFETIME EXCLUSIONS

The estate and gift tax systems are unified in the sense that the tax-free transfers available during a taxpayer's lifetime and upon death work in tandem. Current law allows an "exclusion amount" for cumulative lifetime transfers of taxable gifts (that is, those above the annual exclusion or qualified expenses described above) of up to $1 million. All transfers constituting taxable gifts in excess of $1 million are subject to gift tax at a top rate currently of 45%. Any portion of the lifetime exemption that is not used is available for transfers made upon death. The combined exclusion amount for transfers made during lifetime and upon death is $3.5 million in 2009 and unlimited for estate taxes in 2010, but only for that year (while remaining $1 million for the lifetime gift exemption, with a maximum gift tax rate of 35%). Thereafter, unless amended, the exclusion amount will fall to $1 million for both gift and estate tax transfers combined, with the maximum tax rate reverting to the pre-Economic Growth and Tax Relief Reconciliation Act level of 55%.

An important reason to use the lifetime gift exclusion is similar to one of the reasons for making gifts of the annual exclusion amount. All income and appreciation on the transferred property are removed from the transferor's estate. Thus, a lifetime transfer of $1 million can result in estate tax savings on hundreds of thousands or millions of dollars in earnings and appreciation on the $1 million that would otherwise be included in the transferor's estate if no gift were made.

As with all other transfers, there may be more important nontax reasons for making a gift. It is important to recognize that tax savings alone should not motivate important financial decisions, particularly those infused with family relations.

TRANSFERS TO A SPOUSE

There is no tax on transfers of property to a spouse who is a U.S. citizen, whether made outright or in trust, during lifetime or upon death. However, for transfers in trust to a spouse to qualify as tax-free, the trust must, at a minimum, distribute all income to the spouse for life. There can be no limitation on this requirement. Thus, a trust that provides distributions of income to a spouse until that spouse remarries or until a house is sold will not qualify.

Trusts can qualify for the tax-free transfer between spouses even if the surviving spouse receives a life estate if the executor elects to have the property qualify as a QTIP trust, an acronym for "qualified terminable interest property" trust. Why use a QTIP trust? First, like any transfer of assets to a spouse, no estate tax applies on the transfer. Ultimately, an estate tax will apply upon the death of the spouse, as the assets in the QTIP trust will be includible in the spouse's gross estate and potentially subject to estate tax. However, a QTIP trust can achieve a deferral of estate tax for an unlimited amount of property.

Second, the use of a QTIP trust assures that assets that remain upon the death of the surviving spouse will pass to the beneficiaries previously designated by the deceased spouse. In contrast, if the deceased spouse's assets are left outright to the surviving spouse, there can be no assurance that those assets will ultimately end up with those beneficiaries selected by the deceased spouse. Finally, the QTIP trust can provide a measure of asset protection for the surviving spouse. Assets in a QTIP trust can be used for the benefit of the surviving spouse but are not generally recoverable by the surviving spouse's creditors.

COMBINING THE LIFETIME EXEMPTION AND QTIP TRUST

The easiest way to demonstrate how the QTIP trust and lifetime exemption can be used together in a typical estate plan is by way of example. Assume the following facts: Husband (H) and wife (W), both age 60, have three children. They have a combined net worth of $6 million and live in a community property state. All of their assets are considered community property. H and W want whichever of them outlives the other to have full use of the assets. They also want to minimize estate tax liability and to assure that their children eventually receive all assets remaining after both of them have died. H and W have made no taxable gifts during their lifetimes. Assume that H died in 2007 and W dies in 2009, and that upon W's death, the fair market value of their combined assets has declined to $5 million.

What are the options? In the simplest of plans, H and W could have each provided that all of the deceased spouse's assets pass outright to the surviving spouse. Because of the unlimited marital deduction, there would be no estate tax on the transfer of all of H's assets to W. However, upon W's death in 2009, her gross estate of $5 million would exceed her available exemption amount of $3.5 million by $1.5 million. As a result, the estate tax due upon her death would be $675,000.

The primary point is that H, by leaving everything outright to his spouse, did not take advantage of his own exemption amount. Instead, H could have left up to $2 million in a trust for H and W's children, (typically referred to as a "bypass trust") so that these assets would not be includible in W's estate upon her death. A bypass trust can provide substantial benefits for the surviving spouse, yet still exclude the assets in it from the surviving spouse's estate. The surviving spouse can receive all of the income of the bypass trust and may invade principal as necessary for his or her health, support and maintenance.

Therefore, instead of leaving $3 million outright to W, H could leave $2 million to a bypass trust for W's benefit and the remaining $1 million outright to W. Both transfers would be exempt from estate tax. As a result, W's gross estate would be less than $3.5 million, the exemption amount available in 2009. Accordingly, no tax would result upon the deaths of both H and W, and their children would divide the entire $5 million upon W's death, assuming that W did not alter her estate plan documents after H's death.

But what if one or both spouses are concerned about the final disposition of the assets that passed to the surviving spouse? In our example H and W have the same children, so there may be less concern that the surviving spouse would change his or her plan to alter what their children would receive. However, if the children were all H's from a prior marriage, he may want to make sure that his remaining assets pass on W's death to his children, and not to W's children, or to W's new spouse. Accordingly, by transferring all of his assets to the bypass trust and a QTIP trust, he can provide for W during her lifetime and, at the same time, provide irrevocably that his children will receive the remaining assets upon W's death. Therefore, instead of leaving outright to W his remaining assets beyond those passing tax-free in the bypass trust, H may provide that the excess go to a QTIP trust for W's benefit.

Although estate planning is often complicated by additional tax and nontax considerations, many or most plans for otherwise taxable estates employ some strategic combination of the marital and lifetime gift exclusions, if not the other common exclusions. And since the ideal time to begin planning for these strategies is well before they are needed, it behooves CPAs to make sure they broach the subject with their clients as an integral part of their services. v

AICPA RESOURCES

PFP Center and PFS Credential

Membership in the Personal Financial Planning (PFP) Section provides access to specialized resources in the area of personal financial planning, including complimentary access to Forefield Advisor. Visit the PFP Center at www.aicpa.org/PFP. Members with a specialization in personal financial planning may be interested in applying for the Personal Financial Specialist (PFS) credential. Information about the PFS credential is also available at www.aicpa.org/PFP.

CPE

Estate Planning Essentials: Tax Relief for Your Clients' Estates, a CPE self-study course (#737100)

Conferences

- Advanced Personal Financial Planning, Jan 19-21, San Diego
- Tax Strategies for the High-Income Individual, May 7-8, Las Vegas

Books

- *The Adviser's Guide to Counseling Aging Clients and Their Families* (#091024)
- *The Adviser's Guide to Family Business Succession Planning* (#091023)

For more information or to place an order or register, go to www.cpa2biz.com or call the Institute at 888-777-7077.

EXECUTIVE SUMMARY

n **CPAs are in an ideal position to explore** with their clients their arrangements for taking optimal advantage of common exclusions from gift and estate tax, especially since in 2011 the excludable portion of estates is scheduled to revert to $1 million, upon the sunset of increases in the exclusion and one-year repeal of the estate tax wrought by the Economic Growth and Tax Relief Reconciliation Act of 2001.

n **Common exclusions include the annual gift tax exclusion,** currently $13,000 per year per donee and the lifetime gift tax exclusion of $1 million, which works in tandem with the estate tax exclusion, to the extent that the latter is reduced by any amount excluded under the former.

n **In addition, payments for qualified education and health care expenses** can be excluded from gift taxes under IRC § 2503. These amounts are unlimited but must be made directly to the provider of education or medical services.

n **Most prominently, couples may use the unlimited tax-free transfer** of property between spouses, especially in conjunction with the lifetime exclusion, to pass on to their heirs the maximum amount free of tax while providing for the needs of the surviving spouse. To that end, a qualifying terminal interest property (QTIP) trust is often paired with a "bypass trust."

***William M. Weintraub**, Esq., is a partner at Jeffer Mangels Butler & Marmaro LLP in Los Angeles, where he specializes in estate planning and transactional tax matters. **Michael B. Allmon**, CPA, is a partner at Michael B. Allmon & Associates LLP, and the founding chair of the California Society of CPAs Estate Planning Committee. Their e-mail addresses, respectively, are wweintraub@jmbm.com and mike@mbacpas.com.*
