Nautilus Navigator

Charting Your Financial Future

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Estate Planning

Basics of lifetime gifts.

Many Americans make gifts to their children and other family members for a variety of reasons. Although such gifts are most often made out of a sense of love and caring, lifetime gifts may also have a practical purpose, such as estate planning or to observe how a donee will handle money. Accordingly, the donor can help the recipient learn sound money or business management skills. Making lifetime gifts often requires careful planning in light of gift and estate taxes.

Federal gift tax return.

A donor must file a federal gift tax return for any year in which the donor makes a taxable gift. However, not all gifts are taxable for federal gift tax purposes.

For example, the Internal Revenue Code excludes the following forms of gifts from a donor's taxable gifts: (1) "annual exclusion" gifts under IRC Section 2503(b); and (2) direct payment of qualified educational and medical expenses under IRC Section 2503(e).

Annual exclusion gifts.

A donor can give an inflation-adjusted "annual exclusion" amount (currently $14,000) to an unlimited number of donees without gift taxes. Through "gift splitting," both spouses can use their annual exclusions for a donee, even if only one spouse actually transfers property.

Only gifts of a "present interest" are eligible for the annual exclusion. Gifts of a "future interest" are ineligible. If a recipient receives a gift with no strings attached, the gift is of a present interest. Generally, if there are conditions on the gift or if there is a delay in the enjoyment of the gift, the gift is a future interest gift. A gift to a trust is a gift of a present interest only if it meets certain conditions, such as:

Right to income: If a grantor creates a trust and gives a beneficiary a right to income, the gift of the income interest may qualify for the annual exclusion. The value of the gift will be the actuarial value of the income interest based on the term of the income interest, the size of the gift, and the prevailing interest rates.

However, if the property transferred is not income producing, the IRS may argue that, for annual exclusion purposes, the value of the income interest cannot be measured, or is zero.

Withdrawal rights: A gift to a trust is a gift of a present interest to the extent the beneficiary has a right to withdraw the gift. Named after the case that first established this rule of law, the right to withdraw a gift to a trust is sometimes called a "Crummey right," and the trust a "Crummey trust." The IRS has agreed to the principle of the Crummey case, but imposes several requirements for a Crummey right to be effective. First, the trustee beneficiary should have actual notice of the contribution and his or her withdrawal right. In addition, the beneficiary must have a reasonable amount of time to exercise the right before it lapses. Although there is no set number of days that qualifies as reasonable, the IRS has approved a withdrawal period as short as 30 days.

Minor's trusts: A gift to a trust for the benefit of a minor under age 21 can qualify as a gift of a present interest (and thus qualify for the annual exclusion) even without Crummey rights. The trust must either distribute income to the minor at least annually [as in a so-called "2503(b) Trust," referring to that section of the Code] or distribute principal to the beneficiary upon attainment of age 21 [as in a "2503(c) Trust"].

Gifts for educational and medical expenses.

Direct payment to the provider of qualified educational or medical expenses on behalf of another does not constitute a taxable gift. The definition of educational expenses only includes tuition paid directly to the educational institution, not room and board, books, etc. For medical expenses, IRS regulations describe exactly what types qualify as expenses for medical care.

Applicable exclusion amount.

The "unified credit" allows a donor to avoid tax on a certain amount of gifts during life and transfers at death. After computing the tax on gifts in excess of a donor's annual exclusions, the donor can reduce or eliminate any gift tax due by the amount of any remaining unified credit. At death, the executor of the decedent's estate will then reduce the amount of estate tax due by any unified credit not used during the donor's life.

The amount of assets the credit effectively exempts from federal gift and estate tax is the "applicable exclusion amount." A taxpayer's applicable exclusion amount for federal gift and estate tax purposes is $5,450,000 in 2016.

The importance of life insurance in planning for a population with increased longevity.

By Patricia M. Annino, Esquire

Part two of a two-part discussion in a special guest author series provided by The Nautilus Group®.

In this article, noted Boston attorney Patricia Annino takes a detailed look at the increased role life insurance plays in planning for a population with increased longevity.

In this final segment, Annino addresses inheritance protection as it relates to covering the risk of divorce, funding a grandchild's inheritance by buying insurance on your child, and protecting the quality of life for your siblings and your generation.

In part one of this article (see the Nautilus Navigator, Volume 6, Issue 1), she discussed the dual purpose of cash flow security and protecting one's inheritance, planning for couples in second marriages, and how to protect an inheritance from the risk of asset depletion due to long term care costs.

In an era of increased longevity, life insurance has an increased role in overall planning. As advisors, we are in a unique position to influence planning that spans those generations. This discussion explores some of the reasons why deciding to purchase life insurance remains an important part of planning for multiple generations.

Inheritance protection: Covering the risk of divorce.

People are getting re-married much later in life. Seventy-five is the new 35. With marriage comes the possibility of divorce. For many Americans, divorce—especially in older years—is a bigger threat to cash flow and net worth dissolution than estate taxes. An alimony order or property division can strike later in life and destroy an individual's retirement plan and the plan to pass assets on to children. Multiple marriages (due to increased life spans) can lead to multiple divorces, and without adequate planning such as strong pre- or post-nuptial agreements, to the slicing of net worth and the abolishment of well-made plans. Life insurance to ensure the children will receive an inheritance, paid for over time during one's earning years, can be a safety net. Life insurance in an irrevocable trust payable to the children cannot be compelled in a divorce action to be paid to a spouse, as the parent does not own it.

Funding a grandchild's inheritance by buying insurance on your child.

Buying life insurance on a child's life for his/her children is a way to generationally plan. Traditionally parents have thought about and purchased life insurance on an adult child's life when that adult child has young children. It is a wonderful way to protect the adult child's family and make sure if the adult child/parent dies, there will be sufficient assets to care for his or her children's tuition, housing and related expenses. The ownership of the life insurance on the adult child's life can be the adult child, or an irrevocable trust for the benefit of his/her family.

Utilizing an irrevocable life insurance trust to remove the proceeds from the adult child's estate can be beneficial if the parents want to control the disposition of the proceeds (to the adult child's spouse and issue) but not have the proceeds go outright to their child's spouse or young children. Annual gifting to the trust can be very cost effective, especially if the policy is purchased while the adult child is young and insurable. Since the parents are purchasing, it is likely the insurance will be permanent rather than term. Should the adult child live to life expectancy, this life insurance can be "repurposed" for estate taxes or any other traditional life insurance strategy. Paying for the premium is an ongoing gift to the adult child and is much more leveraged and financially powerful than gifting $14,000 outright, which would in all likelihood be spent each year. This is a plan for the future sustainability of the family.

An indirect benefit of this planning process is that if the adult child does die while the children are young and the young family does not have enough assets, the parents may very well

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have to step in and help financially. This can complicate the relationship between the parents and daughter- or son-in-law as the parents may feel they should contribute funds but want to have an awareness as to how they are spent. Taking this issue off the table in advance by annual funding of life insurance on the adult child's life has the additional benefit of taking the financial component of the relationship off the table.

As the population will continue to age and the adult child may be grown up with adult children of his or her own, funding a life insurance policy on the adult child's life serves other purposes. It helps the child who is the parent guarantee his or her children an inheritance at affordable rates. It also provides the traditional cushion of wealth replacement, mortgage payoff and regular family needs if the child/parent dies before his or her time. If the "price is right" that insurance can be permanent so that if the child lives to life expectancy, any estate taxes have already been taken care of. With an increased longevity, it is increasingly possible that an adult child in his or her 60s or 70s could predecease his or her parent. This planning strategy covers that risk, as well as the risk that the adult child survives the parent, but the parent does not have a significant inheritance left. In essence it builds up what the adult child can pass to his or her children in case the inheritance the child receives is significantly diminished by the cost of the parent's long term care.

From a planning perspective, thinking about this should expand past parents funding life insurance on an adult child's life to a grandparent funding life insurance on an adult grandchild's life. With increased longevity, it is important to think about planning across the generations. Even if the grandparent does not live long enough to fully fund a policy with annual exclusion gifts, the payment of the premiums for a period of time puts an important planning mechanism in place and jump starts the premium payments, taking pressure off the adult child's own financial obligation.

When a family that spans generations thinks of planning as part of its DNA, it strengthens the bonds that already exist.

Protecting the quality of life for your siblings and your generation.

Recently, for the first time in my practice, a couple in their late 50s with no children came into my office with an estate planning objective of putting a family safety net in place for the care of their siblings. Many times couples without children have come into my office asking for a plan to educate nieces and nephews; this plan was different in that it was intended to benefit those at the same generational level. The couple explained to me that they had concerns about making sure each sibling was able to live their lives and have the medical and custodial care they needed. While alive, they would help them. At death they wanted a safety net trust for that entire generation, a spray trust that would end when the last sibling died and then pass equally to nieces and nephews. They explained to me that not only would this ensure the siblings' care issues were taken care of, it also would provide a safety net for the education expenses of the next generation. Looking at planning across generational levels is increasingly important.

In sum, the probability of increased longevity and possibility of diminished physical or mental capacity means that as advisors, we must look at planning through different lenses than we have used over the past decades.

All of the old planning concerns and techniques still matter and should remain part of the planning process, however addressing those concerns is no longer sufficient. Expanding our thinking to include the new risks and concerns that clients face must be an essential part of today's planning strategies.

Patricia M. Annino, Esquire

Patricia is a nationally recognized authority on estate planning. She is a partner in the Boston law firm of Prince Lobel Tye LLP, where she chairs the firm's Estate Planning and Tax Group and is a member of the firm's Media and Intellectual Property Group. She represents high net worth families, the owners of closely held businesses, authors, artists, and musicians in estate planning and probate matters. Patricia is the author of three books, including "Women & Money, A Practical Guide to Estate Planning," which was recommended reading in the Wall Street Journal, as well as a number of articles and treatises. She has been voted by her peers as one of the Best Lawyers in America (trust and estates), a SuperLawyer and a Top 50 Massachusetts SuperLawyer. She is a Fellow of the American College of Trust and Estates Counsel (ACTEC).

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Business Planning

Taxation of qualified small business stock and built-in gains.

The Protecting Americans from Tax Hikes ("PATH") Act of 2015, signed into law in December 2015, permanently extended many previously expired but popular tax benefits, one of which is the 100% exclusion of capital gains for Qualified Small Business Stock ("QSBS") under Section 1202 of the Internal Revenue Code.

Another is the permanent reduction to 5 years of the built-in gains tax applicable under Internal Revenue Code Section 1374 following the conversion of a C corporation to an S corporation.

Qualified small business stock gain exclusion.

Benefits. The permanent extension of this provision can greatly benefit investors and entrepreneurs alike, especially in light of the increase of the maximum long-term capital gains rate from 15 percent to 20 percent. In addition to the 100 percent exclusion of capital gains, QSBS gain may be excluded for federal alternative minimum tax purposes as well. Moreover, QSBS gain that qualifies for the exclusion may additionally escape the 3.8 percent Medicare tax.

Taxpayer criteria. To qualify for the QSBS gain exclusion, the holder of the stock must not be a corporation. Only individuals and certain pass-through entities may qualify. The holder of the stock also must have acquired the stock at original issuance and have held it for at least 5 years. The taxpayer must also have acquired the QSBS after September 27, 2010, to qualify for the 100 percent capital gain exclusion. A reduced 50 percent or 75 percent exclusion may be available for stock acquired between August 10, 1993, and September 27, 2010, depending on the particular acquisition date.

Qualified small business stock. For a company's stock to qualify for the QSBS gain exclusion, the company must be a C corporation. The corporation must also be an "active business," meaning that at least 80 percent (by value) of the assets of the corporation must be used in the active conduct of one or more "qualified trades or businesses."

A qualified trade or business means any trade or business other than (i) any trade or businesses involving the performance of services in the fields of health, law, engineering, architecture, accounting, performing arts, financial services, brokerage services, etc. and any other trade or business where the principal assets of such trade or business is the reputation or skill of one or more of its employees; (ii) banking, insurance, financing, leasing, investing or similar businesses; (iii) any farming business; (iv) any business involving the production or extraction of certain products; and (v) any business operating a hotel, motel, restaurant or similar business. The corporation must also be a "qualified small business" with aggregate gross assets not in excess of $50 million (generally measured by reference to the tax basis of the corporation's assets). When determining aggregate gross assets, members of the same parent-subsidiary controlled group are aggregated.

Finally, certain stock redemptions (i.e., the purchase by the corporation of its own stock) may also disqualify the corporation's stock from QSBS treatment.

Reduced holding period for the built-in gains tax.

The PATH Act also permanently reduced to 5 years (instead of 10 years) the period for which an S corporation must hold assets following a conversion from a C corporation in order to avoid the "built-in gains" tax. The new 5-year recognition period is effective as of January 1st, 2015.

The built-in gains tax is a corporate-level tax on an S corporation that was formerly a C corporation (or received assets from a C corporation in a carryover basis transaction such as a tax-free reorganization) that disposes of assets with built-in gains that are attributable to the former C corporation. The built-in gains tax is imposed at the highest corporate tax rate (currently 35 percent) if the built-in gain is recognized during the holding period.

Conclusion.

Entrepreneurs, investors and their advisors should be aware of the newly permanent exclusion of gain on QSBS and the reduced holding period for the built-in gains tax. Proper planning before forming an entity or upon a liquidation event may greatly reduce the tax burden.

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