

## **23. Preserving Family Wealth: Tax-Free Transfer of Future Appreciation**

The changes to estate taxes under the 2001 Tax Act and the uncertainty that the Act's 2011 sunset provisions create make estate tax planning more complicated than it once was. It is advisable that you contact your tax advisor before embarking on any of the strategies discussed in this chapter.

You may own property, such as a business or real estate, that is likely to appreciate substantially in value between now and when you die. If you continue to own the property until death, the value of the property, including the appreciation that occurs between now and the time of your death, will be subject to federal and state estate taxes. For example, assume you own a parcel of real estate presently worth \$1 million. Assume your death occurs 10 years from now when the parcel is worth \$3 million. If you are in the 45% estate tax bracket, the \$2 million of appreciation that has taken place will increase your estate taxes by \$900,000!

Because of the large impact of estate taxes, you may wish to implement a planning strategy that attempts to exclude future appreciation in the value of your property from estate taxation at your death. One strategy might involve giving property to your children now.

### **Giving Property to Your Children**

For example, assume that you give your parcel of real estate to your children when it is worth \$1 million. If you had already used your gift and estate tax exemption (\$1,000,000 in 2003) and your annual gift tax exclusion (\$11,000 in 2003) for each child, you would have to pay \$490,000 in federal gift taxes (assuming a 49% rate of gift tax). Assume, again, that the parcel increases in value to \$3 million by the time you die. Because you do not own the parcel at your death, it will not be taxed in your estate. On the other hand, if you had kept the parcel until death, your ownership would cost approximately \$1.5 million in estate taxes. Thus, giving the property to your children during life, instead of transferring it to them at death, could save as much as \$1 million in estate taxes. There are, however, other considerations.

### **Before You Make Substantial Gifts**

Although the estate tax savings from giving property away can be significant, you may not be willing to relinquish control of your property to your children or want to lose the economic benefits the property may produce. If this is the case, there are more complicated planning devices that can shift future appreciation in the value of your property to your children by restructuring the ownership of your property. This restructuring will allow you to retain some degree of control over, and the income from, the property for your lifetime or some stated period.

The restructuring usually involves a conversion of your equity interest in property into an interest in property that thereafter has little or no growth potential, except through income accumulation. Because the growth potential of your new interest is fixed, this type of planning is often referred to as "estate freezing," *i.e.*, the value of your interest is "frozen." As a part of the restructuring, your children would receive a "growth" or "unfrozen" interest in your property. To illustrate, let's look at two examples.

### **Sale to the Children**

Assume you sell your \$1 million parcel of real estate to your children for \$1 million, the fair market value of the property at the time of the sale. Assume the children make no down payment but give you a secured promissory note for \$1 million to be amortized over the next 15 years. As a result of the sale, you will have converted your equity interest in the parcel into an interest-bearing promissory note - a fixed return investment - that has little

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if any growth potential. The children now own the parcel, a growth investment, Assume you die in 10 years when the parcel is worth \$3 million. No part of the parcel will be included in your estate for tax purposes. Only the balance of the note and any income and principal payments you have reinvested and not consumed will be taxed in your estate. As a result, you will have shifted \$2 million of growth in the value of the parcel to your

children "tax free," yet you will have had the secured note payments to help finance your retirement or other needs.

### **Give Stock to Your Children**

Assume you have a closely-held business. You are the sole shareholder owning 1,000 shares of common stock. Each share is presently worth \$100. You decide to give your two children 100 shares each, for a total gift of \$10,000 to each child, which escapes gift taxation because of the annual gift tax exclusion. Assume your death occurs 10 years later when the value of the shares has increased to \$400 per share. The value of each child's shares would then be \$40,000. Because of the gifts to the children, you will have reduced your estate by \$80,000, \$60,000 of which represents appreciation that occurred after the initial gift. Consequently you will have reduced estate taxes by \$40,000 (assuming a 50% estate tax rate). At the same time, you have retained control of the company through your stock ownership, as well as your salary (income) from the company. In other words, it has cost you little in terms of control or income to shift some of the future growth in the value of the corporation to the children. If you were to continue this "gifting" over several years, additional tax savings would result. For more information regarding this topic, see chapter entitled "Tax on Lifetime Gifts."

### **Chapter 14**

There are other techniques available to shift future appreciation in the value of property to younger generations. However, Congress enacted Internal Revenue Code Chapter 14 to prevent you from shifting to children a disproportionate amount of future growth in the value of property while at the same time retaining income or other rights with respect to that property. This statute is complex and its scope has yet to be clarified. Suffice it to say that Chapter 14 has increased the complexity of shifting future value to younger generations.

### **Other Planning Techniques**

A detailed explanation of other, more sophisticated techniques, is beyond the scope of this outline. If one of the following strategies is appropriate for your circumstances, you should consult with a knowledgeable estate planning advisor.

**Limited Liability Company.** A tax entity often set up to transfer units of ownership to a younger generation. This technique allows the owner to transfer interests in the limited liability company yet retain control by serving as the manager. Valuation of the units is often discounted due to ownership of a minority interest and lack of marketability.

**Limited Partnership.** Another type of tax entity set up to transfer units of ownership to a younger generation. This technique allows the owner to transfer interests in the limited partnership yet retain control by serving as the general partner. Valuation of the partnership units is often discounted due to ownership of a minority interest and lack of marketability.

***Qualified Personal Residence Trust (QPRT)***. An estate planning technique where the taxpayer gifts a personal residence or second residence (vacation home) to a trust. The taxpayer retains the right to live in the residence for a stated period. At the end of the stated period, the residence passes to the designated beneficiary. This technique serves to remove the residence and appreciation from the donor's estate at a reduced transfer tax cost.

***Grantor Retained Annuity Trust (GRAT)***. An irrevocable trust into which the grantor places assets in exchange for the right to receive payment of a fixed amount for a fixed period of years.

***Grantor Retained Unitrust (GRUT)***. An estate tax saving strategy whereby the grantor places assets into an irrevocable trust in exchange for the right to payment of a fixed percentage of the value of the trust property (determined annually) for a fixed period of years.

***Irrevocable Life Insurance Trust*** An estate planning technique utilized primarily to shift the ownership of life insurance policies from the insured's generation to a lower generation. This removes the policy proceeds from estate taxation at the death of the insured. This strategy is most often utilized to create liquidity for payment of death taxes.

### **Summary**

Planning that will allow you to shift appreciation in the value of your property to younger generations is very technical and complex and should be done only with the help of a knowledgeable tax advisor. There are many other tax and nontax issues not discussed above that you should review before you embark upon a course of action. Nevertheless, this type of planning can save substantial amount of estate taxes if carefully thought out and properly implemented.