



Estate Planning Report®

Fall 2008

Giving to Save Estate Tax

Making substantial lifetime gifts remains an essential element of sound estate planning. In the Summer 2008 *Statistics of Income Bulletin*, the IRS reported on major gifts made during 2005. That year 261,104 donors reported total gifts of \$38.5 billion to 959,612 donees. Fewer than 3% of the returns required the payment of federal gift tax, however. Some combination of the annual gift tax exclusion, the federal gift tax credit against the first \$1 million in taxable gifts, and the marital and charitable deductions protected 253,440 donors from having to write a check to IRS for the privilege of transferring their wealth. The report does not analyze how taxation was avoided. Still, that leaves 7,664 donors actually paying a gift tax in 2005, and their total liability came to \$1.7 billion, an average gift tax due of \$221,816.

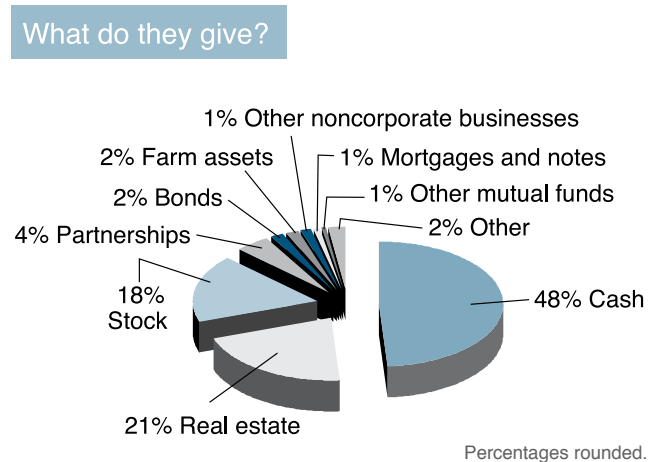
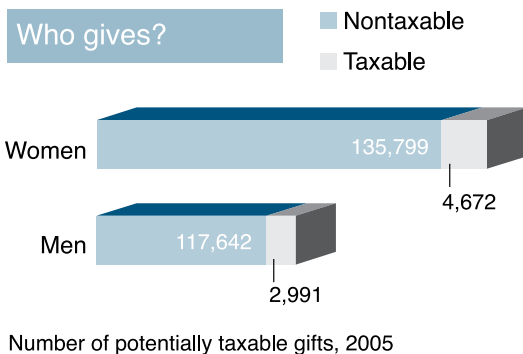
Women filed 53.8% of the 2005 gift tax returns, and they filed 61.0% of the returns showing a gift tax payable. (See *Who gives?* below.) No explanation is offered for the disparity, but as women generally outlive men, they are overrepresented in the wealthy segment of the elderly population. Perhaps men are more likely to rely upon transfers at death, given the availability of the unlimited marital deduction to protect the family fortune at that time. Men and women were represented more equally in the donee population

(46.3% and 47.3% respectively), with the balance going to trusts or unknown.

Nearly half of all 2005 gifts were of cash or the equivalent (such as money market funds). (See *What do they give?* below.) The next largest categories were of assets expected to appreciate after the gift, so the transfer will save even more in estate taxes. Real estate—including personal residences; farmland and vacant land; and commercial real estate, real estate partnerships and real estate mutual funds—made up 20.8% of the gifts. Common stocks, both publicly traded and privately held, came to 17.5% of the total. Interestingly, bonds came to only 1.8% of the gifts, and farm assets (apart from land) to 1.5%.

Valuation discounts

Much of an estate planner's effort is spent securing valuation discounts for gratuitous transfers of property. The 2005 gift tax data reveal that 16.5% of the gifts were discounted a total of \$3.1 billion. That's an aggregate discount of less than 10%, but there is no discount possible for an outright transfer of cash. About half of the returns claimed a discount of some sort, with nearly two-thirds of these falling into



Source for all graphs: *Statistics of Income Bulletin*, Summer 2008

the 20% to 40% range. Over 10% of the gift tax returns claimed a discount of 40% or more.

Had the entire amount of the claimed discounts been subject to gift tax at 45%, gift tax collections would have increased by nearly \$1.4 billion, almost as much as the \$1.7 billion actually collected. Thus, it may be that the valuation discounts cut the final gift tax obligations in 2005 roughly in half.

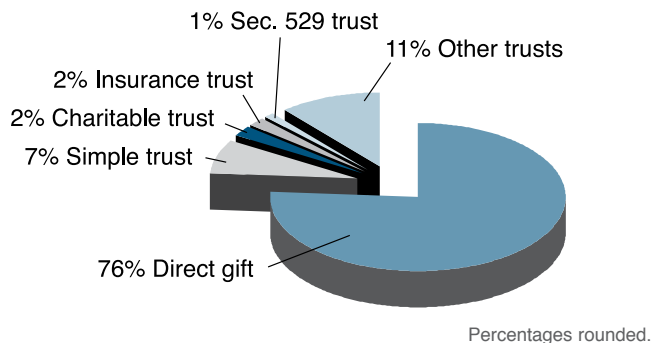
Transfers in trust

Nearly one-quarter of 2005 transfers were in trust, with the balance being direct gifts. (See *How do they give?* at right.) That translates into about \$10 billion in undiscounted asset values being transferred in trust. Men were slightly more inclined than women to use trust strategies to execute their gifts. Simple trusts that provided all of their income annually to one individual made up 7.3% of the total. Nearly \$400 million was transferred to Section 529 education trusts, some \$800 million to insurance trusts, and about \$1 billion to charitable split interest trusts. Marital trusts, personal residence trusts, family trusts and generation-skipping trusts were included in the “other trust” category in the IRS tabulations.

Crummey trusts

A power of withdrawal over an addition to a trust may be used to give a beneficiary a present interest in the transfer sufficient to permit the annual gift tax exclusion, which was \$11,000 in 2005. The strategy was sanctioned in *Crummey v. Comm’r* (1968), and such powers are routinely referred to as Crummey powers. In *Cristofani Estate v. Comm’r* (1991), a court held that contingent remainder beneficiaries, including grandchildren, also could have valid Crummey powers if they were given adequate notice to exercise their withdrawal rights.

How do they give?



Thus, fairly significant tax-free transfers may be made to a Crummey trust that has many beneficiaries. The annual exclusion in 2008 is \$12,000, and in 2009 it will increase to \$13,000 based on inflation.

In 2005 a total of \$1.6 billion in assets was transferred subject to Crummey powers. This represents about 16% of the transfers in trust. Cash, at \$1.0 billion, was the most-utilized asset for these trusts, followed by stock at \$268 million and real estate worth \$114 million. Just over a third of the trusts with Crummey powers were simple trusts, nearly a quarter were family trusts, and 18% were life insurance trusts.

If Congress decides against repealing the federal estate tax next year, as now seems likely, the importance of tax-conscious gift planning will rise dramatically for wealthy families.

Recent Developments

No Discounts Allowed for Transfers of Restricted Management Accounts.

Rev. Rul 2008-35, 2008-29 IRB 116

In this Ruling the IRS describes a restricted management account, in which Depositor transfers investment assets into the care of a bank for a fixed term. During the term the bank will be solely responsible for investment decisions, though Depositor may nominate an investment advisor for the account. Depositor may not withdraw assets from the account during the term of the contract, though he or she may transfer a portion of the account to a family member. In that case a new restricted management account will be created for that family member.

The purpose of the fixed term is to give the bank more flexibility to maximize long-term performance without having to be concerned

about a premature withdrawal. Because the bank is certain to collect its investment fees for a number of years, it has agreed to accept a reduced annual fee.

Given the restrictions that have been placed on the account, may its value, or a share of its value, be discounted for transfer tax purposes? After all, a willing buyer would not pay full value for the underlying assets if they were subject to access limitations.

IRS holds that no discounts are allowed for either the gift tax or the estate tax. The Service compares this situation to the claim by a taxpayer that the value of inherited retirement plan assets should be discounted to reflect the income tax restrictions that come along with them. That argument was rejected in *Smith ex. Rel. Estate of Smith v. U.S.*, 391 F.3d 621 (CA-5, 2004). IRS also analogizes the investment management contract to a long-term property management contract for real property. The existence of such a contract would not affect the fair market value of the real property, the Service concludes.

The result is buttressed by IRC §2703(a)(2), which provides that the value of property for transfer tax purposes will be determined without regard to restrictions on the right to buy or sell it. Although that Code section was not intended to apply to arm's length business arrangements, which the restricted management account is, it does operate to prevent the intrafamily transfers for less than adequate consideration.

Joint Income Beneficiaries May Divide a Charitable Trust Without Adverse Tax Consequences.

Rev. Rul. 2008-41, 2008-30 IRB 170

Several individuals are joint income beneficiaries of a charitable remainder annuity trust or unitrust. They want a state court to divide the trust, so they each keep an income interest. The separate trusts may have different trustees. If one dies, his or her share would be added to the other share or shares.

The news is all good in this Revenue Ruling:

- pro rata division of the trust won't impair its qualification as a charitable trust under IRC §664;
- division of the trust won't be a sale or exchange producing gain or loss, and each trust will take the holding period of the assets as held by the original trust;
- the trust's status under the private foundation rules will not be affected by the division, so no excise tax will be due under IRC §507(c);
- the division will not constitute an act of self-dealing under IRC §4941; and
- the division will not constitute a taxable expenditure under IRC §4945.

The same ruling also applied to a married couple going through a divorce, where if one died, his or her share would not pass to the survivor, but would go directly to the charity. No additional charitable deduction would be permitted, however.

Surviving Spouse's Disclaimers of Jointly Owned Brokerage Accounts Are Held Qualified.

Private Letter Ruling 200832018

Husband and Wife owned two brokerage accounts as joint tenants with right of survivorship. Husband was the sole contributor to Account 1, and during his life he had the right to withdraw unilaterally all the funds from it. After his death, Wife set up a new brokerage account in the name of Husband's estate. Before the new

account was opened, Wife had received a number of distributions, totaling \$A, from the old account. She deposited those checks into her own money market account. After the account was established in the estate's name, Wife transferred to it all the funds that she had received in the interim, to make it whole.

Wife now proposes to disclaim her survivorship interest in the brokerage account, which will cause the assets to pass to a marital trust and a family trust. She also will disclaim her nongeneral testamentary power of appointment over the trusts. A pecuniary amount of \$A will be carved out of the disclaimer, the amount that she accepted and that can no longer be disclaimed. IRS holds that the disclaimer will be qualified.

Husband and Wife jointly contributed to Account 2. This account will be divided in two, with one-half going to a new account for Wife and the other to an account in the name of Husband's estate. With this account there were no distributions, but a municipal bond was redeemed by the bond's issuer, and the proceeds were reinvested with Wife's approval. Again, Wife plans a disclaimer, but IRS holds that Wife's authorization of the reinvestment of bond proceeds amounted to an acceptance of that portion of the account. She may disclaim all but the Husband's one-half interest in those proceeds.

A Testamentary Power of Appointment Is Held to Be Nongeneral, and, Therefore, the Exercise Is Nontaxable.

Private Letter Ruling 200832015

Grantor created two trusts for her daughter-in-law and the children of her son and daughter-in-law. The trusts were created before October 21, 1942. Each child has a separate share in each trust and began to receive a life income from the trust upon reaching the age of majority. Each child has a testamentary power of appointment, which is restricted to family members, defined as "the husband or wife, as the case may be, and the children or other descendants of said person, and the children of Grantor and their descendants, but no other persons."

One of Grantor's children has asked the IRS whether the exercise of this power of appointment will be subject to the estate tax. The Service holds that the restrictions on the power mean that the child may not exercise in favor of his estate or his creditors, so it is not a general power of appointment. Accordingly, the exercise of the power will not cause the property that is subject to the power to be included in the child's taxable estate.

Washington Talk

Repeal of the federal estate tax, an idea with bipartisan support just a few years ago, is now a policy prescription in retreat. Both Presidential candidates favor retaining the estate tax. Obama would freeze the transfer tax rules in 2009, with an exemption amount of \$3.5 million for estates and a tax rate of 45%. The Center for a Responsible Federal Budget (CRFB) scores that proposal as a \$44 billion revenue raiser compared to current law (which, for scoring purposes, includes 2010 as a year without an estate tax). McCain would provide a small bump in the exemption amount to \$5 million, but advocates a drastically reduced tax rate of just 15%, the same as the rate on long-term capital gains. Still, the CRFB reports that his approach would raise \$10 billion more than current law.

Whoever is elected President, tax reform will be an early priority in 2009, and the transfer tax undoubtedly will be included in that process.

More work may be needed on the proposed alternate valuation date regs. The IRS remains upset over its loss in *Kohler*, in which the Tax Court gave effect to a post-death reorganization that had the effect of depressing the value of a business interest. The Service believes that the alternate valuation date election should reflect solely those reduced asset values attributable to market events that are outside the control of the executor of the estate, and it has proposed regulatory changes to implement that desire.

Both the American Bar Association's Section on Taxation and the American College of Trust and Estate Counsel have responded with comments seeking clarification. Both groups recognize that an abuse potential needs to be curbed. The ABA believes that Treasury does not have the power to achieve that through regulation, that

a legislative fix is required. Additionally, the proposed regs. need to define "outside the control" more narrowly, identifying whose control is at issue as well as how that control is exerted.

ACTEC similarly is looking for better and narrower definitions. Their official comment to the IRS included the observation that "The proposed regulations, however, use a meat cleaver approach to solving the problem when the proposed regulations should have used a scalpel."

A patch for the AMT was included in the \$700 billion "rescue plan" (or "bailout bill"; pick your poison), along with 115 other tax provisions. For the 2008 tax year, the AMT exemption for singles is \$46,200, and for marrieds filing jointly it's \$69,950. IRS administrators heaved a sigh of relief that the issue wasn't left until later in the year.

Other tax extenders of interest to individual filers:

- the deduction for state and local sales taxes;
- the qualified tuition expense deduction;
- the above-the-line deduction for teachers' classroom expenses;
- the standard deduction for nonitemizers' property taxes, as passed in the Housing and Economic Recovery Act of 2008; and
- the "charitable IRA rollover," which allows those over age 70½ to make tax-free distributions of up to \$100,000 from their IRAs to charity.

The bill also included a relaxation of the tax return preparer penalties.

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