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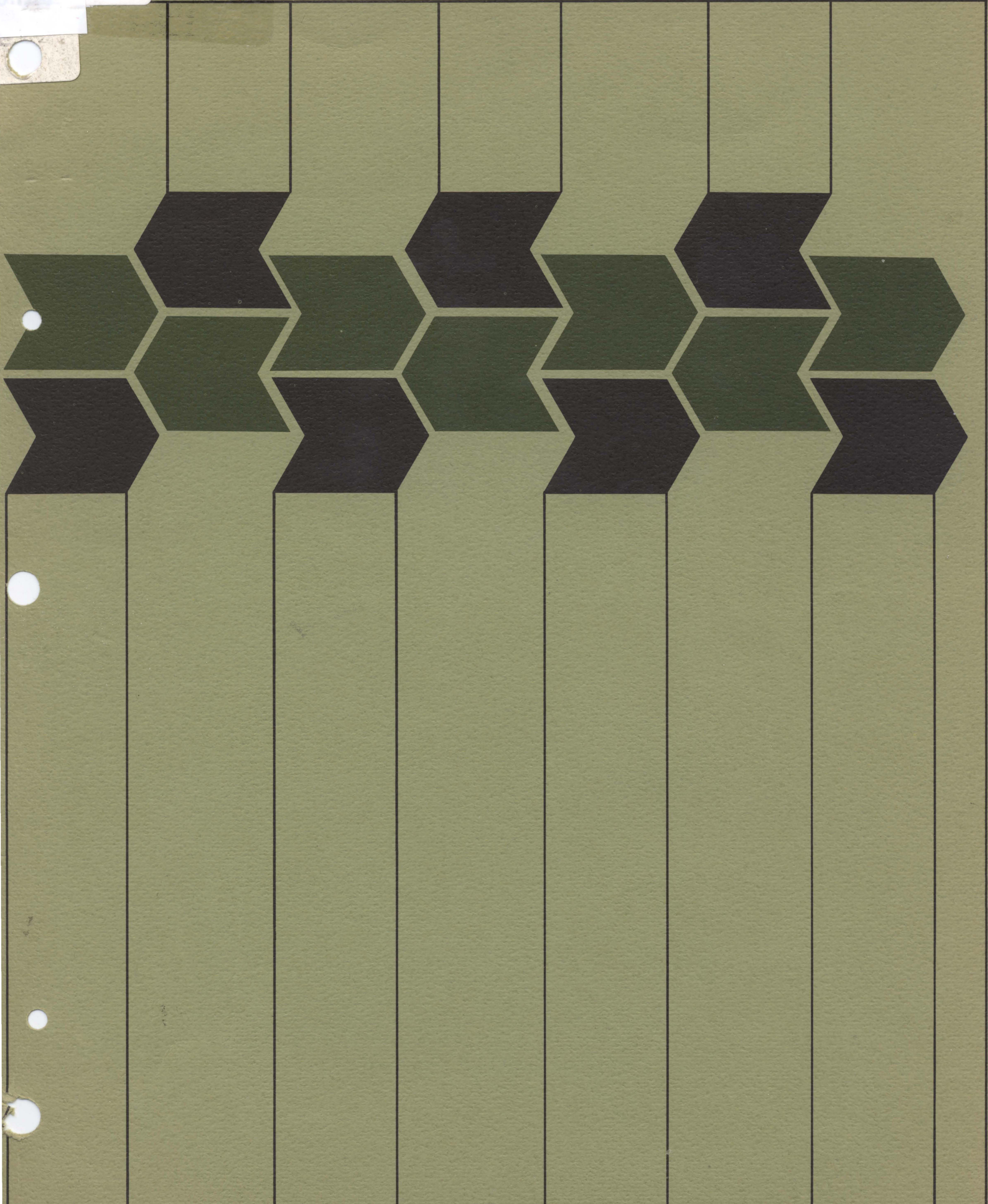

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Planning Estate Transfers
(The Changing Role of Federal Estate and Gift Taxation)

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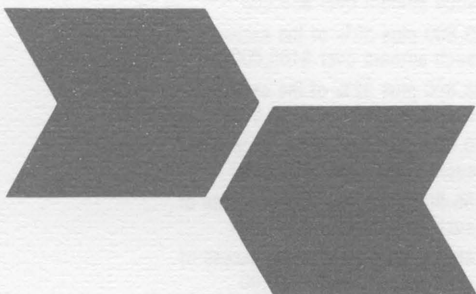
INTRODUCTION

This publication describes the Tax Reforms of 1976 which affect the Federal Estate and Gift Tax and its impact on estate planning. It is meant to be a guide to the reader in analyzing and planning an estate.

Professional estate planners such as attorneys, estate tax attorneys, accountants, trust officers, and insurance agents and financial management personnel should be consulted for further details. Attorneys should be consulted for all legal information.



ESTATE AND GIFT TAX CHANGES

Estate planning has taken on new dimension and direction as the result of sweeping changes in our nation's tax laws, particularly in the estate and gift tax areas. The Tax Reform Act of 1976 has made substantial changes in the approaches citizens will take in making estate transfers.

To better understand the new provisions, consider for a moment this brief review of the old law which consisted of two separate taxes: an estate tax and a gift tax. The estate tax was levied upon all property one owned at death. The gift tax discouraged lifetime gifts which would reduce one's holdings at death, thereby thwarting the estate tax. However, the old gift tax rates were less than comparable estate tax rates, so gift-giving proved in many cases to be an effective estate reducer. Gifts were a popular method of saving estate taxes in the transfer of one's property to family members and others, even though a gift tax might be involved.

The new law merges the old estate and gift tax provisions into one unified tax on property transfers regardless of when they occur (either during life or after death). The tax costs of giving one's estate away under the new unified tax rate schedule was designed to be the same whether a donor makes the gift during his life or after death (when a gift and transfer of all one owns occurs). The excise tax concept of a tax on one's right to transfer his property and estate continues to provide a basic framework for the unified transfer tax structure which has been created.

The new tax law retains some provisions of the prior law. Estate assets will continue to be valued at fair market value. However, some substantial tax-saving changes in the method of valuing farm

enterprises and closely held small businesses have been made. A major change in the new law states that the gross estate shall now include the value of all lifetime gifts to individuals made after January 1, 1977, regardless of the motivation which the donor had in making such gifts. To avoid the incentive taxpayers might have to make deathbed gifts, the amount of gift tax paid during the 3 years prior to death also is included in the gross estate.

Other items for gross estate evaluation include, but are not limited to, cash, personal effects, household goods, automobiles, insurance proceeds, real estate holdings, farm equipment and livestock. An estate planning inventory form available from any County Extension office will prove helpful in compiling an all-inclusive list of assets required by law.

The $60,000 exemption on estate tax returns has been replaced by a phased-in system of credits which increase yearly from 1977 to 1981. The credit permits a dollar for dollar reduction in the actual tax owed up to the amount of the credit. The credit allowed in a particular estate depends upon the year of the decedent's death. The $30,000 lifetime exemption on gifts has been abolished in the creation of the unified tax.

Once the gross estate has been determined, the net taxable estate is determined by subtracting the deductions allowed. These deductions might include estate administration expenses, debts, charitable gifts, and any marital deduction allowed on gifts to a surviving spouse. On the figure remaining, the tax is then calculated according to the following rate schedule:

If the amount with respect to which the tentative tax to be computed is:	The tentative tax is:
Not over $10,000	18% of such amount
Over $10,000 but not over $20,000	$1,800 plus 20% of the excess of such amount over $10,000
Over $20,000 but not over $40,000	$3,800 plus 22% of the excess of such amount over $20,000
Over $40,000 but not over $60,000	$8,200 plus 24% of the excess of such amount over $40,000
Over $60,000 but not over $80,000	$13,000 plus 26% of the excess of such amount over $60,000
Over $80,000 but not over $100,000	$18,200 plus 28% of the excess of such amount over $80,000
Over $100,000 but not over $150,000	$23,800 plus 30% of the excess of such amount over $100,000
Over $150,000 but not over $250,000	$38,800 plus 32% of the excess of such amount over $150,000
Over $250,000 but not over $500,000	$70,800 plus 34% of the excess of such amount over $250,000
Over $500,000 but not over $750,000	$155,800 plus 37% of the excess of such amount over $500,000
Over $750,000 but not over $1,000,000	$248,300 plus 39% of the excess of such amount over $750,00
Over $1,000,000 but not over $1,250,000	$345,800 plus 41% of the excess of such amount over $1,000,000
Over $1,250,000 but not over $1,500,000	$448,300 plus 43% of the excess of such amount over $1,250,000
Over $1,500,000 but not over $2,000,000	$555,800 plus 45% of the excess of such amount over $1,500,000
Over $2,000,000 but not over $2,500,000	$780,800 plus 49% of the excess of such amount over $2,000,000
Over $2,500,000 but not over $3,000,000	$1,025,000 plus 53% of the excess of such amount over $2,500,000
Over $3,000,000 but not over $3,500,000	$1,290,800 plus 57% of the excess of such amount over $3,000,000
Over $3,500,000 but not over $4,000,000	$1,575,800 plus 61% of the excess of such amount over $3,500,000
Over $4,000,000 but not over $4,500,000	$1,880,800 plus 65% of the excess of such amount over $4,000,000
Over $4,500,000 but not over $5,000,000	$2,205,800 plus 69% of the excess of such amount over $4,500,000
Over $5,000,000	$2,550,800 plus 70% of the excess of such amount over $5,000,000

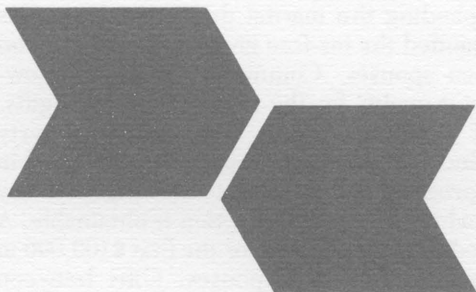
Against the tentative tax computed from this rate schedule, the credits allowed have a value compared to the tax reduction benefit of the now repealed $60,000 exemption, as reflected in the following table:

NEW DEATH TAX CREDITS

Year	New Credit Allowed	"Equivalent" Exemption
1977	$30,000	$120,667
1978	34,000	134,000
1979	38,000	147,333
1980	42,500	161,563
1981 and thereafter	47,000	175,625

The table shows that the new tax law *in effect* gives tax relief in 1977 equivalent to more than double the relief allowed by use of the $60,000 exemption during 1976 and earlier years. And by 1981, the amendments in the tax code will nearly triple the value of credits over the prior exemption.

Under the new law an estate tax return must be filed only if a decedent's gross estate exceeds the credit equivalent allowable in the year of death. Up to the end of 1976, a return had to be filed for all estates with a gross value of $60,000 or more. The new requirement from 1977 to 1981 and thereafter will vary from $120,000 to $175,000, depending on the year of death as shown in the foregoing table. Estate tax returns are still due and payable 9 months after the date of death; an alternate evaluation date of 6 months after death rather than the date of death itself may be used by an executor or administrator when estate asset values have undergone a serious depreciation immediately after the decedent's death.



MARITAL DEDUCTIONS

Unlike the income tax with its substantial number of deductions, the estate and gift tax laws provide for relatively few deductions. The marital deduction, however, is an important deduction which Congress initially enacted to equalize the impact of these taxes on persons living in non-community property states, compared to residents of community property states.

At the time of death, a spouse in Texas owns one-half of the community estate and the remaining one-half is the property of the spouse who survives. Therefore, only one-half of the estate is subject to estate taxation. This division of property is automatically accomplished under Texas law. The law of each of the states determines what ownership rights its citizens may have in property within its boundaries.

Several states (so-called common law property states) declare that the property acquired during a marital union belongs to the spouse whose labors are responsible for its acquisition. If the husband is the sole bread winner and the wife is not employed outside the home, the law would declare that all of the marriage property belongs to the husband. In the event of his death, 100 percent of the marital property (rather than 50 percent as in the case of community property in Texas) would be subject to federal estate taxation.

The inequity of such an arrangement is obvious. To correct this imbalance, the marital deduction was provided to allow up to one-half of the adjusted gross estate to be excluded from estate taxation provided the deceased gave it outright to the spouse without any restriction on its use. In states such as Texas, the survivor has no restrictions on the use of his/her one-half. Of course, the amount of the marital deduction is limited to the amount the surviving spouse actually receives.

The marital deduction applies to those Texans who own separate property apart from community holdings. The marital deduction can be used to exclude half the value of one's separate property from inclu-

sion in the gross estate, provided that comparable value (in either separate or community property) has been given outright without restriction to the surviving spouse. Thus the gross estate of a Texas decedent would include his one-half interest in any community property and all of his separate estate.

In an effort to provide a larger measure of tax relief to those families with holdings under $500,000, Congress has expanded the marital deduction. The new law provides that persons will be allowed to leave to their spouses on a non-taxable basis up to $250,000 or one-half of their adjusted gross estate — whichever is greater.

A special adjustment was enacted to allow married couples in community property states who hold community assets of $500,000 or less to gain tax treatment equivalent to the extra benefits conferred on citizens of the common law property states.

An example of the expanded marital deduction and how it applies in conjunction with community property is given below:

Total community estate	$400,000
Decedent's one-half interest	$200,000
Less community share (½) of debt and administration cost	– 15,000
Decedent's net estate	$185,000
Decedent allowed marital deduction not to exceed	$250,000
Less adjusted community property interest	– 185,000
Entitlement remaining to exhaust full expanded marital deduction	$ 65,000
Net estate	$185,000
Less remaining marital deduction	– 65,000
Net taxable estate	$120,000

To prove the foregoing example, consider the result if all of the property in question was the separate property of the deceased (as would be the case in a non-community property state).

Decedent's separate property	$400,000
Less total amount (not ½) of debt and administration cost	– 30,000
Adjusted gross estate	$370,000
Marital deduction:	
Less the greater of ½ of adjusted gross estate or $250,000	– 250,000
Decedent's net taxable estate	$120,000

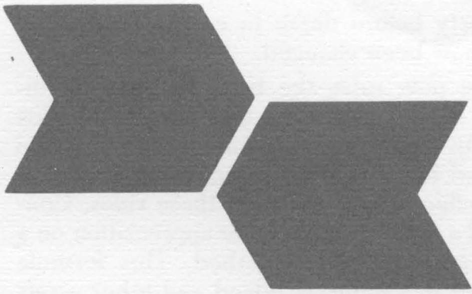
What portion accrued to the surviving spouse under the above example? Consider this example:

Adjusted gross estate	$370,000
Less taxable estate	– 120,000
Marital deduction (Amount to surviving spouse)	$250,000

A further example shows that the marital deduction portion enjoyed by the surviving spouse is the same in the community property state (using figures above).

One-half of community estate vesting in surviving spouse	$200,000
Marital deduction (in community property example)	65,000
TOTAL	$265,000
Less community share (½) of the debt and administrative cost	– 15,000
Net marital deduction benefit to surviving spouse	$250,000

The marital deduction not only is applicable in estate taxation but also applies in the area of lifetime gifts. In expanding the marital deduction, Congress also has expanded the tax-free giving opportunities on gifts between spouses. Community property, however, does not qualify for the marital deduction gifts. Citizens of Texas and other community property states will find that separate property may be used in such a gift program set out in the following statutory pattern for which a marital deduction is obtainable. A complete deduction is allowed for the first $100,000 in lifetime transfers between spouses. Gifts between $100,000 and $200,000 are fully subject to taxation. Thereafter, 50 percent of all gifts to a spouse in excess of $200,000 would be tax free. This marital deduction for gifts is integrated with marital estate deduction. Therefore, in certain cases where previous gifts were made, estate deductions will be reduced.



GENERATION SKIPPING CHANGES

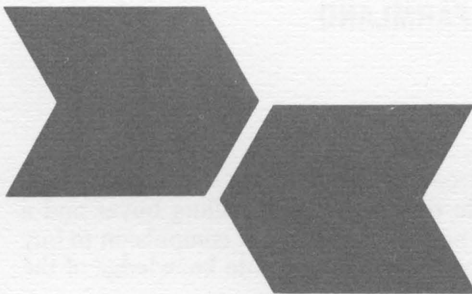
Certain generation skipping transfers which provided obvious tax saving advantages in avoiding double taxation will now be subject to estate taxation for the first time. This tax will apply in those instances where a transferor seeks to split a gift between two younger generations, such as where grandfather gives property to son's life, and upon son's death the remainder goes equally to two grandsons. In the past, at son's death the value of grandfather's property was not included in son's gross estate value.

To accomplish this, estate planners often used the trust arrangement to create what is called a "generation skipping transfer." A transfer of this type, whether contained in a trust or created by some other legal device, is now subject to some important limitations.

When son's death occurs or his interest in the transferred property ceases, a taxable event is now triggered in the property. It will still be possible to skip one generation in some instances, such as where a father leaves property in trust for a child, for later distribution among grandchildren. The most, however, that can be transferred tax free under this exception is $250,000 for each child so skipped. This exclusion is *not* $250,000 per each grandchild, but is $250,000 per each child of grandfather through whom he desires to create such a generation skipping arrangement.

The tax imposed on these arrangements will be the equivalent to the estate tax which would have been imposed if the property had been transferred outright to each successive generation, and will be imposed at the estate tax rate of the beneficiary of the generation who is skipped. Trust property is subject to reduction for the purpose of paying this tax. Any appreciation of trust value will also be subject to taxation. The creation of multiple trusts does not provide any additional tax benefits.

Generation skipping arrangements in existence or contained in an irrevocable trust before April 30, 1976 are not affected. Persons having these provisions in current wills will need to consult an attorney to assess their rights under the new rules. Changes, if needed, must be made by January 1, 1982.



CARRYOVER BASIS

Congress made substantial changes with respect to the *basis* which would be given to inherited property. This was accomplished by adapting a "fresh start" rule. It also structures a new capital gain tax into the estate tax picture. The basis, of course, is the cost foundation of properties in the hands of an owner from which any capital gain or loss would be computed at a subsequent transfer of this property to another.

Prior to these changes, the rule of basis transfer involved in lifetime giving was generally that the donee received the same basis as his donor. However, if an owner retained his property and estate and owned it at death, those who participated in its inheri-

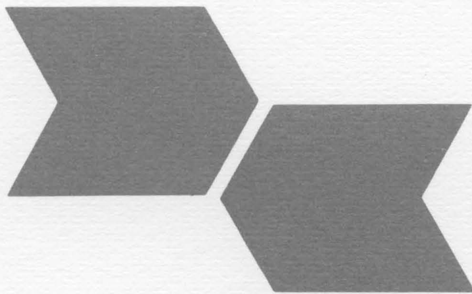
tance acquired the property with a cost basis equal to the value at the date of the owner's death. This new basis in the hands of devisees and heirs was often referred to as a "stepped-up" basis in view of the fact that the property inherited generally had enjoyed an appreciation in value during the period of the decedent's ownership. A sale by the heirs of inherited property resulted in little or no capital gain taxation when the sale followed shortly after a decedent's death.

On the other hand, a sale of land by a donee received during the donor's life would trigger the same capital gains tax obligations in the donee's income tax return as the donor would have incurred had he not given the land but had sold it to the donee or perhaps another. Even the donor's death shortly after a lifetime gift would not itself have sufficed to increase the donee's cost basis. For that reason, under prior law, the best gifts for use in lifetime giving were gifts having a relatively high cost basis or cash. Many who considered giving low cost basis land were probably better advised to retain their property until death, thus assuring a stepped-up cost basis at death and an income tax break for those getting the land should they choose to sell it. Of course, individual decisions would certainly have been based on other factors besides tax saving, as is proper in any type of estate planning. The old rule, which often allowed appreciation in property before death to escape taxation as income, has now been changed.

Under the new rules the basis in property inherited after 1976 shall be the decedent's cost plus appreciation in value after December 31, 1976. To avoid the need for a nationwide appraisal as of that date, and to effectively implement these rules, Congress adopted a formula to pro-rate appreciation on a straight-line apportionment method. This formula will be needed in valuing farmland and other assets not readily marketable. (For stocks and securities having a market, the cost basis is the greater of either the purchase price or value on December 31, 1976.) Basically, the formula works as follows:

$$\frac{\text{Amount of time asset owned after December 31, 1976}}{\text{Total time asset held before sale}} \times \text{Total appreciation} = \text{Appreciation subject to taxation}$$

No appreciation occuring before 1977 will be taxed. Congress further provided that each estate shall be allowed a minimum aggregate basis of $60,000. In addition, up to $10,000 worth of household goods and personal effects may be excluded from these provisions. This action gives a tax break to beneficiaries of smaller estates.



SPECIAL TAX VALUE ON FARMLAND

For those dying before January 1, 1977, property included in their gross estate was assessed at its fair market value determined on its "highest and best" use. Farmland used in agricultural production which might be more valuable for residential subdivision purposes would be valued for tax purposes not as farmland, but as higher value residential subdivision land. Fair market value traditionally has been defined as the value upon which estate taxes of real property, stocks and bonds and other property is calculated at death. It is established on values owned at death or, alternatively, on the value of the property 6 months thereafter. Federal regulations define fair market value as the price at which property will change hands in a reasonable time between a willing buyer and a willing seller, neither being under compulsion to buy or sell, and both having reasonable knowledge of the facts.

Recognizing the unfairness of this old law, Congress passed some complex new provisions designed to give the land-owning farmer and small businessman a break. This break allows a reduction of the gross estate, in an amount not to exceed $500,000 in reduced estate values, for those dying after December 31, 1976, provided certain conditions are met. The purpose of the law is to allow real estate devoted

to farming and other closely held business interests to be valued on the basis of actual use rather than "best" use.

The qualifications detailed in the law established the following conditions:

1. On the date of the decedent's death the property must be in use for a "qualified use" — as a farm for farming purposes or in a trade or business other than farming.
2. The fair market value in the estate of the qualified farm or closely held business assets, including both real and personal property (less debts owing against the property), must equal at least 50 percent of the decedent's gross estate less any debts owing against the gross estate.
3. At least 25 percent of the gross estate at its fair market value (less debts and unpaid mortgages on all property in the gross estate) must be qualified farm or closely held business real property.
4. Such property must pass to a "qualified heir" such as a member of the decedent's family — including his ancestor or lineal descendant, a lineal descendant of a grandparent of the decedent, his spouse or the spouse of any such descendant.
5. The real property must have been owned by the decedent or a member of his family and used as a farm or in a closely held business for an aggregate of 5 years or more of the 8-year period ending on the date of the decedent's death.
6. During the period referred to in the previous condition, there must have been material participation in the operation of the farm or other business by the decedent or a member of his family.

If the above conditions are met and the farm qualifies, the executor or administrator may elect to have its value determined in accordance with the following formula set out in the tax laws.

FORMULA TO DETERMINE ALTERNATIVE VALUE

5 Year		5 Year		5 Year
Average annual gross cash rental for comparable land used for farming purposes and located in the locality of such farm	LESS:	Average annual state and local real estate taxes for such comparable land	÷	Average annual effective interest rate for all new Federal Land Bank loans

EXAMPLE:

- Assume 500 qualified farming acres having a fair market value of $1,000 per acre. ($500,000.00)
- Assume a gross cash rental value of $25 per acre ($12,500.00)
- Assume average annual state and local real estate taxes of $1,500.00
- Further assume the interest rate for new Federal Land Bank loans is 8%

The value of the farmland by formula would be:

($12,500 − $1,500) ÷ .08 = $137,500.00

This tract of land was valued in the estate at a reduced value of $137,500.00, or $362,500.00 below fair market value, which represents a substantial tax saving to the estate.

If no comparable land exists from which the average annual gross cash rental may be determined, or if the executor elects to have the farm valued in the same manner as a qualifying closely held business, then the executor should choose from one of the methods below in arriving at value:

1. Capitalization of income over a reasonable period of time;
2. Capitalization of the fair rental value;
3. Assessed values for ad valorem taxes in states which provide a differential or use value assessment on agricultural land.
4. Comparable sales of other land or businesses far enough from an urban area where nonagricultural use is not a significant factor in sales price; or
5. Any other factor which fairly determines the farm or closely held business value of the property.

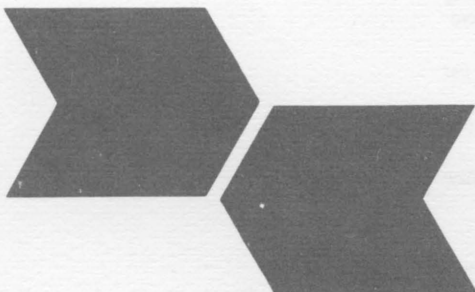
Estates having farming interests in either partnership or corporate forms can qualify for these special valuation provisions.

A farm or other closely held business may become subject to an additional estate tax to be imposed within 15 years, if, after a decedent's death and before the death of a qualified heir, the qualified heir disposes of any interest in the property or ceases to use it in the manner contemplated at the time the property qualified for special tax treatment.

A full recapture of the tax benefits achieved will be made if there is a conversion from a qualified use by the qualified heir. The recapture tax will be less if it is triggered by an unqualified use in the 11th to 15th year following the decedent's death. The tax is reduced 20 percent per year beginning in the 11th year.

Individuals who plan to purchase real estate from qualified heirs should know that there is a special federal tax lien on the land for 15 years in those cases where an executor has elected to obtain a special property value.

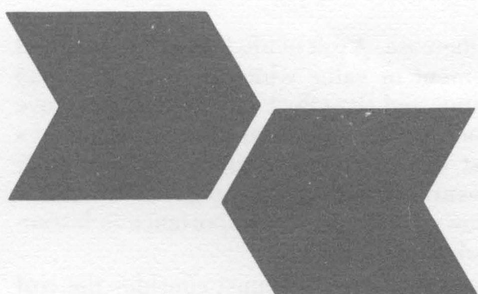
This provision of the law is so complex that families in agricultural production will need to plan carefully to achieve this special benefit in value, and plan to see that it is not lost once it has been achieved.



DEFERRING TAX PAYMENTS

In an effort to prevent forced sales in those estates whose assets might be non-liquid or not readily marketable, the new law expands the former rules on tax deferral. Formerly, payment of estate taxes could be deferred for reasonable periods up to 10 years if payment was found to cause "undue hardship." Under the new law, payment may continue to be deferred if there is "reasonable cause." The test for this deferral privilege which existed under prior law also has been eased somewhat. This deferral was available in those estates where 35 percent of the gross and 50 percent of the taxable estate was attributable to a closely held business operation. The time period for tax payments has been extended to 15 years where the value of closely held assets make up at least 65 percent of the adjusted gross estate. It is now possible to defer the first installment payment date for up to 5 years. In addition, interest on the tax attributable to the first $1 million in qualifying farm or business property, if deferred, qualifies for a new low rate of 4 percent. Interest on taxes in excess of $1 million will be at the higher regular rates.

Extensions of time to pay deficiencies in taxes will also be granted for "reasonable cause."



GIFTS

When and how can a person most economically give his estate to a preferential person? Every effective estate plan strives to answer these questions. Planning the distribution of one's property at or before death is the prime goal of estate planning.

An estate will be distributed at death, whether by will or otherwise. Whether or not one desires to establish a lifetime gift program for the benefit of loved ones and friends is something which must now be carefully considered in the light of the increased tax cost of giving under new provisions of the law. Gifts, as always, must be complete transfers with no strings retained by the donor. Anything that can be taken back is not a gift.

While many persons have made lifetime gifts with taxes in mind, there is a great, intangible satisfaction that flows from giving. This occurs when the donor sees the donee enjoying the benefits of a gift. For many, this reward far outweighs the tax cost or benefits connected with giving. Of course, gifts may sometimes be misused, and this factor must be considered in one's estate distribution plans.

In merging the estate and gift tax systems, several dramatic changes have occurred. The $30,000 tax free lifetime gift giving exemption which each donor formerly possessed has been repealed. The $3,000 per year per donee gift exclusion has, however, been retained. These gifts serve to reduce estate assets and are excluded from estate tax implications.

Heretofore, gifts made within 3 years of death were presumed to have been made in contemplation of death. The new rules effective January 1, 1977 include all such transfers in the gross estate, notwithstanding the donor's motives, and the presumption has been thereby effectively eliminated.

A change has been made in the manner in which the gift tax return is to be filed. Formerly, the law required a gift tax return to be filed by a donor after the end of the calendar quarter in which the gifts were made. No return was due on gifts having a value of $3,000 or less. On gifts in excess of $3,000 made in 1977 and thereafter, the tax return is no longer due on a quarterly basis unless taxable gifts for the quarter plus all other taxable gifts for the calendar year for which no return has been filed exceed $25,000.

The generous person may still give as many gifts having a value of $3,000 or less to as many different persons as he may desire within one calendar year, and no gift tax return is due on any of these gifts. These gifts continue to be tax free. However, if at any time an aggregate of taxable gifts (those above $3,000) exceeds $25,000, a quarterly return must be filed. For an aggregate of taxable giving in one year under $25,000, a donor must file an annual return.

As under former law, each spouse enjoys the $3,000 per year per donee annual exclusion. Thus, two parents can still give a combined total of $6,000 tax free each year to *each* of their various children, grandchildren and other loved ones.

With that exception, however, lifetime giving under the new law has been discouraged, because gifts which were formerly taxed at rates equivalent to three-fourths of the old estate tax rates will now be taxed at new rates which make no distinction in when a transfer occurs. Lifetime gifts are now subject to a gift tax which is equivalent to the tax one would pay at death. While credits built into the gift tax law are used to lessen somewhat the rate of taxation due on a lifetime transfer, a gift tax paid now (allowed as a credit on one's estate tax) is in essence a pre-payment of one's estate taxes. Considering the cost of losing control over one's property in addition to an increased present tax cost of making a lifetime gift donors who decide to make lifetime gifts will most likely have motives for doing so other than saving taxes. Other donors might see some tax benefits in giving as a method of passing future appreciation in their holdings on to younger beneficiaries. On balance, however, the revision in the law has made gift giving a matter that family members must now, more than ever, carefully consider.

In gift giving, as always, personal and family objectives should be given foremost attention. Entering into various arrangements for tax avoidance purposes without proper assessment of long-range consequences may be disappointing, and may also create substantial personal hardships for survivors.

Deeding the farm to a child with a life interest retained by a parent or parents can trigger the full effect of the new gift tax provisions in the law. This should not be done without the advice of competent counsel.

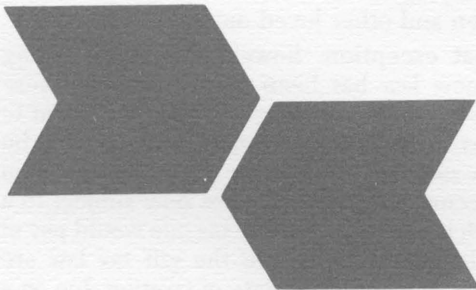
Some farm families have wondered about the parent selling the farm to a child for a nominal sum, or for an amount somewhat less than the fair market value of the land. The Internal Revenue Service regards such

transactions as gifts, subject to gift taxes, if applicable, on the difference between what the parent receives and the land's actual worth.

Before making an outright gift to a minor, be aware that such gifts can often force the creation of a guardianship proceeding in a probate court. This is often cumbersome, expensive and undesirable. Trusts are frequently used as means of avoiding guardianship. Your lawyer can create a trust that meets your specific needs, either in your will or in a separate instrument designed to have present effect.

One gift idea has gained increased significance under the new laws. Making gifts of life insurance policies may increase. A gift of life insurance is the gift of its replacement or value which is much less than the face amount, and the effect can still be to remove insurance proceeds (face amount) from the estate at a lesser tax cost while one is still alive. The flexibility which life insurance has always enjoyed in estate planning is now of even greater importance in lessening the cost of estate transfer.

It is obvious that a person must consider the cost of giving. These costs vary according to the personal financial situation. The assistance of a professional equipped to give knowledgeable counsel and guidance is essential.



PRIVATE ANNUITIES

Another device worth considering in shaping an estate plan is an arrangement called a private annuity. A private annuity is a contract between the owner of property and another, usually a younger member of the family.

In the private annuity arrangement, the property owner transfers his property to another in exchange for periodic payments of specified sums for the remainder of his life. The payments are calculated by using Internal Revenue Service mortality tables which take into consideration the owner's health and life expectancy. The transfer in this instance is permanent and cannot be revoked. If the property involved is of sufficient value, the transfer would be considered a sale rather than a gift, thus avoiding the tax consequences of giving under current law.

As in any kind of estate planning, there are advantages and disadvantages to this type of arrangement.

Factors generally thought to be advantages of the private annuity are:

- Since the transferred property is removed from the owner's estate without loss of economic benefit during his life, some estate taxes are saved. The annuity payments usually end at death. These payments would be taxed at death only to the extent that they had been allowed to accumulate either as savings or placed in some other type of investment.
- Properly arranged, the private annuity is a sale and not a gift. The fair market value needs to be determined by an independent appraisal.
- The transfer may be partly a gift, as the parties may agree. The annuity tables presume the owner is in average health. If the owner is, in fact, in poor health, a gift will be presumed.
- Long term capital gain spreading is achieved. The gain is measured on the difference between the owner's cost and the value of the annuity payments he is receiving.
- Future appreciation of the property is passed to subsequent generations.

There are also disadvantages to the private annuity:

- If the owner lives beyond his life expectancy, the payment obligation of those who received the property may result in payments in excess of its actual value.
- If a lien is retained by the owner to guarantee the periodic payment, then its value would not be excluded from his gross estate for estate tax purposes. (This would seem to defeat one major reason for entering into the arrangement.)
- If the transferee should die before the owner, the transferee's estate must continue to make the

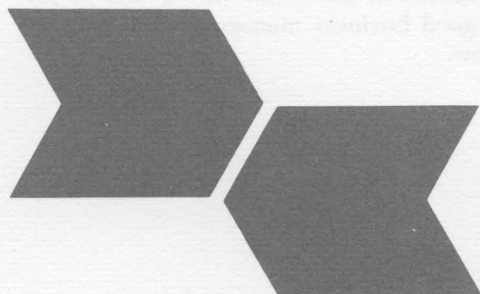
periodic payments. (Life insurance on the transferee can easily protect against this risk.)

- If the transferee holds the property until the owner's death, the transferee's basis in the property will be the annuity payments made.
- For the owner, each annuity payment is part return of basis, part capital gain and part ordinary income. This should be computed in each particular case before a contract is made.
- If the property transferred depreciates in value, the annuity would not be helpful to the owner's estate. (The annuity received might exceed the lessened value of the property transferred.)

From the pros and cons detailed above, it can be seen that the private annuity arrangement may be either desirable or undesirable, depending on the individual circumstances.

When considering the private annuity, one must recognize that the younger the owner, the longer the transferee probably will have to make payments in lower amounts. A transferor with a short life expectancy might discover that the installments are greater than the transferee can pay.

Certainly this arrangement should not be entered into without competent advice from one's family estate planner.



TRUSTS

How can a gift or transfer be made so that sound judgment governs its use? Trusts offer a way to achieve wise, long-range and short-range disposition to an estate owner's descendants. A trust can be as flexible or as rigid as the estate owner desires. Trusts are the estate planner's most versatile tools.

A trust is an agreement between the maker and the trustee whereby the maker delivers property to the trustee to hold and use as the maker has directed for the maker's benefit or for the benefit of third parties. The right to benefit from property is separated from the right to exercise control over it by means of a trust. A trust is often the only or best method of accomplishing a variety of objectives.

In establishing a trust, the maker can retain the right to later change or amend the trust agreement. This type of trust is a "revocable" trust. An irrevocable trust is one in which the maker gives up all right to alter the agreement. Trusts can be created in a will, and while they are revocable in a will during life, they become irrevocable at death.

A trust provides numerous benefits. It can:

- Obtain various tax benefits;
- Assure proper management of estate property;
- Arrange preferred distributions to beneficiaries during life and at death;
- Postpone delivery of gifts;
- Create a regular source of income during life for the maker; and
- Give a gift to charity.

Ways to devise a trust are limitless. Some of the more common types include the "inter vivos" or "living" trust, the insurance trust and differing types of income and gift trusts.

An "inter vivos" trust or living trust is created during life. Certain types of revocable living trusts are proclaimed as surefire ways of avoiding the costs and delays of probate court. In such a trust, when the maker dies a pre-arranged distribution plan becomes operative, and the estate property does not have to pass through probate court channels.

On trusts created before September 8, 1976, if the deceased person maintained any degree of control over the principal, then the property in a trust was considered property which the deceased owned at death and was subject to tax. Trusts which placed the property effectively beyond the reach of the maker and which were irrevocable generally accomplished the purpose of avoiding estate taxes.

Under the new law, such transfers are now includable in the gross estate as gift transfers. The decision to create a trust now, more than ever, requires con-

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sultation with competent counsel.

A life insurance trust is created by life insurance proceeds paid at death. The purpose of this trust is to protect a surviving spouse from a windfall of insurance money if the spouse might not be able to manage it wisely. This type of trust defers the delivery of insurance proceeds so that the money might serve the purchaser's original purposes.

Since a trust is as flexible as the human mind, it is possible to create arrangements that provide income and security for as long as one lives. All tax factors in these arrangements must be determined in each individual situation. A tax consultant is the best source of advice on a particular case.

The danger in creating a trust occurs when one ties up assets too tightly. To be straightjacketed in a rigid trust situation can be unpleasant and unwise. The amount committed to a trust arrangement is a financial decision made in light of one's resources and consistent with sound business practices.

Who shall act as trustee? The best trustee is a trustworthy individual or organization. A trust will never fail for lack of a trustee, but most trusts provide for successor trustees when the originally designated trustee fails to serve. If no substitute is designated, a court will name a trustee. This may be an unsatisfactory arrangement when a trustee is required to exercise a great deal of discretion.

A corporate trustee, like a corporate executor, offers the estate owner experienced management, solvency and continuity. While these are worthy benefits, appointing an individual trustee may prove highly satisfactory.

There are lawful methods of minimizing taxes and other costs. Prudent use of gifts and trusts may represent a solution to estate planning problems. Estate planning may not eliminate all costs or taxes due in a particular estate, but it is exceedingly preferable to inaction in planning financial matters. Estate planning pays big dividends to the estate owner and to survivors. It is good business management to consider the future now.

CREDITS

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