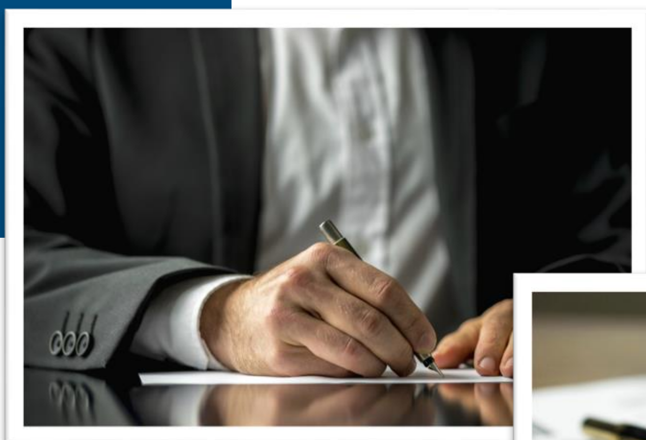
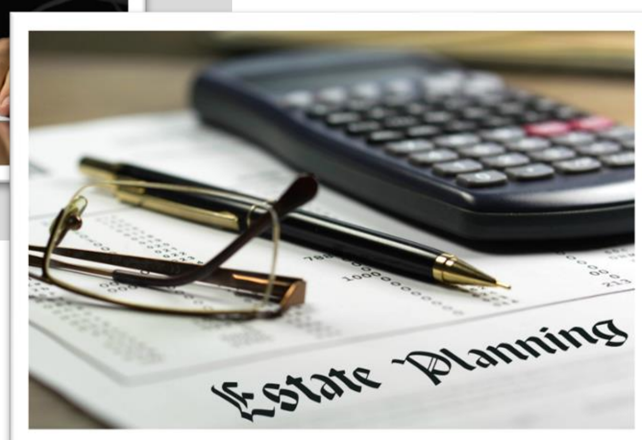
FEDERAL ESTATE AND GIFT TAXES, PENNSYLVANIA INHERITANCE TAXES AND MEASURES TO REDUCE THEM





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Even with the federal estate tax exemption at an historically high $5,450,000 (in 2016) and the estate tax rate at an historically low 40%, federal estate tax is no fun to pay. Neither is Pennsylvania inheritance tax, which has no exemption. This outline describes these taxes and the steps you can take to minimize or avoid them so that your assets pass to the beneficiaries you choose and not to the government.

Federal Estate and Gift Tax and Use of Applicable Exclusion Amount

1. TAX RATES

The federal estate and gift tax rate is calculated on a graduated rate table that reaches a maximum of 40%.

2. ESTATE AND GIFT TAX

These two taxes are cumulative. This means that the taxable gifts an individual makes during life are added to the value of that individual's taxable estate at death to determine the amount of federal estate tax due. Taxable gifts mean gifts which are not annual exclusion gift (*see* paragraph 19) and which do not qualify for the education or healthcare exclusion (*see* paragraph 22). *See also* paragraph 21.

3. APPLICABLE EXCLUSION AMOUNT

In 2016 there is a $5,450,000 exemption from federal estate and gift tax referred to as the "applicable exclusion amount." That amount is adjusted to inflation each year.

4. PORTABILITY

To the extent that the applicable exclusion amount is not consumed by the first spouse to die during life or by his or her estate at death it can be added to the applicable exclusion amount of the surviving spouse which means the combined exclusion can approach $11,000,000.

5. USE OF APPLICABLE EXCLUSION FOR THE MARRIED COUPLE

For estates under the applicable exclusion amount it may not be necessary to prepare an estate plan with the avoidance of the federal tax in mind. However, for estates of married individuals in excess of the applicable exclusion amount, good planning often requires preparing a will which will utilize the applicable exclusion available to each spouse and the federal estate tax marital deduction for any amount in excess of the amount sheltered by the applicable exclusion. Under the wills of a married couple with formula marital deduction provisions, upon the death of the first spouse to die, a portion of his or her estate equal to approximately the applicable exclusion amount will be held in a trust (such a trust has many names but will be referred to in this outline as a "non-marital trust"). A non-marital trust is normally for the sole benefit of the surviving spouse, although children or others can also be beneficiaries.

6. PENNSYLVANIA MARITAL TRUSTS

The advantage for Pennsylvania residents of making the spouse the sole beneficiary of the non-marital trust is that it will qualify for the Pennsylvania marital exemption (hereinafter a "Pennsylvania Marital Trust").

7. QTIP TRUSTS

Any balance of the estate of the first spouse to die in excess of the applicable exclusion amount will pass outright or in a marital deduction trust (either a general power of appointment trust or a qualified terminable interest property ("QTIP") trust) to or for the benefit of the surviving spouse.

8. NON-MARITAL TRUST

The property in the non-marital trust will not be subject to federal estate tax at the death of either spouse regardless of its value at the death of the surviving spouse. It will, however, be subject to Pennsylvania inheritance tax at the surviving spouse's death if: (i) it qualifies as a Pennsylvania Marital Trust in the estate of the first spouse to die; (ii) the surviving spouse is a Pennsylvania resident at the surviving spouse's death; and (iii) the executor of the will of the first spouse to die does not elect out of Pennsylvania Marital Trust treatment. If the non-marital trust does not qualify as a Pennsylvania Marital Trust or the executor of the will of the first spouse to die elects out of Pennsylvania Marital Trust treatment, Pennsylvania inheritance tax will be due at the first death but not at the second death. The election out of Pennsylvania Marital Trust treatment can be made for all or part of a sole use trust. *See also* paragraph 18.

9. DEFERRAL OF TAX

Because of the federal marital deduction, the marital portion of the estate of the first spouse to die (that is the portion in excess of the amount used to fund the non-marital trust) will not be subject to federal estate tax at the first death but will be subject to federal estate tax, to the extent not expended or sheltered by the surviving spouse's applicable exclusion amount (taking into account portability, *see* paragraph 4), at the second death. One exception is that to the extent the executor of the estate of the first spouse to die does not elect to qualify an otherwise qualifying trust as a QTIP trust, federal estate tax will be due at the first death.

10. DIVIDING ASSETS BETWEEN SPOUSES

There are many ways to design a marital deduction formula and in doing so the needs of the particular client and the transfer and income tax implications of the different formulas should be carefully reviewed. It is essential in using a formula provision to make sure as part of the estate planning process that to the extent possible each spouse has a separate estate in his or her own name with up to at least the applicable exclusion amount. If everything is held jointly, there will be nothing with which to fund the non-marital trust, and the applicable exclusion in the estate of the first spouse to die will be wasted as a result of which the tax will be increased at the second death.

11. WORD OF CAUTION CONCERNING DIVISION OF ASSETS

There are at least two potential downsides to dividing assets between spouses. First, until the death of the first spouse to die, under Pennsylvania law assets held jointly between the spouses are free of the claims of most creditors one spouse may have alone. Once the spouses divide the assets between them, any creditor which one of them may have alone can successfully make a claim against the assets in that spouse's separate name. In addition, once the spouses divide assets between them, they will each be free to dispose of their respective separate assets during life, or at death, in any way they choose, without the consent or knowledge of the other spouse. In the event of a disagreement between the spouses, or in the event of marital discord or divorce, the division of assets may create a problem.

Pennsylvania Inheritance Tax

12. RATE FOR SURVIVING SPOUSE

Transfers to a surviving spouse or a Pennsylvania Marital Trust for a surviving spouse are subject to Pennsylvania Inheritance Tax at the rate of 0%.

13. ANCESTORS AND DESCENDANTS

Transfers to grandparents, parents, lineal descendants and to the spouse of a living or deceased child are taxed at a rate of 4.5%, except that transfers from a child under the age of 21 to a parent are taxed at a rate of zero. Children include natural children, whether or not they have been adopted by others, and adopted children and stepchildren. Lineal descendants include children of natural parents and their descendants, whether or not they have been adopted by others, adopted descendants and their descendants, and step-children.

14. "COLLATERAL" BENEFICIARIES

Transfers to collateral beneficiaries are taxed at a rate of 15%, except that siblings are taxed at a rate of 12%. These beneficiaries include all beneficiaries other than a spouse and lineals and other than charitable organizations. A sibling is defined as "an individual who has at least one parent in common with the decedent, whether by blood or by adoption."

15. CHARITABLE AND EXEMPT ORGANIZATIONS

are not subject to Pennsylvania Inheritance Tax.

16. LIFE INSURANCE

and property which is joint between spouses is not subject to Pennsylvania Inheritance Tax.

17. TRANSFERS WITHIN ONE YEAR OF DEATH

are subject to Pennsylvania Inheritance Tax but there is a $3,000 exclusion per beneficiary per year.

18. SOLE USE TRUSTS

A trust which qualifies for the federal marital deduction will also qualify as a Pennsylvania Marital Trust. Therefore, unless the executor of the will of the first spouse to die elects out of Pennsylvania Marital Trust treatment, Pennsylvania inheritance tax will not be due at the first death but will be due at the second death if the surviving spouse dies a resident of Pennsylvania. In summary, both the Pennsylvania marital exemption and the federal marital deduction allow the executor of the will of the first spouse to die to prepay the death tax or to defer it until the second death. In the case of a Pennsylvania Marital Trust the executor "elects out" of marital exemption treatment. In the case of a QTIP trust, the executor "elects" QTIP treatment. If for Pennsylvania purposes the executor elects out of marital exemption treatment inheritance will be due on the value of the sole use trust minus the value of the surviving spouse's interest as determined actuarially.

Gifting Techniques

19. ANNUAL EXCLUSION GIFTS

Any individual can make an annual, outright gift of $14,000 (in 2016) to any individual and this gift is excluded from gift taxation and will not consume any applicable exclusion. Spouses can "split" their gifts so that one spouse can give up to $28,000 to any one or more individuals without gift tax consequences (provided the other spouse consents to the split and does not make his or her own gift to that individual). The $14,000 and $28,000 amounts are inflation-adjusted and these are the amounts that apply in 2016.

20. ANNUAL EXCLUSION GIFTS MUST BE OF A PRESENT INTEREST

This means the donee must have access to the funds, at least for a limited period of time as with a "Crummey Withdrawal Right". A Crummey Withdrawal Right is a right given to a beneficiary under a trust agreement to withdraw contributions to the trust for a limited period of time, after which the withdrawal right lapses. As long as the lapse of the power of withdrawal is in an amount equal to or less than the greater of $5,000 and 5% of the principal of the trust, the lapse is not a gift. Beneficiaries with withdrawals rights must be notified of those rights and that is done by the trustee sending a Crummey Notice to the beneficiary.

21. LIFETIME GIFTS TO UTILIZE APPLICABLE EXCLUSION

Taxable gifts in excess of the annual exclusion can be made that use up the applicable exclusion available to each individual. The benefit is that future appreciation of the gifted assets is removed from the estate. Cumulative gifts in excess of the annual exclusion, gifts for education and healthcare and the applicable exclusion, will be subject to the payment of gift tax.

22. PAYMENT OF MEDICAL OR EDUCATIONAL EXPENSES

Payment of medical or educational expenses on behalf of another individual (as long as the payments are made directly to the school, facility or institution providing the services) are exempt from gift taxation. The amount of the payments which are excluded is unlimited.

23. SECTION 529 EDUCATIONAL ACCOUNTS

These are educational savings plans offered by most states (you are not required to invest only in your state of residence) and managed by large financial institutions. An individual can contribute up to five years of annual exclusion gifts ($70,000) to a plan and allocate the exclusion over succeeding years (the value doubles to $140,000 if the gift is split by spouses). Appreciation grows tax-free and distributions are income tax-free when spent by the designated beneficiary for higher-education expenses.

Irrevocable Life Insurance Trust

24. GOALS

Remove face value of life insurance from estate. Allow funds to be utilized by the surviving spouse during his or her lifetime. Provide for estate tax-free distribution of assets to children upon death of surviving spouse.

25. USE OF NON-MARITAL TRUST-LIKE TRUST TO ACHIEVE GOALS

Ownership of life insurance policy(ies) is transferred to the trust. Cash or other property is contributed to the trust to purchase or pay premiums on life insurance policies.

26. OPERATION OF LIFE INSURANCE TRUST PRIOR TO DEATH OF INSURED

During year of initial funding and during any year in which additional contributions are made to the trust to pay premiums, up to $14,000 per beneficiary may be excluded from gift taxation (depending upon the value of other gifts made by the insured/donor during the same period). Upon each contribution to the Trust, a Crummey Notice is sent to the beneficiaries notifying them of their ability to withdraw certain property from the trust for a limited period (usually 30 days). Value of contributions for gift tax purposes is the cash surrender value of policies upon contribution or the value of the cash contributed to pay premiums, *not* the face value of the insurance. Since contributions to the trust are subject to gift taxation (but insured/donor unlikely to be required to pay gift tax due to annual exclusions and applicable exclusion), the eventual distributions of the insurance proceeds will not be subject to estate taxation upon termination of the trust.

27. OPERATION OF LIFE INSURANCE TRUST AFTER DEATH OF INSURED

During surviving spouse’s lifetime (if survivor is not the creator of the trust), he or she can receive all of the income earned by the trust. During surviving spouse’s lifetime, he or she can receive distributions in the discretion of the trustee for the health, support, maintenance or education of the surviving spouse and children. The surviving spouse is generally given a power to appoint the property by will to or among descendants to provide the survivor some flexibility to take changed circumstances into account (the "Be nice to Mom/Dad" clause). Upon the death of the surviving spouse, the property passes to the children free of federal estate tax. Depending upon the ages of the children at surviving spouse's death, the property either passes outright or in trust for the children's benefit.

Family Limited Partnerships and Limited Liability Companies

28. IN ORDER TO HELP REDUCE FEDERAL ESTATE TAXES IN A CLIENT'S ESTATE, THE CLIENT CAN ESTABLISH A FAMILY LIMITED PARTNERSHIP (AN "FLP") OR LIMITED LIABILITY COMPANY ("LLC")

and contribute real estate, real estate partnerships or LLCs or other business interests to it. The client is hereinafter sometimes referred to as the "funder" and an FLP or LLC is hereinafter sometimes referred to as the "entity."

29. GENERAL AND LIMITED PARTNERSHIP OR LLCS UNITS

Initially the client (and spouse) will be the sole 1% general partner and the 99% limited partner. Over the years the IRS has mounted successful attacks against FLP/LLCs where the funder of the FLP/LLC retains the power to make distributions from the FLP/LLC to the partners. To avoid this problem, someone other than the funder should be the GP or perhaps there can be two general partners, one who controls the timing and amount of distributions and one which has all other operational functions of a general partner. The general partner can be an LLC owned by the funder, but the LLC must be designed so that the funder does not control distributions.

30. STATE LAW

Often the FLP/LLC is established under the laws of Delaware, since the laws of that state are more favorable than are the laws of Pennsylvania (and many other states) in assuring relatively high valuation discounts of the types described below. *But see* Proposed Regulations to Internal Revenue Code Section 2704 issued August 2, 2016 (the "2704 Proposed Regulations").

31. GIFTING FLP/LLC UNITS

The client will make gifts of limited partnership units to children and grandchildren or great-grandchildren, or others (or to trusts for them).

32. LACK OF MARKETABILITY AND MINORITY INTEREST DISCOUNTS

The gift tax value of the FLP or LLC units will be determined by an appraiser. The value will take into account lack of marketability and minority interest discounts. Those discounts cause the gift tax value of a *pro rata* share of the FLP/LLC to be worth less than the same *pro rata* share of the business interests or real estate owned by the entity. The FLP/LLC would therefore enable the client to "leverage" his/her annual exclusions and federal estate and gift tax applicable exclusion amounts. Of course, the greater the discounts the greater the leveraging. Discounts for FLP/LLCs funded with real estate or business interests normally range from 20% to 35%. That determination is made by an appraiser. As a result of the discount, the estate tax savings can be dramatic. Also, any limited FLP/LLC units which are part of the client's estate when s/he dies will also receive minority interest and lack of marketability discounts for federal estate tax purposes. *But see* 2704 Proposed Regulations.

33. A U.S. GIFT TAX RETURN

will be due for each year that the funder makes a gift of FLP/LLC units. The returns are due on April 15th of the year following the year of the gift. **Returns reflecting gifts with valuation discounts are more likely to be audited by the IRS than are other returns.**

34. CONTRIBUTION TO FLP/LLC

The amount to be contributed to the FLP/LLC is up to the client, although it should be an amount which, estimating very conservatively, the client would not need to enable him/her to maintain his/her current and anticipated future life style.

35. GIFTS OF FLP UNITS

Presumably, each recipient of FLP/LLC units would receive each year FLP/LLC units valued at at least the annual exclusion amount. Sometimes it is recommended that the client give away each year, in addition to the annual exclusion amount, a portion of the applicable exclusion amount. As long as the client does not give away more than the applicable exclusion amount (plus annual exclusions) no gift tax will be due and, more importantly, the appreciation on the gifted property will be removed from the client's estate for federal estate tax purposes and will, in effect, be transferred to descendants on a transfer-tax free basis.

36. QUALIFYING FOR THE ANNUAL EXCLUSION

Case law requires that the donee has a present right to use the property gifted. In order to satisfy that requirement, some practitioners draft their FLP/LLC agreements to provide the partners or members with a Crummey Withdrawal Right, for period of 30 or 60 days, to withdrawal assets from the entity equal to the value of the FLP/LLC interest given. Other practitioners give the limited partner who receives the gifted units the right to "put" his or her FLP/LLC units to the entity for a limited period of time. Either of these techniques enables the donee to realize the value of the gifted units and should satisfy the present interest requirement.

Qualified Personal Residence Trusts

37. RETAINED RIGHT TO OCCUPY

Contribute personal residence to trust and retain right to occupy it for term of years.

38. DISTRIBUTION TO CHILDREN

At end of term, residence passes to beneficiaries.

39. RETAINED INTEREST

Value of gift to trust reduced by the value of donor's right to continue to occupy residence for term of years (retained interest). If the residence is worth $1,000,000 and in August 2016 a single 63 year old donor contributes it to a five-year qualified personal residence trust (QPRT) the value of the gift, which is required to be reported on a U.S. gift tax return, is $860,460.

40. INTEREST RATES

This technique is more powerful when interest rates are higher.

41. PRINCIPAL RESIDENCE EXCLUSION

If the residence transferred to the QPRT is the donor's principal residence, no loss of use of $250,000/500,000 exclusion from capital gains during the period of the retained interest.

42. TERMINATION OF RETAINED INTEREST

At end of period of the retained interest, the donor may lease or purchase the residence from beneficiary(ies) at fair market value, but there can be no agreement to that effect at the inception of the QPRT.

Grantor Retained Annuity Trusts

43. WHAT IS A GRAT?

A grantor retained annuity trust ("GRAT") is in effect a delayed gift. The GRAT is funded with assets from which the settlor (the creator of the trust) will receive a fixed-dollar payment for a period of years that the settlor is likely to survive. At the end of the GRAT term, the balance in the GRAT will pass to or in trust for descendants or other beneficiaries.

44. S CORPORATION SHAREHOLDER

Unlike many other types of trusts, a GRAT is an eligible S corporation shareholder.

45. BENEFIT OF A GRAT

As with all delayed gifts, the benefit of the GRAT is that the gift is considered made at the time that the settlor funds the GRAT. However, the value of the gift to the settlor's family is reduced by the value of the settlor's right to receive the annuity for the period of years. The IRS makes certain actuarial assumptions about how the value of that right is determined for gift tax purposes. As long as the asset which the settlor contributes to the GRAT appreciates at a rate faster than is assumed by the IRS, the "excess" appreciation will pass on to descendants estate and gift-tax-free. A GRAT can even be drafted so that the value of the gift is zero.

46. EXAMPLE FOR CLIENT MAKING GIFT TO GRAT IN AUGUST, 2016

If a client were to make a $2,000,000 gift to a GRAT in August, 2016 which pays the client an annuity of $148,751 per year for 15 years after which the GRAT passes to descendants, the value of the gift would be zero. If the term of the GRAT were reduced to 10 years and the payout were $148,751 per year, the value of the gift would be $620,899. While there is a back-flow of value to the settlor through the annuity payments, the appreciation in the assets contributed to the GRAT passes onto the settlor's descendants estate and gift-tax-free.

47. INTEREST RATES

This technique is more powerful when interest rates are lower.

48. CASCADING GRATS

A variation on GRATs are "cascading" GRATs. Cascading GRATs would minimize the risk of the Settlor's death prior to the end of the GRAT term. The Settlor would typically set up one of a series of cascading GRATs each year for a period of, for example, 5 years. The term of each GRAT would typically be two or three years and the payout rate would be relatively high – in August 2016 around 34% of the value of the Settlor's initial contribution to the GRAT. The GRATs established in years 2, 3, 4 and 5 (for example) would be funded with distributions from the prior year's GRATs.

49. BENEFIT OF CASCADING GRATS

The benefit of cascading GRATs over one GRAT with a longer term is that with a long-term GRAT, if the Settlor were to die prior to the end of the GRAT term (even just one day before the end of the term) 100% of the property remaining in the GRAT will be included in the Settlor's estate for federal estate tax purposes. With cascading GRATs, as to each GRAT, the Settlor need only survive the term of that GRAT. Thus, there is a hedge against premature death.

Charitable Remainder Unitrust Trusts

50. HOW DOES A CRUT WORK?

A charitable remainder unitrust ("CRUT") is a trust to which the settlor would contribute (typically low basis) securities. The trust would pay the settlor, for the settlor's lifetime, a fixed percentage of the value of the trust as re-valued each year. For example, if the trust were funded with $250,000 and were required to pay the settlor a 5% "unitrust amount" each year, in the first year the settlor would receive $12,500 from the trust. If at the end of the next year the trust were worth $275,000, the settlor would receive $13,750 from the CRUT. At the settlor's death, the trust principal would pass to a charity or charities designated by the settlor or by the trustees. The CRUT could alternatively continue for children for their lives (if they were old enough to pass the 10% test (*see* paragraph 53) when the CRUT is funded) and pass to charity at their deaths.

51. INCOME TAX CONSEQUENCES OF A CRUT

A CRUT does not pay tax on its ordinary income or capital gains. Rather, the settlor as the beneficiary, will pay income tax on the CRUT's income as, and to the extent that, unitrust payments are made to the settlor each year. During a year that the CRUT earns more than it is required to pay, the excess is accumulated within the CRUT without being subject to income tax in that year. For example, if the CRUT were to generate in a particular year a 10% return on its investments and were required to pay the settlor 7% of its value each year, the settlor would in most years pay tax on the 7% unitrust payment but the trust would not pay tax on the 3% which it earned but did not distribute to the settlor. The tax-free accumulation of funds within the CRUT is similar to the tax-deferral which makes an IRA so attractive.

52. CAPITAL GAINS

This tax benefit is enhanced in a situation where the CRUT is funded with low-basis securities which the CRUT sells right after it receives them. If the settlor were to sell the same securities without the CRUT, the settlor would have only the after-tax proceeds to invest. However, if these securities were contributed to a CRUT and the CRUT sold the securities shortly after receiving them, it would not pay the capital gains tax; rather, the settlor would pay it in annual increments as the capital gains were deemed "carried out" to the settlor as part of the unitrust payments each year. It is possible, depending upon the amount of the interest and dividends earned by the CRUT (which are deemed carried out to the settlor before the capital gain), that the settlor might end up never paying tax on all of the capital gain.

53. CHARITABLE INCOME TAX DEDUCTION

In funding the CRUT, the settlor would be entitled to an income tax charitable deduction equal to the actuarially-determined present value of the charity's "remainder" interest in the trust. That interest must be worth at least 10% of the value of the trust at inception.

Our Attorneys

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