Insight on estate planning

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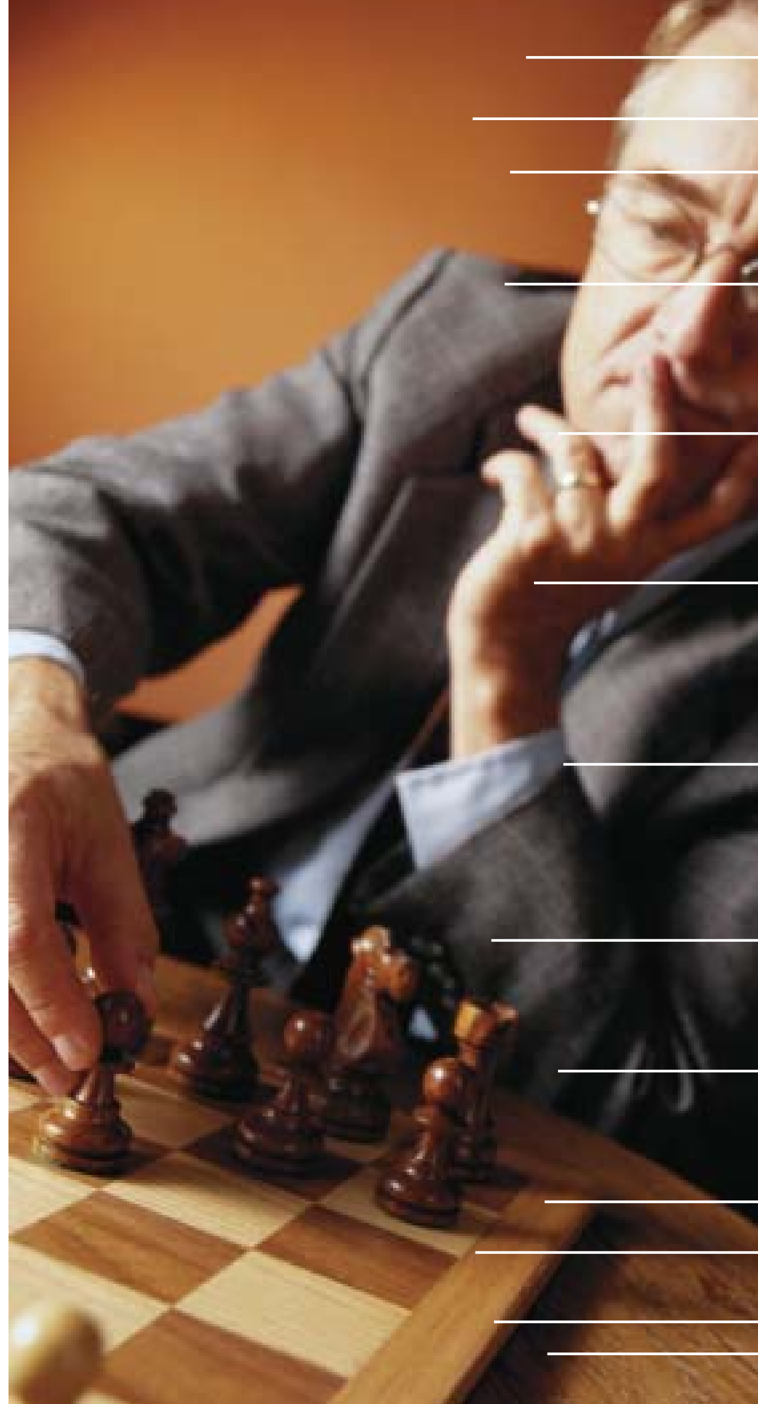

Like-kind exchanges

How to defer capital gains tax on investment-property sales

GRATs and GRUTs reduce gift tax, provide you income

Maintain liquidity with second-to-die insurance

PLUS!
Capital gains tax cuts and your estate plan

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Like-Kind Exchanges

How To Defer Capital Gains Tax on Investment-Property Sales

A like-kind exchange defers capital gains tax on the sale of an appreciated investment property by replacing it with a similar property. When you use the like-kind exchange technique in connection with estate planning, you and your heirs may be able to avoid the capital gains tax altogether.

How Does It Work?

Capital gains may seem less urgent since Congress lowered the tax rate earlier this year. The long-term capital gains tax is now 15% for people in the higher (25% to 35%) income tax brackets. But remember that the tax cut "sunsets" after 2008, when it returns to its previous maximum rate of 20%, unless Congress extends the cut. And even 15% of a large gain is a large dollar amount going to Uncle Sam rather than to you or your family.

So when selling business or investment property that has appreciated, consider the following two-step technique for erasing capital gains:

1. Structure the transaction as a like-kind exchange instead of an outright sale. That way, you can defer paying capital gains tax until you sell the replacement property.

2. When you die, the property will pass to your heirs, who will receive a basis adjustment to the property's fair market value as of the date of death (or alternate valuation date). In other words, if your heirs sell the property soon after your passing, there will be virtually no capital gains. If your heirs hold onto the property for a number of years before selling it, the basis for the gain will be the property's value on the day you died (or alternate valuation date), not its value on the day you acquired it. The estate tax is scheduled for repeal in 2010, and the step-up in basis will be limited. Unless Congress extends the repeal, though, both the tax and step-up in basis will return in 2011.

So why would you want to replace business or investment property that has appreciated, rather than simply leaving it to an heir? Perhaps the answer is because it no longer fits your risk profile or because you've fully depreciated it on your tax return.

Keep in mind that the like-kind exchange technique doesn't eliminate the estate tax. The replacement property is still included as part of your estate for federal estate tax purposes. However, if you use an additional strategy following the like-kind exchange, you may also minimize estate taxes. For example, you may contribute the replacement property to a family limited partnership and then transfer limited partnership interests (at a substantial discount for gift tax purposes) to your children, thereby removing the value of the replacement property from your estate. But be careful that the post-exchange contribution of the replacement property

doesn't jeopardize the qualified-use requirement (see below). Also, the partnership contribution may inadvertently trigger tax if your tax basis in the replacement property is less than the liabilities against the property.

What Are the Exchange Rules?

The rules governing like-kind exchanges can be complex, so let's look at a simplified version. Before you enter into a like-kind transaction, make sure you meet *all* of Section 1031's qualifications, or the IRS could try to "recapture" the capital gains tax you're attempting to defer.

Primarily real estate investors have used like-kind exchanges. But they're not limited to real property — they can include business property, such as machinery, equipment and vehicles, or even intangible property such as franchises and patents.

To qualify as a like-kind exchange under Section 1031, the transactions must involve properties traded and received for business or investment purposes (a "qualified use"), and held for a reason other than resale. Ineligible properties include residences, inventory, work in progress, intangibles such as securities or partnership interests, condemned property, and certificates of trust or beneficial interest.

How Are Properties Exchanged?

Using the word "exchange" might be misleading. After all, it implies that you trade properties simultaneously or as part of a single transaction. That's not necessarily true. You can sell the old property in the first transaction and, within a limited period, buy a replacement (known as a deferred exchange). (See "3 Rules for Deferred Exchanges" at right.)

Under most circumstances, you can't reverse the exchange; that is, you can't purchase the replacement property before you sell the old one. Doing so would disqualify the exchange. But, you can circumvent this restriction by using an "accommodation party" to buy and hold the replacement property until you sell the old one, or to buy the old property from you before you buy the new one. Exchanges between related parties or entities are disqualified or limited if either party intends to dispose of the property within two years.

What Does "Like-Kind" Mean?

The exchanged properties must be similar — you can trade real estate for real estate and equipment for equipment — but they don't have to be *exactly* the same type. For instance, you can trade raw land for an apartment building, a factory for an office building, or a lathe used to make furniture for a paint sprayer used in a furniture business.

3 Rules for Deferred Exchanges

Like-kind exchanges can be simultaneous or deferred, but the latter are now more common. In a simultaneous exchange, you simply trade property with another party. In a deferred exchange, you first sell your old property to another party, who gives the purchase money to a qualified intermediary. The intermediary then uses the cash to buy the replacement property and transfers it to you. To facilitate a deferred exchange, an intermediary uses escrow or trust funds.

Timing is as crucial in a deferred exchange as it is in comedy. To qualify for like-kind tax treatment, a deferred exchange must meet three conditions:

1. You must identify in writing to the intermediary, within 45 days of selling the old property, the replacement property you will receive.
2. You must possess the replacement property either by your tax return due date (including extensions) for the transfer year or within 180 days of selling the old property, whichever comes first.
3. You may not control the sale proceeds between the sale and purchase dates.

Make sure to discuss an intermediary's necessary qualifications and other requirements of Section 1031 before you attempt a deferred like-kind exchange.

In the intellectual property area, the nature and character of the rights involved, and of the underlying property to which the rights relate, must be similar. For example, you can exchange copyrights on screenplays, but you can't exchange a screenplay copyright for a song copyright.

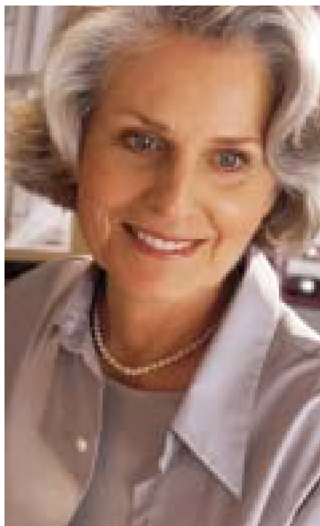
Exchanged properties don't have to be of equal value. If you trade up (the property you buy is worth more than the one you sell), the transaction qualifies. But trading down (you owe less on the newly acquired property than you owed on the old one) may cause partial capital gains recognition and taxable income. You can potentially avoid this by restructuring the debt before or after the exchange.

Where Do We Go From Here?

Properly structuring a like-kind exchange requires careful planning and attention to detail. If not done correctly, the IRS can disallow the deferral of capital gains tax, and you might be left without cash from the exchange to pay the tax. Nevertheless, like-kind exchanges provide significant tax-saving opportunities. ▮

GRATs and GRUTs Reduce Gift Tax, Provide You Income

Through vehicles such as grantor retained trusts, you can give large gifts of property at a relatively low tax cost and retain an income stream. Two types are grantor retained annuity trusts (GRATs) and grantor retained unitrusts (GRUTs), but they also present potential risks you should consider.



How GRATs and GRUTs Work

Grantor retained trusts are irrevocable trusts in which you, as the grantor (or creator of the trust), retain an income interest. You can use them to transfer income-producing assets to your children or other heirs without adverse estate tax consequences, discount the value of the assets for gift tax purposes, and continue receiving income from those assets during the term of the trust.

The term can be any number of years. You could use the income for support until you reach the age at which you begin taking distributions from retirement plans, such as an IRA or 401(k) plan. Or you could use GRATs and GRUTs for supplementary retirement income.

At the end of the term the trustee either distributes the assets outright to the beneficiary — completely tax-free — or continues to hold the assets in trust for the beneficiary, according to your wishes as spelled out in the trust document.

A grantor retained trust provides the greatest tax benefits when the trust assets appreciate quickly, as we'll discuss below. For that reason, it is important to transfer to the trust only those assets that you expect will appreciate significantly over the trust term. Such assets may include stock (especially stock in a closely held business that could go public during the trust term) or real estate.

GRATs vs. GRUTs

The main difference between a GRAT and a GRUT is how the payments to you are determined.

With a GRAT, you receive a fixed dollar amount each year, expressed as a percentage of the assets' value on the date you transferred them to the trust. The minimum annual payout is 5%. Thus, if you fund a 5%, 15-year GRAT with assets worth $500,000, you will receive $25,000 per year for 15 years.

The trustee must pay the annuity each year whether or not the assets actually generate income. If the assets don't earn sufficient income to pay the annuity, the trustee will use principal to make the required payment. Once the GRAT is initially funded, you may not make additional contributions to the trust.

In general, a GRAT works best for people who want to receive a fixed payout each year. This preserves the asset's appreciated value for your beneficiaries.

GRUTs are similar to GRATs, except you receive a fixed percentage of the trust assets' value as they're revalued each year. The minimum is 5%, and though the percentage doesn't change, the payout increases or decreases each year along with the assets' value. Unlike a GRAT, you may make one or more additional contributions to a GRUT.

A GRUT works best for people who depend on the trust income to meet living expenses and keep pace with inflation, because the yearly payouts increase as the assets' value increases.

Let's look at these trusts in action. If you fund a 5%, 15-year GRUT with assets initially worth $500,000, the trust will pay you $25,000 in the first year. If the assets' value increases in the second year to $510,000, the trust will pay you $25,500. But, if the value decreases to $490,000, that year's payment would be $24,500.

As grantor, you are taxed on all trust income, including any income earned by the trust but not distributed to you in satisfaction of your annuity or unitrust interest. Your payment of the income tax allows the trust assets to appreciate tax-free for the benefit of the beneficiaries. Also, because the trust is a grantor retained trust, any trust distribution of noncash assets in satisfaction of your annuity or unitrust interest is tax-free.

Both types of grantor retained trusts have one major disadvantage: If you die before the trust term's end, the assets are included in your estate for estate tax purposes. Therefore, your age and health should significantly factor into setting the term.

A GRAT works best for people who want to receive a fixed payout each year.

Determining the Gift Tax

When you transfer assets to a grantor retained trust, you're giving a gift to the beneficiary, so you must file a gift tax return for that year. Transfers to grantor retained trusts don't qualify for the $11,000 annual gift tax exclusion because they're not gifts of a "present interest." (That is, the beneficiary can't receive the gift until the end of the trust term.) But you can use your $1 million lifetime gift tax exemption.

How do you calculate the gift's value for tax purposes? Not surprisingly, the IRS dictates how this value is calculated, and it can get quite complex. To roughly estimate the tax, divide the trust into two components:

1. **The income stream (the annuity or unitrust payments to you throughout the term period).** To calculate the income stream's present value, you must discount the annual payments to you, using the Section 7520 rate, which the IRS publishes monthly on its Web site www.irs.gov.

2. **The remainder (the assets that remain in trust at the end of the term).** You must pay gift tax on the remainder's present value. You can calculate that by subtracting the *present* value of the total

income stream from the value of the assets on the day you transferred them to the trust.

The lower the Section 7520 rate, the higher the present value of the income stream is, meaning the present value of the remainder is lower. No matter how much the trust assets appreciate, another dime in gift tax will never be due on those assets. Of course, the greater the appreciation, the greater are your tax savings. Because the Section 7520 rate is tied to interest rates, which are currently the lowest they've been in decades, now may be a great time to consider a grantor retained trust.

Evaluating Your Options

If you wish to someday bestow income-producing assets to your children or other loved ones, but currently receive income from those assets, consider a GRAT or GRUT. A grantor retained trust may allow you to give more at a lower gift tax cost. ■

Capital Gains Tax Cuts and Your Estate Plan

Any time Congress passes a new tax law, you should review your estate plan. In fact, changes under the Jobs and Growth Tax Relief Reconciliation Act of 2003 may indirectly affect some of your estate planning strategies, even though the $350 billion tax cut package has no direct bearing on the gift, estate or generation-skipping transfer tax rates.

Over the next few years, at least one aspect of the 2003 act could impact your estate plan: cuts in the capital gains tax rates. The lower tax rates for income and dividends won't affect most people's estate plans significantly, but consult your tax advisor to be sure. For a rundown of the rate changes, see "Federal Tax Rate Cuts" below.

Federal Tax Rate Cuts

OLD TAX RATES	NEW TAX RATES
Ordinary Income*	
38.6%	35%
35%	33%
30%	28%
27%	25%
10% and 15%	No change
Long-Term Capital Gains**	
20%	15%
10%	5%
Dividends*	
38.6%	15%
35%	15%
30%	15%
27%	15%
10% and 15%	5%***

* New tax rates effective Jan. 1, 2003
** New tax rates effective May 6, 2003
*** 0% in 2008

Though tax issues (federal, state and local) shouldn't dictate your investment strategy, you may want to consider selling appreciated assets and taking long-term gains while the tax rates are low.

You may also want to gift highly appreciated stock up to the $11,000 annual exclusion amount ($22,000 for couples) to children age 14 and over. Assuming the child is in the 10% or 15% tax bracket, he or she can then sell the stock and pay only 5% tax on the gain (zero in 2008). Children under 14 will be taxed at their parents' marginal rate on unearned income exceeding $1,500 (as adjusted for inflation.)

Finally, some estate planning strategies are designed mainly to avoid or minimize capital gains tax. These include like-kind exchanges and donating highly appreciated assets to charity. Whether these methods continue to make sense for you depends on your financial situation and goals.

Maintain Liquidity With Second-To-Die Insurance

Mr. and Mrs. Smith have two grown children and a net worth of several million dollars. Even with an estate plan in place, they know that, after the death of the survivor of them, the survivor's estate will owe taxes unless the estate tax is repealed. But their assets are mostly illiquid, including a family business. When the time comes, where will their executor find the cash to pay the estate tax? Must the children sell the business to pay Uncle Sam?

Life insurance might be the Smiths' best solution to their liquidity issue. After the survivor dies, the executor can use the insurance proceeds to pay the estate tax. But instead of buying two individual policies, the Smiths may want to consider one second-to-die policy.

Two Advantages

Second-to-die insurance covers two lives jointly, and pays a benefit after the survivor dies. It's a viable option to individual life insurance because the insurance company spreads the risk over two lives instead of one; thus, the premiums typically are lower.

Second, a spouse, let's say, who can't qualify for individual life insurance may be insured under second-to-die insurance, provided the other spouse is healthy. But the premium might not be much lower than it would be for the healthy spouse alone.

Premium Payments

Before you purchase a second-to-die policy, plan how the premiums will be paid after the first spouse dies. If the deceased earned the income needed to pay premiums, the surviving spouse will require an income stream to continue paying them. You could add a rider to the second-to-die policy providing funds to pay the surviving spouse's premiums. Or you can buy second-to-die insurance in the form of a whole life policy (or term, universal life or variable life), which builds cash value that can later help to pay premiums.

Before committing, ask whether policy provisions, especially premium or cash value, will change after the first insured dies. Some policies increase premiums because the insurer's risk rises when only the surviving spouse's life is insured (risk is no longer spread over two lives).

Irrevocable Life Insurance Trust

If you or your spouse, or you two jointly, owns a second-to-die policy, the proceeds will be included in the surviving spouse's taxable estate. One choice is to hold the policy outside of the estate and avoid paying tax on the proceeds by acquiring the policy inside an irrevocable life insurance trust (ILIT). If an existing policy is transferred to an ILIT, that transfer must be more than three years before the surviving spouse's death to achieve the desired estate tax savings.

If the ILIT is properly structured, you and your spouse can make annual exclusion gifts (up to $22,000 times the number of trust beneficiaries) to the insurance trust, enabling it to pay premiums. Just remember that after the first spouse dies, only one exclusion gift of $11,000 (this amount is indexed for inflation and may be higher) times the number of beneficiaries will be available to pay premiums.

Comparative Analysis

To see whether second-to-die insurance would benefit your estate plan, you may need to apply for individual life insurance policies, compare coverage and premiums, and then determine whether a second-to-die policy makes sense. We're here to help. ∎

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Personal Legal Services Group

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