HERMENZE & MARCANTONIO LLC
ADVANCED ESTATE PLANNING TECHNIQUES - 2017

I. Overview of federal, Connecticut, and New York estate and gift taxes.

A. Federal

1. 40% tax rate.
2. Unlimited estate and gift tax marital deduction for U.S. citizens.
3. Estate and gift tax exemption of $5,490,000 (indexed periodically for inflation).
4. Portability enables a surviving spouse whose spouse died on or after January 1, 2011 to utilize the unused portion of the deceased spouse's federal estate and gift tax exemption if certain requirements are met.
5. $14,000 per year gift tax exclusion (indexed periodically for inflation).
6. Gift tax exclusion for direct tuition and medical payments.
7. Lifetime and at-death transfers to qualified charity are gift and estate tax free.

B. Connecticut

1. Estate and gift tax rates are 7.2% to 12%.
2. Unlimited marital deduction.
3. $2,000,000 estate and gift tax exemption.
4. No portability of exemption to surviving spouse.
5. $14,000 per year gift tax exclusion (indexed periodically for inflation).
6. Gift tax exclusion for direct tuition and medical payments.
7. Lifetime and at-death transfers to qualified charity are gift and estate tax free.

C. New York

1. Maximum estate tax rate is 16%.
2. Unlimited marital deduction.

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3. $5,250,000 estate tax exemption. Will increase to equal federal estate tax exemption amount in 2019.
4. No portability of exemption to surviving spouse.
5. At-death transfers to qualified charity are estate tax free.
6. No gift tax, but most taxable gifts made within three years of death are subject to New York estate tax.

II. **Gifting may be more tax efficient than holding property until death, when it will be subjected to estate tax.**

A. $14,000 annual gift tax exclusion and exclusion for direct tuition and medical payments are available only for gifts, not at-death transfers.

B. All income earned on gifted property after date of gift is out of your estate.

C. All appreciation on gifted property after date of gift is out of your estate.

D. Consider capital gains tax consequences upon sale of gifted property. Recipient of gifted property receives the donor's cost basis in the property.

III. **Look for tax-advantaged methods of making gifts -- methods which leverage the value of your gift tax exemption. Some examples:**

A. Gifts of Individual Life Insurance Policies

1. At death, your taxable estate includes the value of the proceeds of any life insurance policy of which you are the owner (including employer-provided group term insurance).
2. Giving the policy to your spouse doesn't achieve any tax savings -- at your spouse's later death, proceeds will be included in your spouse's taxable estate.
3. If instead, you give the policy to an Irrevocable Life Insurance Trust, and live for three years after the transfer, the entire policy proceeds payable at your death will be excluded from your taxable estate and your spouse's taxable estate. Contributions you make to the trust for payment of insurance premiums constitute gifts to the trust, but if the trust is

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structured properly, gifts can be covered by your $14,000 annual gift tax exclusions. This greatly leverages the use of your $14,000 exclusions.

4. The Irrevocable Life Insurance Trust permits your spouse and children access to policy proceeds after your death to maintain their lifestyles, yet keeps the proceeds out of your spouse's taxable estate. The trust also allows you to choose an appropriate management structure for funds passing to your children.
5. A new insurance policy, purchased by the trust itself, is not subject to the three year waiting period referred to above.
6. Giving policy to your children, instead of a trust, seems simpler but has some problems. Your spouse will not have the use of the proceeds after your death; children may cash in policy, or give it away; the policy can be subject to the children's creditors or spouses in the event of divorce; and when the children die, their interest in the policy goes to beneficiaries chosen by them, rather than by you.
7. Second-to-die Life Insurance. A policy specifically designed to increase inheritance to children -- pays off at death of surviving spouse. Can be owned by an Irrevocable Life Insurance Trust, so that entire policy proceeds are excluded from both spouses' estates. Proceeds can provide liquidity to pay estate and income taxes and administration expenses at surviving spouse's death.

B. <u>Qualified Personal Residence Trust ("QPRT")</u>

1. You give your home or vacation property to a QPRT which you create. The gift to the QPRT is a taxable gift.
2. The QPRT lasts for a fixed period of years, chosen by you when the QPRT is created. During that period, you live in the house rent free. You continue to pay the expenses attributable to the house (such as taxes, insurance, and repairs) and can still claim the same income tax deductions.

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3. Once the QPRT period chosen by you ends, assuming you survive the period, the home can pass gift tax free to a trust for your spouse, or to your children (or other beneficiaries). The home is no longer subject to estate tax at your death.

4. The leveraging advantage: The value, for gift tax purposes, of your gift of the home to the QPRT is dramatically discounted because of the actuarial computation IRS uses to calculate the value of gift. For example, if you are age 65, create a QPRT which will last for 12 years, and gift your $1,000,000 house to the QPRT, the value of your gift to the QPRT is not $1,000,000, but is instead $557,100. You pay no out-of-pocket federal gift tax when you transfer the home to the QPRT because the transfer uses up a portion of your federal gift tax exemption. Assuming you survive the 12 year period, and the house appreciates at an annual rate of 3%, the home at the end of the 12 year period will be worth $1,425,761. You will have transferred a home worth $1,425,761 at a gift tax cost of $557,100. Thus, $868,661 in value is removed from your estate for "free." At a federal estate tax rate of 40%, your estate saves $347,464, plus additional state estate tax savings.

5. Additional QPRT details:

   a. If you die before the QPRT ends, the value of the home at the time of your death is included in your estate. This puts you in same position you would have been without the QPRT. No tax loss - only cost is expense and inconvenience of creating QPRT.

   b. If you wish to use the home after QPRT period ends, you must rent it from children or other beneficiaries at fair market rental.

   c. If you sell and do not replace home within two years, you receive a qualified annuity payment for the balance of the trust term.

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d. Children or other beneficiaries receive home with your cost basis for capital gains tax purposes -- capital gains tax cost must be compared to estate tax savings.

e. A QPRT is particularly attractive in a higher interest rate climate.

f. You can serve as Trustee of the QPRT during the QPRT period.

6. Additional QPRT examples:

Your age	Value of house	QPRT term in years	Taxable value of your gift to QPRT	Amount passing to beneficiaries	Federal estate and gift tax savings
55	$3,000,000	10	$2,175,510	$4,031,749	$742,496
55	$3,000,000	20	$1,374,120	$5,418,334	$1,617,686
70	$3,000,000	10	$1,639,740	$4,031,749	$956,804
70	$3,000,000	20	$479,460	$5,418,334	$1,975,550

(Examples assume IRS discount rate of 2.2%; federal estate tax rate of 40%; a 3% annual growth rate; and ignore state gift and estate taxes and capital gains tax cost.)

C. Grantor Retained Annuity Trust ("GRAT")

1. You give assets to a GRAT which you establish. The gift to the GRAT is a taxable gift.

2. The GRAT lasts for a fixed period of years chosen by you when you establish the GRAT. During the period of the GRAT, you (or your estate if you die) receive a fixed amount from the trust each year.

3. Once the GRAT period chosen by you ends, the trust assets pass to your children (or other beneficiaries), or to trusts for their benefit, gift tax free.

4. The leveraging benefit: The value, for gift tax purposes, of your gift to the GRAT is dramatically discounted because of the actuarial computation IRS uses to calculate the value of the gift. For example, if you create a GRAT that will last for 10 years, gift assets valued at $1,000,000 to the GRAT, and receive an annual payment from the trust of $60,000, the value of your gift to the GRAT is not $1,000,000, but is instead $466,642. You

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pay no out-of-pocket federal gift tax at the outset because the transfer uses up a portion of your federal gift tax exemption. Assuming you survive the 10 year period, and the trust assets grow at an annual rate of 10%, the trust assets at the end of the 10 year term will be worth $1,637,497. Thus, you will have transferred $1,637,497 using only $466,642 of your federal gift tax exemption. That is $1,170,855 passing estate and gift tax-free. The tax savings, at a 40% estate and gift tax bracket, is $468,342, plus additional state estate tax savings.

5. Currently, it is possible to establish a GRAT where the value of the assets gifted to the GRAT is close to zero. For example, if you create a GRAT which will last for 8 years, gift assets valued at $1,000,000 to the GRAT, and you (or your estate) receive an annual payment from the trust of 13.76898% of the value of the gift to the GRAT each year, the value of your gift to the GRAT is not $1,000,000, but 29¢! Assuming you survive the 8 year period, and the trust assets grow at an annual rate of 10%, the trust assets at the end of the eight year term will be worth $568,984. Thus, you will have transferred $568,984 using only 29¢ of your federal gift tax exemption. That results in $568,983 passing tax-free, and a federal estate tax savings of $227,593. There would also be state estate tax savings.

6. A GRAT is effective if it is funded with assets likely to appreciate in value so that the total return on those assets exceeds the IRS interest rate used in the actuarial computation. A GRAT generates the greatest transfer tax benefit in a low interest rate climate because it is more likely that the return on assets in the GRAT will exceed the low interest rate.

7. Additional GRAT details:

    a. If you die before the GRAT ends, all or a portion of the trust assets at the time of your death are included in your estate.

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b. The children or other beneficiaries receive the trust assets with your cost basis for capital gains tax purposes. Capital gains tax cost must be weighed against the transfer tax benefits.

c. You can serve as the GRAT trustee. In some cases, it is preferable to have a trust company, bank, accountant, attorney, or other financial advisor serve.

8. Additional GRAT examples:

Value of assets gifted to GRAT	GRAT Term (in years)	Fixed dollar amount paid to you each year	Taxable value of your gift to GRAT	Amount passing to beneficiaries	Federal estate & gift tax savings
$3,000,000	2	$1,545,000	$9,035	$385,000	$150,386
$3,000,000	5	$636,000	$19,577	$948,686	$371,643
$3,000,000	10	$336,000	$13,195	$2,426,253	$965,223

(Examples assume IRS discount rate of 2.2%; federal estate tax rate of 40%; a 10% annual growth rate; and ignore state gift and estate taxes and capital gains tax cost.)

D. Charitable Remainder Trust ("CRT")

1. Ideal if you have low cost basis, low income-yielding property, which you would like to sell in order to improve the income, but which you are reluctant to sell because of the capital gains tax you will have to pay. For example, you have rental property with a fair market value of $1,000,000, a cost basis of $50,000, and which yields you an annual net income of $30,000 (3%). Another example might be your portfolio of 5,000 shares of X Company stock, for which you paid $50,000, and which is now worth $1,000,000, and which has an annual dividend yield of $30,000 (3%). Assume that the federal capital gains tax rate is 20%, and that your ordinary income tax rate is 39.6%. Assume further that if you sell the asset and put the proceeds in a better, but still conservative investment, you can increase your yield from 3% to 6%.

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2. If not for capital gains tax, you could sell the asset, reinvest the $1,000,000 proceeds at 6%, and increase your annual income from $30,000 to a more desirable $60,000.
3. However, capital gains tax will be $190,000 ($950,000 gain x 20%); thus your after-tax proceeds will be $810,000. Invested at 6%, your annual income will only be $48,600, not the $60,000 you want.
4. Instead, you can give the asset to a CRT, created by you, which provides that you get 6% of the trust assets each year. At your death, the entire trust property goes to a charity or charities of your choice.
5. CRT trustee can sell the investment you gifted to the CRT, without paying any capital gains tax. The entire proceeds can then be reinvested to achieve the 6% annual return of $60,000 that you desire.
6. You receive a current income tax deduction upon funding the CRT for the actuarial value of the eventual distribution of the CRT property to charity at your later death. For example, assuming you are age 65 at the time of your transfer of a $1,000,000 asset to a 6% lifetime CRT, when the IRS discount rate is 2.2%, your income tax deduction would be $389,760. At a 39.6% income tax bracket, that deduction can result in income tax savings of $154,345.
7. At your death, there is no estate tax on gifted property, because it passes to charity.
8. <u>Note</u>: At your death, your heirs don't receive the gifted property, charity does. However, consider using part of the increased stream of income, plus cash saved from income tax deduction, to purchase a "wealth replacement" life insurance policy for the benefit of the children. Use of an Irrevocable Life Insurance Trust will keep the policy proceeds out of your taxable estate.

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9. Additional CRT details:

a. The amount paid to you by the CRT each year can be either an annuity amount (a fixed dollar amount that doesn't change from year to year), or a unitrust amount (a fixed percentage of the value of the trust, paid each year, that can change as the value of the trust increases or decreases). You choose the fixed amount or the percentage when the CRT is created, and cannot change it later.

b. The amount paid to you by the CRT can be paid for the combined lifetime of you and your spouse.

c. The CRT is irrevocable. You can, however, retain the right to change the charity or charities which will eventually receive the CRT property.

d. You can serve as the CRT trustee. In some cases, it is preferable to have a trust company, bank, accountant, attorney, or other financial advisor serve.

10. Additional CRT examples:

Your age	Gift to CRT	Amount paid to you each year	Income tax deduction	Federal income tax savings
55	$3,000,000	6%	$785,460	$311,042
55	$3,000,000	8%	$546,810	$216,537
70	$3,000,000	6%	$1,398,000	$553,608
70	$3,000,000	8%	$1,123,260	$444,811

(Examples assume IRS discount rate of 2.2%; federal income tax rate of 39.6%; and ignore state income tax.)

E. Charitable Lead Annuity Trust ("CLAT")

1. You give assets to a CLAT which you establish. The gift to the CLAT is a taxable gift.

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2. The CLAT lasts for a fixed period of years chosen by you when you establish the CLAT. During the period of the CLAT, a charity or charities chosen by you receive a fixed amount from the trust each year.
3. Once the CLAT period chosen by you ends, the trust assets pass to your children (or other beneficiaries), or to trusts for their benefit, gift tax free. The assets are no longer subject to estate tax at your death.
4. The leveraging benefit: The value, for gift tax purposes, of your gift to the CLAT is dramatically discounted because the amount going to charity is deductible from the gift tax, and because of the actuarial computation the IRS uses to calculate the value of the gift. For example, if you create a CLAT that will last for 20 years, gift assets valued at $1,000,000 to the CLAT, and charity receives an annual payment from the trust of $60,000, the deemed value of your gift to the remaindermen (your children or beneficiaries) of the CLAT is not $1,000,000, but is instead $18,916. You pay no out-of-pocket federal gift tax at the outset because the transfer uses up a portion of your federal gift tax exemption. Assuming the trust assets grow at an annual rate of 10%, the trust assets passing at the end of the 20 year term gift tax-free will be worth $3,291,000. Thus, you will have transferred $3,291,000 to your children or other beneficiaries while using only $18,916 of your federal gift tax exemption. That's $3,272,084 passing estate and gift tax free. Your federal estate tax savings, at a 40% estate and gift tax bracket, is $1,308,834. There would also be additional state estate tax savings. In addition, depending upon how the CLAT is structured, you may be entitled to an income tax deduction of $981,084 at the time of the gift.
5. A CLAT is an effective wealth transfer device if it is funded with assets likely to appreciate in value, so that the return on those assets exceeds the IRS interest rate used in the actuarial computation. A CLAT generates the

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greatest transfer tax benefit in a low interest rate climate because it is more likely that the return on the assets in the CLAT will exceed the low interest rate.

6. Additional CLAT details:

a. If you die before the CLAT ends, the CLAT still works.

b. Your children or other beneficiaries receive the trust assets with your cost basis for capital gains tax purposes. Capital gains tax cost must be weighed against the transfer tax benefits.

7. Additional CLAT examples:

Value of assets gifted to CLAT	CLAT Term (in years)	Fixed dollar amount paid to charity each year	Taxable value of your gift to CLAT	Amount passing to beneficiaries after charitable term	Federal estate & gift tax savings	Possible income tax deduction	Possible income tax savings
$3,000,000	10	$110,000	$66,531	$2,521,877	$982,138	$2,933,469	$1,161,654
$3,000,000	20	$60,000	$112,764	$9,873,000	$3,904,094	$2,887,236	$1,143,345

(Examples assume IRS discount rate of 2.2%; federal estate tax rate of 40%; federal income tax rate of 39.6%; 10% annual growth rate; and ignore state gift and estate taxes and capital gains tax cost.)

F. Generation-Skipping Transfer Tax Exempt Trusts ("GST-Exempt Trusts")

1. As wealth passes from generation to generation, federal government assesses a federal estate tax (40%) at each generational level.

2. Prior to 1986, you could "skip" the estate tax on the wealth passing to your children by leaving the property in trust for your children, with them having access (but not unlimited access) to the trust property. At children's later deaths, trust property would pass to your grandchildren, free of estate tax at that time, because the trust property would not be included in the estates of the children (because their access to the trust property would not be enough of an ownership interest in the trust property to bring it into the children's taxable estates).

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3. In 1986, Congress passed the Generation-Skipping Transfer Tax ("GST"). The GST rate is equal to the federal estate tax rate (40%). It is imposed on transfers, outright or in trust, to grandchildren or more remote descendants, if the transferred property is not subject to estate tax at each generational level.
4. Each person has an exemption from the GST equal to $5,490,000 (indexed annually for inflation). Thus, a married couple can structure their estate plan so that up to $10,980,000 of the couple's estates (after the payment of estate or gift taxes at their generational level) can be held in lifetime trusts for their children. Children will have use of the trust property to maintain their lifestyles, but at their later deaths, the trust property passes to the couple's grandchildren free of estate, gift, and GST tax. Assuming no growth in the trust assets during the lifetimes of the couple's children, transfer tax savings at the children's later deaths can be $4,392,000 ($10,980,000 x 40%), plus additional state estate savings. Assuming trust asset growth over the lifetimes of the children, savings is much greater.
5. In addition to significant transfer tax savings, trust structure may also better protect children's inheritance from creditors or from a spouse in the event of the child's divorce or death.
6. For couples without children, generation-skipping tax planning utilizing lifetime trusts can be beneficial to transfer wealth to nieces and nephews and other younger beneficiaries.

This outline deliberately over-simplifies technical aspects of tax, property, probate, and trust laws in the interest of clear communication. Examples are in some cases based upon unstated assumptions. Under no circumstances should you or your advisor rely on the contents of this outline for technical advice, nor should you reach any decisions with respect to planning without consulting a qualified advisor.

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