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Reduce Estate Taxes Without Reducing Your Liquidity

As year-end approaches, so does the tenacity with which estate and financial planners implore their clients to take advantage of the fleeting opportunity to make very significant tax-free gifts during the remainder of 2012. Over the past six-months I've offered much such advice within this column. On a few occasions I've been told that my "advice" has crossed over to "admonishment." I guess my passion for what I view as, perhaps a once-in-a-lifetime opportunity, runneth over!

The short version of what fuels the passion expressed by so many of my colleagues and me is the impending expiration of the estate tax provisions of the Tax Relief Act of 2010, an enhancement of the "Bush Tax Cuts" which increased the lifetime gift exemption from \$1 million to \$5 million (\$5.12 million in 2012) which applies to estates, lifetime gifts and the generation skipping transfer tax. Even under the original Bush Tax Cuts when the highest estate tax exemption reached \$3.5 million, lifetime gifts still were limited to \$1 million.

What does this mean? For some wealthy families, the chance, right now, to transfer substantial assets at little to no Federal gift tax cost might expire at year-end. For the remaining four months (or possibly less subject to the whims of a lame-duck Congress), a married couple can transfer up to \$10.24 million in assets out of their estates free of Federal gift tax, reduced by any previous transfers.

Many clients with both the necessary dispositive intentions and the requisite balance sheet have taken advantage of these gifting provisions; others intend to do so (hopefully not all at once in December); and still others would like to do so but lack liquidity. The last group often has sizeable chunks of their assets tied up in businesses, real estate, venture capital and personal residences. As a wealth strategist, I have a great deal of respect for client liquidity needs – both the very real and the psychologically driven. I vividly recall how folks of similar net worths experienced the 2008 financial

meltdown very differently based on the extent of their balance sheet liquidity. So what are one's options when one has the requisite intention without the ability to write a check or transfer portfolio assets to a trust? For many reasons, I'm a fan of gifting one's personal residence to an intentionally defective grantor trust (IDGT).

However, even for individuals with the means and desire to give as much as possible, the challenge is always to give in a manner or up to the point that does not jeopardize liquidity and lifestyle through life expectancy. As I recommended in this column last year, "Your Smartest Estate Planning Move Ever: Give Away Your House" (<http://www.forbes.com/sites/robclarfeld/2011/06/22/your-smartest-estate-planning-move-ever-give-away-your-house-now/>) very often one's personal residence can be an ideal asset to gift to a trust, removing both the asset as well as future appreciation from one's estate. Structured correctly, the current environment for such gifting couldn't be more favorable. The gifting laws have never been more favorable, and, very likely, will sunset at year-end; housing prices remain depressed by historical levels resulting in favorable valuations; grantor trust laws, currently under congressional scrutiny, appear solid through year-end; and, other than professional fees, one's liquidity isn't impaired. An all-important factor is that one may continue to remain in the residence but only as a tenant — perhaps with a rider to the lease providing for the option of lifetime renewals at the future prevailing rental values.

I addressed structuring considerations within my previously cited blog. In general, here's how I would consider structuring such a gift:



- Set up an "Intentionally Defective Grantor Trust" (IDGT) — that is, a trust that allows transferred assets to be removed from your estate for estate and gift tax purposes, but not so for income tax purposes. (This is a somewhat confusing concept, but for discussion purposes, follow along with me.) The use of IDGTs in estate planning has become very popular because of the numerous planning possibilities that result from this unique tax treatment. In this instance, the tax treatment becomes particularly important after the transfer of the residence to the trust. Of course, carefully crafting the trust provisions, including dispositive and potential generation skipping transfer (GST) provisions, is of utmost importance.
- Obtain an independent appraisal of the fair market value of the residence. At the same time, I'd ask the independent appraiser to determine the fair market rental value of the residence (assuming you want to retain the post-transfer use of the residence).
- Transfer the residence to the trust. The transfer will constitute a gift and be applied against your lifetime gift exemption. (A married couple can choose to "split" the gift regardless of how the residence is titled.)
- The trustee would be responsible for collecting the rent, paying the expenses of the residence, etc. As with any rental, the lease should clearly delineate which party is responsible for utilities, general maintenance, etc.

This strategy can be a straightforward transfer (i.e. gift) of title to a trust for the benefit of family members, or perhaps the interposition of an LLC may be advisable. The beauty of transferring the residence to an IDGT is that the rental income will not create a tax liability and real estate taxes and any mortgage interest deductions will "flow through" to the grantor's tax returns. Not only are these rental payments free from income taxes, but as long as they are consistent with the residence's fair market rental value, they are also gift-tax free.

An additional advantage to this structure (if this were an infomercial, here's where I'd scream "but wait, there's more!") is that the trust's accumulation of

rental income beyond its expenses are tax-free additions available for inevitable future capital expenses such as a new roof or furnace, additional investment, or to pay premiums on life insurance policies owned by the trust.

The transfer of a residence to an IDGT is a strategy that enables a wealthy family to remove a valuable asset from their estate **without impinging upon liquidity**. It is built upon using time-tested estate planning concepts that are very likely to remain through year-end. When coupled with a soft real estate market, I don't believe I'm exaggerating when I say that this could prove to be one of the smartest estate planning moves one will ever make.

For more information, visit www.clarfeld.com, or contact me at rob@clarfeld.com.

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