CPA Practice Advisor



Craig Smalley • Oct. 04, 2017


Most people think that estate planning is for the ultra-wealthy. However, everyone needs some basic form of estate planning in order to pass their assets to the intended beneficiaries. When you die, your estate goes through a probate process and in every state this process is a little different. The goal of estate planning is to minimize the effects of probate.

If you die intestate, that means there is no estate plan or even a basic will. In this case, the probate process kicks in so your creditors are notified and the hearing becomes public information. Anyone that thinks they have a claim to your estate can petition the Probate Court for what they believe is their share of the decedent's



it is commonly referred to. However, as of 2017, you must have assets that exceed $5.89 million to be subject to the estate tax. If you are married and elect portability (which is a special section of the Tax Code), then that allows the surviving spouse to use the unused portion of the deceased spouse's first estate tax exemption. Conceivably, with portability the surviving spouse could have an almost $11 million estate tax exemption. As a result, the estate tax for most people doesn't even come into play. But as we will discuss later in this paper, estate planning can go hand in hand with tax planning.

If you die as something called testate, that means you die without any estate plan or at the very least a will. Additionally, as was mentioned earlier, every estate goes through probate and even a will can be contested.

There are two ways that assets can pass at death. One is through an act of law, meaning that someone had a trust, which is legal document that passes the assets and is out of reach from probate court. The other way that assets can pass at death is through a will, which when made public, must go through the probate process. A will can be contested and be tied up in probate court for many years.

When planning for someone's estate and tax concerns are not evident, it is common to form a Revocable Living Trust (RLT). Revocable means that it can be changed, Living, because you are alive, and Trust meaning a legal document. There are three parties to a trust. The Grantor or Trustmaker, this is the person creating the trust. A Trustee is the person or entity that controls the assets. In a RLT the grantor is the Trustee until they die and a contingent Trustee is named. Then there are the Beneficiaries, the persons or entities that will inherit the assets of the trust.

In a trust, you can control how the assets of the trust are inherited. For instance, if a minor child is a Beneficiary of the trust, it is not uncommon to put an age limit on when they can inherit the assets. The assets earmarked to minors are just kept in the trust until the restrictions are met, and then the Trustee distributes the assets.



can't be changed. The trust then has to apply for an Employer Identification Number (EIN) with the IRS. The corpus isn't taxable, but any money that the trust makes after death is taxable to the beneficiaries. For instance, let's say that you put a brokerage account into the trust. If the securities earn dividends or capital gains, then the beneficiaries are taxed on the income of the corpus.

# Titling of Assets

The titling of assets is extremely important. In the trust document, you can list the assets that make up the trust, but in order for those assets to legally make up the corpus, they must be retitled to the trust.

Taking a trust out of the equation, you may be able to avoid an estate plan altogether if you title your assets right. Again, you need to check with state law because it varies from state to state. However, I am going to mention the most common ways to title assets along with the repercussions of each method.

First of all, you have Joint Tenants with the Right of Survivorship (JTWRS). This is commonly done with a husband and wife. If one spouse dies, the asset just passes to the surviving spouse.

Another way to title your assets is as Tenants in Common (TIC). This is generally done with an unmarried couple or friends. When one of the owners dies, the asset passes to the other person automatically.

The JTWRS and TIC are the most popular ways to title assets and more importantly, they both keep the assets out of probate court.

# Giving Money to Minor Children and



There are better ways to give children money today. One option is through an Irrevocable Trust. Irrevocable as I mentioned before, means that it can't be changed. Just like an RLT, there are the same three parties to the trust. However, in an Irrevocable Trust, it is common to put restrictions on the assets in the trust.

To start with, an Irrevocable Trust is a taxable entity. You must apply for an EIN from the IRS. The corpus of the trust isn't taxed but it is not uncommon to invest the corpus into securities that make money. The Trust has to file a tax return listing all of the income for the year and then that income flows to the beneficiary to be taxed on their personal return.

Irrevocable Trusts, unlike RLTs, protect assets from creditors and even divorce. They can be used to remove assets from a taxable estate and move them to the trust. If the estate tax is the reason for the trust, then under the Internal Revenue Code, the minor child must inherit the assets when they turn 21. As we mentioned above, there are restrictions that you can put on the corpus of the trust like the GPA or drug and alcohol provision, or pretty much anything you want.

## Gift Tax

There is such a thing as gift tax. How it works is that you can give a person, or in this case a trust, up to $14,000 a year. If you are married and your spouse and yourself elect to split your gifts, you can give one person or trust $28,000 a year. If you go over this amount, then the excess is subtracted from your estate tax exemption and you then must file a gift tax return.

When a client is subject to the estate tax, it is a common strategy for them to give gifts, up to the gift tax limit, to everyone in their family. A completed gift, meaning the giftor has no say over the money, removes the money or asset from their taxable



## Where Asset Protection, Tax Planning and Estate Planning Intersect

Since the estate tax isn't much of a concern for a majority of the population, when completing an estate plan, it is not uncommon to do asset protection at the same time. With asset protection, there has to be tax planning.

Most business owners are familiar with basic asset protection. They set their businesses up as corporations or limited liability companies to protect their personal assets in case the company is sued.

Asset protection can basically be explained as protecting your assets so that if a claim is filed, the assets that would be in jeopardy would be at an absolute minimum.

Before every state had laws favoring limited liability companies (LLCs), it was not uncommon in asset protection to form a family limited partnership (FLP). The FLP has a general partner, which is usually a shell corporation controlled by the senior members of the family. Additionally, the FLP can have an infinare number of partners that have no say in the FLP.

Today it is more common to use a family limited liability company (FLLC), which is made up of managers and members. You can also have the title of managing-member and act as a general partner. Again, they are basically shell corporations run by the senior members of the FLLC while the members, as limited partners, have no control over the FLLC.

Assets such as real estate are moved to the FLLC to protect them from creditors. However, the person doing the asset protection has created a taxable entity and if the assets are not contributed to the FLLC in the right way, you have also generated a gift



pass the family business to their children. One way to do this is to form a Grantor Annuity Remainder Trust (GRAT). A GRAT does a few things. For one, it freezes the asset, meaning it removes it from the estate. The owner of the business sells the business to the GRAT for a certain amount of money.

For instance, let's say that the business is sold for $1 million to the GRAT. The GRAT now owns the business, the grantor is the business owner, the trustee is the business owner, and the beneficiaries of the trust are whomever the business is passing to. The term of the GRAT can be 10 years or 20 years. Over the period of 10 or 20 years, the money that is earned from the business is paid as an annuity with interest to the owner.

As another example, let's say that a business owner sells his business to a GRAT for $1 million with the term of the GRAT at 10 years. The beneficiaries of the GRAT are the children and the interest rate paid to the owner is 3%. The GRAT would pay the business owner $103,000 a year over 10 years with this money paid out from the current income of the business. After 10 years, the business is worth $2 million and then the beneficiaries of the GRAT inherit the business with a basis of $1 million.

**CAUTION**: By placing the business into a GRAT, the asset is removed from the estate and the amount of the asset is frozen at the value at the time of sale. HOWEVER, if the owner dies while the GRAT is still in place, the value of the business at the time of death is added back to the estate. Also, if the company is owned by the GRAT and is an S-Corporation, a new Form 2553 (Election to Be Taxed as an S-Corporation) needs to be refiled with a Q-Sub Election.

Most businesses are set up as S-Corporations which can only have one class of stock. Usually, senior members of the family want to sell their business to their children but for various reasons they don't want to lose control of the corporation. What they can then do is split the shares between voting shares and non-voting shares, the voting shares being given to the senior member of the family. Under normal circumstances,



The beauty of an IDGT is that the money that is used to pay the owner comes from the current income of the company. In addition, if the company is an S-Corporation, the owner holds all the voting shares and can pay themselves distributions out of the S-Corporation.

For example, let's say you have an owner with an S-Corporation. He wants to sell the business to his children but doesn't want the money to come out of the kids' pockets. In addition, the owner isn't ready to retire and wants to maintain control of the S-Corporation. He would form an IDGT, then split his common shares into voting and non-voting shares. 1% of the value of the outstanding shares are the voting shares that the owner retains, and the 99% of the voting shares are transferred to the IDGT for $2 million paid over 10 years. The owner would receive $200,000 a year for ten years. The money doesn't come out of his kids' pockets, instead it is paid from the current income of the business. In addition, to supplement the owner's income, they can take monthly distributions from the company.

As with the GRAT, the IDGT freezes the asset at the selling price to the trust. However, unlike the GRAT, if the owner dies while the IDGT is in effect, the business stays out of the owner's estate. One thing to remember with an S-Corporation is just like a GRAT, you have to refile the S-Corporation Election (Form 2553) as a Q-Sub Election.

## Estate Planning for Blended Families

When the estate tax exemption was lower and portability didn't yet exist, it was common to use a strategy like an AB Trust. Pre-portability, an AB Trust was meant to transfer to the surviving spouse the decedent's unused estate tax exemption. Since we now have portability, an AB Trust or ABC Trust can be used for blended families.

This is useful and necessary in the light of the fact that in the US, the divorce rate is



*two children and completely disinherit his three children. Wife may have the same exact concerns if she were the first to pass away.*

*As a result, estate planners use a special type of trust to alleviate these concerns. It is known as an AB trust, which is a typical revocable living trust for during the Husband and Wife's lifetimes. However, it is also a contract between Husband and Wife that provides that, at the death of the first spouse, two trusts must be created: Trust A and Trust B. Trust A will hold the survivor's half of the community property and all of the survivor's separate property, and Trust B will hold the decedent's half of the community property and all of the decedent's separate property.*

*Generally, the surviving spouse becomes the Trustee over both Trust A and Trust B and can have access to both trusts during his or her lifetime for the survivor's benefit. The rules are that the survivor is in complete control of Trust A and can do whatever he or she deems appropriate with that half of the estate. The survivor may choose to amend Trust A to disinherit the deceased spouse's children or the survivor can leave Trust A intact and it would go to both Husband and Wife's children equally when the survivor passes away.*

*The survivor is not in complete control of Trust B, however, and the survivor is not permitted to change the beneficiaries of Trust B because Trust B becomes irrevocable at the death of the first spouse. This is meant to offer protection for the deceased spouse and ensure that at least part of the estate will ultimately go to the children that the deceased spouse had originally planned to leave the estate to.*[1]

Another way to do estate planning for blended families is through a Qualified Terminable Interest Property (QTIP) Trust. A QTIP trust is therefore particularly useful in second marriages because the client can provide for a spouse by putting assets in trust with the income going to the spouse, but can also dictate that the assets go to the client's children and not the spouse's children after the death of the spouse.

A QTIP trust can also add tax-planning flexibility because it does not qualify for the



Remainder Annuity Trust (CRAT). A CRAT works best when you donate appreciable property to the CRAT, but you can also contribute cash. The CRAT has a cousin called a Charitable Remainder Unitrust (CRUT). The difference between the two is that with a CRAT, you can only make a one-time contribution. With a CRUT, you can make a contribution each year.

Let's say that you want to pay for private primary school for your kids but you want to make those payments to the school tax deductible, when they ordinarily aren't. You could contribute either cash or appreciable assets to the CRAT or CRUT and receive a tax deduction.

For example, let's say that you have a portfolio where you have a basis of $2 million. If you were to sell the portfolio, you could sell it for $3 million. This would leave you with a taxable gain of $1 million that would be subject to 23.8% tax. With a CRAT, you would simply donate the portfolio to the Trust. The trust then sells the portfolio and now you have $3 million in the trust. You don't have a taxable gain from the sale.

The longest term of a CRAT or CRUT is 20 years. In that time, the trust pays you a 5% annuity per year. That would be $150,000 a year for 20 years for a total of $3 million. However, the CRAT or CRUT reinvests the $3 million into other securities and makes $1 million. You would receive a $1 million charitable deduction and at the end of the 20-year term, the $1 million going to the charity of your choice.

If you are anything like me, you don't trust a lot of charities. For a non-profit to see a donation from me, I need to first investigate their Form 990 (Tax Return for Exempt Organizations), which is open for public inspection. By examining this form you will find that oftentimes, about 60% of every dollar given to a charity is eaten up by administrative costs and fundraising. The other 40% will actually go to the charitable endeavor. That being said, the beneficiary of the CRAT or CRUT has to be an IRC § 501(c)(3) organization. Why not start your own 501(c)(3) organization so



lifetime and has the legal responsibility to maintain the property as well as the right to use it, rent it out, and make improvements to it.

When the life tenant dies, the house will not go through probate, since at the life tenant's death the ownership will pass automatically to the holders of the remainder interest. Because the property is not included in the life tenant's probate estate, it can avoid Medicaid estate recovery in states that have not expanded the definition of estate recovery to include non-probate assets. Even if the state does place a lien on the property to recoup Medicaid costs, the lien will be for the value of the life estate, not the full value of the property.

Although the property will not be included in the *probate* estate, it will be included in the *taxable* estate. Depending on the size of the estate and the state's estate tax threshold, the property may be subject to estate taxation.

# Taxable Basis of Gifts and Inherited Property

One thing to keep in mind when making a gift or when someone inherits property, is that the person receives the gift or inheritance on a taxable basis. To figure out the gain on the sale of property, you subtract the selling price from the basis of the taxpayer. Basis is what the asset was bought for plus any improvements made to the property, or any fees paid to acquire the asset.

If you gift property, the person receiving the gift inherits the basis of the person giving the gift. For instance, let's say that I bought Disney Stock in the 70's for $25 a share. I initially bought 1000 shares, but the stock split 2 to 1 in 1990. Now I have 2000 shares at the original basis of $25,000. This is where knowledge of the Tax

Code comes in. First of all, I can only give a gift of $14,000 to any one person in a



income for the year and this is the only income they will have, they can receive up to $37,950 of capital income and not pay any taxes on the money. That is to say, if you have capital income and you are in the 10% or 15% tax bracket, then the taxes owed are zero.

What you don't want to do is give a gift of something like a house that has a basis of $30,000 but is worth $100,000 today. The person giving the gift would have to file a gift tax return and the person receiving the gift would have a capital gain of $60,000.

The basis of someone inheriting an asset is different from someone receiving the asset as a gift. If I inherit an asset, my taxable basis is the value of the asset on the date of death. Typically, it is best for a person receiving an asset as an inheritance to get an appraisal of the asset as close to the date of death as possible. That way, if audited, the person receiving the inheritance has proof of the basis of the asset.

# Conclusion

As you can see, estate planning is not just for the ultra-wealthy. Further, you need an attorney to draw up the documents, as well as a tax accountant that specializes in estate taxation to minimize the taxable effect of the estate or asset planning.

================-

**ABOUT THE AUTHOR**

Craig W. Smalley, MST, EA, has been admitted to practice before the Internal Revenue Service as an Enrolled Agent, has a Masters Certificate in Taxation from UCLA, and is a Certified Tax Resolution Specialist. He has been in practice since 1994 and is the

CEO and Founder of CWSEAPA®, PLLC, Tax Crisis Center®, LLC, and Cannabis



[1] What Type of Trust Should Be Established for a Blended Family