Fundamentals of Estate Planning for Large Estates – Part 1

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Estate planning is the process of determining the size and extent of the estate, developing testamentary objectives such as who will be the heirs or beneficiaries of the estate, determining who is appointed to oversee and administrate the estate and its assets, and planning to reduce or eliminate estate taxes or gift taxes with respect to the estate.

The size and extent of the estate can be determined by means of an inventory of the assets and liabilities of the estate. A large part of this can be accomplished in the form of a detailed personal financial statement. In addition it may be necessary to include supplemental schedules for life insurance or other items not otherwise identified on the personal financial statement.

For tax purposes the size of the estate is the fair market value of all assets of the estate less any liabilities on the date of death (tax law allows an alternate valuation date that may be applied in certain cases). This value of the estate is referred to as the gross estate before any deductions or adjustments are made.

Testamentary objectives are expressed in the form of a Last Will and Testament (the Will). The Will should be a written document prepared by an attorney and properly signed and executed among witnesses who can testify if called upon that the person making the will had testamentary capacity (knew what he or she was signing) and signed of their own free volition.

In preparing a written will an attorney may also suggest that other documents be prepared and executed as part of the estate plan. These other documents typically include a Power of Attorney for Property and a Durable Power of Attorney for Health Care (in some states called an Advance Directive for Health Care). The Power of Attorney for Property names an agent that can make decisions and deal with property of the owner as though the agent were the owner. The Durable Power of Attorney for Health Care allows a named agent to make certain health care decisions for the Grantor of the health power, if the Grantor is unable to make those decisions themselves.

The Will can be changed, amended, or voided at any time during life so long as the testator has testamentary capacity. The will becomes irrevocable at death.

In addition to The Will, Power of Attorney, and Durable Power of Attorney for Health Care, there are other documents or contracts that may make up part of the estate plan. Other documents may include living trusts or testamentary trusts, Grantor trusts, irrevocable life insurance trusts, various charitable trusts, Dynasty trusts, a Qualified Personal Residence Trust, a private foundation, a family corporation or family partnership, or other documents designed to help with estate planning and reduction of estate and gift taxes. Contracts that impact estate planning include life insurance and annuity contracts, pension and retirement plans, deferred compensation arrangements, and various business agreements (including succession plans).

Current (2015) estate and gift tax law provides for a unified credit equivalent of $5.43 million per spouse. What this means is that individuals with less than $5.43 million at death will generally not owe any federal estate tax. Married couples with proper estate planning can shelter up to $10.86 million from estate tax by using their combined unified credits. This is important because the estate tax rate on large estates is as high as 40%, and is typically due 9 months after the date of death.

The estate tax law provides for portability of the unified credit. This means that if the first spouse to die does not use up all of their unified credit, then with proper planning the surviving spouse can use the remaining unified credit of the deceased spouse plus their own unified credit.

Without proper planning large estates can be devastated by the estate tax. For example, a $50 million estate without planning might be subject to estate taxes and other estate related costs in the range of $16 million to $20 million. With proper estate planning the estate tax can be significantly reduced and sometimes eliminated entirely.

How is it possible to greatly reduce or eliminate a large estate tax? A fundamental concept is that the government can't tax what you do not own. So to reduce the estate tax it is necessary to reduce the reportable size of the estate.

There are two primary ways to reduce the size of the estate. One is to implement a plan of giving away parts of the estate either to family members, other heirs or charity. The other way is to use various strategies that allow the application of valuation discounts to be applied to the estate.

It is also helpful to stay healthy and live a long time. Even though your estate may be growing each year, the longer you live, the more time you have to gift property away and utilize strategies that can significantly reduce the reportable size of your estate.

The estate and gift tax law has a gifting provision known as the annual exclusion. The 2015 annual exclusion allows you to gift up to $14,000 per year to any individual without incurring a gift tax. Each spouse has an annual exclusion amount so that with joint spousal gift splitting up to $28,000 per year can be given to each child, to each spouse of each child, to each grandchild or to other persons. Owners of large estates often find that by using the annual exclusion wisely and making annual gifts to many family members they transfer large amounts each year without any gift taxes.

In addition to the annual exclusion amount you are allowed simply by following a few requirements to gift an unlimited amount for qualified education expenses and medical expenses. Combining annual exclusion gifts with education gifts and medical expense gifts can transfer large sums over time without incurring estate or gift taxes.

You are also allowed to gift to charitable entities. Gifts to qualified charitable organizations made during life or at death are generally deductible and excludable from the estate. There exist sophisticated estate planning strategies that combine elements of charitable gifting with transfers of property to family members at very low transfer tax cost. Some of these strategies include the use of certain charitable trusts that benefit both charity and family members.

We have mentioned that you can reduce the size of your reportable estate by gifting away parts of the estate, and also by applying valuation discounts to reduce the reportable size of the estate. We have discussed basic gifting concepts such as using the annual exclusion to make gifts to family members and we also discussed making charitable gifts.

Valuation discounts are another way to significantly reduce the reportable size of an estate. A large estate usually will own assets that need to be appraised in order to determine value. Whenever property needs to be appraised there can be a range of values at which it might be appraised depending upon a number of facts and circumstances.

The valuation of property and use of valuation discounts provides a significant opportunity to save on estate taxes. Depending upon facts and circumstances valuation discounts can range from 10% to 40% or more, with 25% often being a typical discount.

The use of valuation discounts often involves establishing an entity that owns property to which a valuation discount can be applied. Family corporations and family partnerships are two such entities. A family corporation or family partnership can own stocks, bonds, real estate or other valuable assets. The estate tax law allows valuation discounts for family corporations and family partnerships because of lack of liquidity and marketability, lack of management and control, or other reasons. The use of valuation discounts is a sophisticated area of planning requiring expert legal advice, but the potential estate tax savings can be huge.

Let's consider estate planning for an individual with a $50 million dollar estate. How would it be possible to reduce the estate tax from about $20 million to zero?

Suppose the large estate owner set up a family corporation and transferred $40 million in property in the form of stocks, bonds, real estate and other assets to the family corporation. Then the estate owner set about gifting shares in the family corporation to other family members, i.e., sons, daughters, grandchildren and others and began a program of annual gifting of shares in the family corporation.

The appraised value of the family corporation is reduced by 25% because of valuation discounts for lack of liquidity and other reasons. What was valued at $40 million going in is now valued at $30 million because the assets are in a family corporation that is subject to a valuation discount.

The large estate owner and spouse make joint gifts of $10.86 million in stock in the family corporation to other family members outright or in trust and file gift tax returns on these gifts. By applying their unified credits there is little or no out-of-pocket gift tax to be paid.

After making these gifts the large estate owner still owns about $19 million in family corporation shares. He makes annual gifts of family corporation stock for many years applying the valuation discount on the annual gifts and thus leveraging the power of annual exclusion gifting. Over his remaining lifetime several million dollars of stock are transferred to family members without estate or gift tax cost. Whatever family corporation shares he still owns at death are transferred without estate tax to a family private foundation that is run by family members and trusted associates.

The large estate owner also pays tuition expenses and medical expenses for children, grandchildren and other family members. Over time these education and medical expenses may amount to hundreds of thousands of dollars that are removed from the estate tax free.

At the time of his death the large estate owner has transferred $20 million to family members during lifetime without paying estate or gift taxes. His estate at death is valued at $30 million. During life he decided that $20 million was enough to leave to his family and whatever he had over that amount he was going to gift to charity. At death he makes a gift of $30 million to charity, the bulk of which goes to the family private foundation. This gift to charity is deductible on his estate tax return, so that his taxable estate ends up being zero and he owes no estate taxes.

Without estate planning he might have owed the government $20 million in estate taxes, but because of expert counsel and advice he pays zero estate taxes, leaves to his family $20 million, and makes bequests of $30 million to the family private foundation and other charities. Members of the family run the private foundation where they endeavor to carry on the legacy of values they learned from their parents.

This is just an example of how a large estate owner might reduce estate taxes. Many of the estate planning strategies that are available are only hinted at in this example. With large estates it is common to find that trusts play a role in the estate planning. If you have a large estate and would like counsel on what steps you might take to reduce or eliminate estate taxes we invite you to call our office and set up an appointment.

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Sincerely,

George M Hiller Companies, LLC Investment Team

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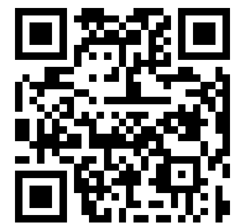

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