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PLANNING WITHIN THE FROZEN GIFT TAX EXEMPTION

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I. ESTATE PLANNING IN A TIME OF CHANGES AND UNCERTAINTY

In the current environment, the evolving nature of the transfer tax system is an important element of the gift planning process. Over the past few years, a combination of the 2001 Tax Act, other federal transfer tax developments, and state law changes have resulted in a significant restructuring of the estate planning environment. Some changes have been phased in (e.g. the estate and gift taxes were still "unified" until January 1, 2004) and others are still coming.

There is a general belief that the system as it is currently structured (suspension of the estate tax in 2010, followed by a return of that tax in 2011 with a return to the $1,000,000 exemption) will be changed. The unknown is what that change will be and how the system will be structured after the change is implemented. Currently, it appears that the two most likely possibilities are:

A. a repeal of the estate and generation-skipping transfer taxes for years after 2009, with a retention of the gift tax and an income tax adjustment that includes the loss of the basis step-up; and

B. a retention of the estate and generation-skipping transfer taxes, with an increase in the exemption amount (e.g. $5,000,000) and a reduction in the tax rates.

Many of our clients are closely monitoring Congressional developments on this front and are consequently questioning whether they should make gifts, given the potential for estate tax reform that might ultimately enable them to transfer their wealth to their children at death without incurring any transfer taxes. While it may be prudent for some clients to adopt a "wait and see" approach, many clients will be better served by pursuing a gifting program designed to accomplish both tax and nontax objectives.

Some clients interested in making gifts may be well served by continuing to employ traditional planning techniques. For others, less traditional means of transferring wealth may be more suitable. This presentation is intended to provide you with the ability to determine whether your client should consider pursuing a gifting program, and if so, to develop a program designed to fulfill your client's tax and nontax objectives.

II. THE BASICS

A. Estate Tax

As it currently stands: the federal transfer tax system exempts the first $2,000,000 of an individual's estate from the estate tax. That exemption amount will stay the same through the year 2008 and increase in 2009 to $3,500,000. In 2010, the estate tax is suspended, but then it returns in 2011 with a $1,000,000 exemption.

For the year 2006, the value of an estate in excess of the $2,000,000 exemption amount is taxed at a flat 46% rate. For the years 2007 through 2009 that tax rate drops to 45%.

B. Gift Tax

Notwithstanding the changing estate tax exemption amount, the gift tax exemption is frozen at $1,000,000 (including the year 2010, when the gift tax, unlike the estate tax, is not suspended). For each year that an individual makes a "taxable gift" [the amount of gifts during the year per donee in excess of the applicable annual gift tax exclusion (discussed below) available for qualifying transfers] the amount of that taxable gift reduces the individual's remaining gift tax exemption. Once the individual has made a total of $1,000,000 of taxable gifts and thus fully consumed his or her gift tax exemption, additional taxable gifts generate gift taxes that are due and payable on or before April 15th of the year following the year in which the gift is made (or the due date for the donor's estate tax return, if the donor dies after making a gift and the estate tax return is due prior to April 15th).

To compute that gift tax, taxable gifts for a given year are added to the total taxable gifts from prior years (including pre-1976 gifts, even though those gifts are not included as adjusted taxable gifts on the estate tax return) and the gift tax for the subject year is the tax on cumulative gifts, less the tax on prior years' taxable gifts. That gift tax is computed under a progressive rate structure that starts at 41% for the first $1.00 of taxable gifts over $1,000,000 and caps off at 46% for cumulative gifts in excess of the $2,000,000 amount. For the years 2007 through 2009, that maximum gift tax rate drops to 45%. Thus, once an individual has made a total of $2,000,000 of taxable gifts, taxable gifts thereafter generate a gift tax at a flat rate equal to the maximum transfer tax rate (46% in 2006 and 45% for 2007-2009).

For example, assume an individual has used up her gift tax exemption through prior year taxable gifts of $1,000,000 and makes a $1,000,000 taxable gift in 2006. The gift tax due (on or before April 15, 2007) on that 2006 gift would be $435,000. Further assume that the individual makes a taxable gift of $2,000,000 in 2007. The gift tax due (on or before April 15, 2008) on that gift would be $900,000 ($2,000,000 x 45%).

The gift tax system changes for years beginning in 2010. At that point, all cumulative gifts in excess of the $1,000,000 gift tax exemption amount will be subject to a flat gift tax rate equal to the maximum income tax rate then in effect (currently 35%).

Typically, a donee will take a carryover basis in a gifted asset (plus an adjustment for any gift taxes paid attributable to unrealized gains) unless the asset's fair market value is less, in which case that value will become the donee's basis in the asset received for determining loss.

C. Generation-Skipping Transfer Tax Planning.

The generation-skipping transfer tax ("GSTT") is a transfer tax imposed on the transfer of property to a person who is two or more generations below that of the transferor. For example, a gift from a grandparent to a grandchild ("Direct Skip") is a gift subject to the GSTT. Also, property placed in trust for the benefit of the transferor's child for life and designed to pass in trust upon the child's death to the transferor's grandchild will be subject to the GSTT at the time of the child's death ("Taxable Termination"). GSTT may also be incurred during the child's

lifetime, if distributions to the child's own children are permitted and are in fact made ("Taxable Distribution").

Just as there are exemptions from the gift and estate taxes, each individual has a GST exemption that allows the individual to transfer property free of GSTT either directly to members of their grandchildren's generational level or to trusts designed to pass from generation to generation without the imposition of transfer taxes. The amount of the GST exemption is currently tied to the amount of the estate tax exemption, so it will be $2,000,000 for the years 2006 through 2008, $3,500,000 for 2009, and reduced to $1,000,000 in 2011. As with the estate tax, the GSTT is suspended for the year 2010.

For large estates, the maximum use of the GST exemption can save a significant amount of transfer taxes that would otherwise be extracted from the family estate over time. For example:

1. A grandparent can transfer $2,000,000 directly to a grandchild. By application of the grandparent's $2,000,000 GST exemption, that transfer would not be subject to the GSTT. That property, and all appreciation and income therefrom, would be available to the grandchild for his/her lifetime without any prior reduction through the payment of federal estate tax by inclusion in his or her parent's estate. Alternatively, if the property were left to the grandparent's child and passed through that child's estate to the grandchild, then the property could be depleted through the imposition of the estate tax on the child's estate before it passed to the grandchild.

2. A grandparent can transfer $2,000,000 to a trust for the benefit of the child. Upon the child's death, the property would remain in trust for the benefit of the grandchild for life. Upon the grandchild's death, the property would pass to trusts for his or her own children and would continue to pass in trust for generations until otherwise terminated. If the $2,000,000 gift to the trust for the child was fully covered by the allocation of the grandparent's $2,000,000 GST exemption on a timely filed gift tax return reporting that gift, then the property (and all appreciation and income therefrom) would forever be exempt from the GSTT and, as it passed in trust from generation to generation, would also avoid the imposition of the federal estate tax until it was taxed in the estate of the descendant who received it when the trust was forced to terminate (e.g., by virtue of the application of the Rule Against Perpetuities).

III. <u>HISTORICAL ADVANTAGES TO LIFETIME GIFTS</u>

As a general rule, it is preferable from a tax minimizing perspective to make lifetime gifts, rather than retain an asset until death and have it included in the decedent's estate, even if gift tax will be incurred in the process (assuming a donor is expected to have a taxable estate). At first glance, the concept of paying the gift tax early (i.e., instead of waiting and subjecting the property to the estate tax in the donor's estate or, if possible, deferring payment of estate tax on the property until the donor's spouse's death by passing the asset initially to him/her or a marital trust) seems

contrary to good policy. If the transfer were delayed until the death of the second spouse to die, the tax would be deferred until nine months from that date of death. However, that first impression is not necessarily correct. In fact, there is support for the position that for an estate of significant size, lifetime gifting with intended payment of gift taxes can yield the lowest overall transfer tax costs and thus shift the greatest amount of assets to the succeeding generations.

The following factors support the benefits of lifetime gifts and are also relevant in analyzing the viability of the gift tax option:

A. Tax Exclusive Nature of Gift Tax. The federal gift tax is a less costly means (from a tax standpoint) of transferring assets than the federal estate tax. The gift tax is "tax exclusive," which means that the dollars used to pay the gift tax are excluded from (not subject to) the gift tax. Dollars used to pay the gift tax are also normally not subject to the federal estate tax, with one exception: if the donor dies within three years of the date of the gift, the gift tax dollars are brought back into the estate for federal estate tax purposes. On the other hand, the federal estate tax is "tax inclusive" because the dollars ultimately used to pay the estate tax are themselves subject to estate tax. Thus, lifetime taxable gifts generally yield a lower effective tax rate than if those assets are held for life and then subjected to the estate tax.

B. Opportunity to Remove Post-Gift Income and Appreciation from Estate. Separate and apart from the transfer tax consequences in (a) above, a benefit achieved through lifetime transfers is that all post-gift income and future appreciation on the gifted assets pass to the donees without being subjected to (depleted by) gift or estate taxes. In the alternative, if the proposed gift is instead retained and transferred upon death, the income generated from those interests and the appreciation in the value of those interests would generate a federal estate tax payable out of such income and appreciation prior to the net amount passing to the heirs.

C. Consideration of Time Value of Money Concept. The current payment of federal gift taxes is not without cost. There is the "time value of money" factor to take into account. Assume the projected federal gift tax due on or before April 15th of the year succeeding a hypothetical gift is $2,208,000. Obviously, if you elected to defer the gift until the death of the first (or later, the second) spouse to die, you would have the beneficial use of that money for that period. However, that money and the income and appreciation that it yielded during that time would ultimately be subject to imposition of the federal estate tax. This goes back to the previous points with respect to the "tax inclusive" nature of the federal estate tax and the benefits of shifting income and appreciation on transferred assets out of the estate at the earliest possible time. Again, for a large estate that generates a federal estate tax at the maximum federal estate tax rate and which contains assets that the donor can afford to part with during lifetime, it is generally better to transfer those assets during life instead of holding them and subjecting them to the federal estate tax.

D. Potential for Shifting Income to Lower Tax Bracket. The transfer of assets to succeeding generations causes the income from those assets to be taxed on the donees' federal income tax returns. This would result in an overall federal income tax savings if the income were taxed at a lower rate on a donee's return than it would be subjected to on the donor's return (keep in mind the "kiddie tax").

E. Minimize Potential Grounds for Challenge by the IRS. The IRS has been aggressively attacking the gift and estate tax transfers of interests in family controlled partnerships for several years. At the present time, when the transfer is by lifetime gift the primary issue raised by the IRS upon an audit of the gift tax return involves valuation of the partnership interest (value of partnership assets, size of the discount, etc.). Alternatively, the IRS has had some recent success in attacking the discounts used in valuing partnership interests reported on estate tax returns based on legal grounds, primarily Section 2036 (Section 2036 does not address, and has not been applied, in the gift tax cases). One argument the IRS has had success with under Section 2036 is that the value of the underlying partnership assets are includable in the taxable estate of the decedent-limited partner (i.e. no discount allowed) on the grounds that there was an implied agreement that the assets transferred to the partnership by the partner would continue to be used for the partner's personal benefit. Thus, there is the possibility that transfers of partnership interests by gift might be subject to less IRS scrutiny than those reported on an estate tax return.

F. Income Tax Basis Considerations. Typically, a donee will take a carryover basis in a gifted asset (plus an adjustment for any gift taxes paid attributable to unrealized gain) unless the asset's fair market value is less, in which case that value will become the donee's basis in the asset received for determining loss. In contrast, if the donor were to retain the asset, it would subsequently receive a step up (or step down) in basis at death under the carryover basis rules applicable until 2010 and in 2011 and thereafter under current rules. (Carryover basis will apply, subject to certain exceptions, for deaths occurring in 2010.) While this is certainly a factor in weighing the decision of whether to make lifetime gifts, since estate tax rates are scheduled to remain (and may ultimately remain, depending upon changes in the law) significantly higher than capital gains tax rates, this "disadvantage" to lifetime gifts may be of little significance to many donors if there is a realistic possibility of shifting significant post-gift income and appreciation (and possibly the gift tax itself) out of what is likely to be an estate subject to estate taxes.

IV. REASONS FOR CONTINUING/IMPLEMENTING A GIFTING PROGRAM

Though the transfer tax laws have changed and there is a cloud of uncertainty over the future transfer tax burden to be imposed on an estate, there are still many important tax and nontax reasons that motivate clients to want to make gifts during their lifetime, including:

A. For income producing and highly appreciating assets, to shift the income and appreciation out of the estate effective as of the date of the gift. Even if there are ultimately no estate taxes saved by such a transfer (either due to repeal of the estate tax or to an increase in the exemption sufficient to shield the donor's estate from tax), you may have the opportunity to reduce the income taxes assessed on post-gift income if the donee's tax bracket is lower than the donor's, which is often the case with gifts to members of the next generation (provided the "kiddie tax" does not apply).

B. For interests in family-owned business:

1. Shift minority interests during lifetime to get minority interest discounts and avoid a control premium if that same stock were transferred at death.

2. Shift equity in the business to "active" children as a reward and/or incentive to work hard and stay in the business.

C. Shift wealth to succeeding generations to accomplish family objectives such as education, business start-ups, etc.

D. Given the increasing life expectancy expectations, shift wealth to the next generation while they are still young enough to enjoy it.

E. Leverage the gift tax exemption and the GST exemption through gift techniques such as gifts to pay life insurance premiums (instead of an estate tax on the proceeds of the life insurance policy), discounted interests in family limited partnerships, etc.

F. A client might want to make a gift of an asset whose income tax basis is higher than its fair market value in order to avoid a "step down" in basis at death under current rules.

V. TAX FREE GIFTS

Thus, in light of the tax and nontax benefits (triggers), and despite the uncertainty in the future of the transfer tax system, a well-conceived and implemented lifetime gift plan should be an important part of many clients' estate plans today. A good starting point for any gift plan is the use of gifts that do not require consumption of any part of the donor's limited gift tax exemption.

A. Annual Exclusion Gifts.

The annual gift tax exclusion allows each individual to transfer up to $12,000 per year per donee and have such gift ignored for federal gift tax purposes. That $12,000 is increased periodically as it is indexed to inflation. Thus, an individual with three children and seven grandchildren could transfer up to $120,000 to those descendants each year ($12,000 x 10) without having such gifts reduce that individual's gift tax exemption or trigger a gift tax. A married individual can double the amount of annual exclusion gifts he/she can make to each donee for a year by using the annual exclusion available for gifts by his/her spouse to that donee (to the extent it would otherwise go unused by the spouse).

So long as the only gifts by an individual to a donee during a tax year consist of annual exclusion gifts, then those gifts do not have to be reported on a Federal gift tax return. However, as mentioned later, gifts that are not reported on a gift tax return do not trigger the running of the gift tax statute of limitations and thus remain subject to IRS challenge.

Gifts of limited partnership interests offer an opportunity to leverage (or expand) the $12,000 annual exclusion gift capacity due to the fact that limited partnership interests are typically valued at a discount. The appropriate discount to use for this purpose would be determined with reference to the rights and restrictions associated with the gifted partnership interests under state law and the partnership agreement (including voting rights, if any, restrictions on transfer, any established pattern of partnership distributions, etc.).

Example: An individual could gift $24,000 worth of separate property limited partnership interests to a donee during a year and have the full gift treated as an annual exclusion gift by accessing that individual's spouse's annual exclusion for gifts to that donee through an election to gift-split. This would be accomplished on the federal gift tax return by reporting the full gift on the individual's return and then having the spouse sign the return to elect gift-splitting for the gift. (The spouse may also have to file a gift tax return.) It is important to note that once gift-splitting is elected for a year, then all gifts by both spouses made during the year must be split between the spouses for both gift tax purposes and for generation-skipping transfer tax purposes. Thus, one-half of any GST exemption allocated to a gift will be charged against the non-donor spouse's $2,000,000 GST exemption. This is an important point to consider. A spouse may see no "cost" to the use of his or her annual exclusion for gifts to a donee of the donor spouse (say, a grandchild from that spouse's prior marriage), but the use of his or her GST exemption for gifts to that donee may not be a good use of that limited exemption from the non-donor spouse's perspective.

Annual exclusion gifts may be made in the following ways:

- outright to an adult donee,
- to a custodial account (if the donee is under age 18),
- to a Section 2503(c) trust (if the donee is under age 21), or
- to a Crummey Trust (typically, the preferred technique).

B. Unlimited Gifts for Tuition

A client can pay a donee's tuition without having to use any gift tax exemption in the process or count the tuition payment as a use of the annual exclusion available for the donee, provided payments are made directly to the qualified educational institution. This exclusion applies only to tuition and not to books, room and board, etc. Many clients like the idea of providing for a grandchild's education, since they view it as a "productive" gift with lasting benefit that will be appreciated by the grandchild and his/her parents.

C. Unlimited Gifts for Medical Care

A client can pay for a donee's medical expenses without having to use any gift tax exemption in the process or count the payment as a use of the annual exclusion available for the donee, provided payments are made directly to the medical care provider. Payments for this purpose may be made for preventative care, as well as for treatment. Payments of health insurance premiums are also covered by this specific exclusion.

D. Payment of Income Taxes Associated with a Grantor Trust Established for a Donee

As discussed in more detail below in Section V of this outline, a certain type of trust created for a donee may be irrevocable for transfer tax purposes (resulting in the trust assets being excluded from the donor's estate) but considered owned by the grantor for income tax purposes. This type of trust is called a Grantor Trust. Even though the grantor is legally obligated to pay the

income taxes associated with any income earned by a Grantor Trust, the payment of those income taxes is not deemed to be a gift to the Trust, even though in fact that is what has effectively occurred by the grantor's payment of the income taxes associated with income retained in the Trust for the donee's benefit. As a caveat, the trust agreement should not require the Trustee to reimburse the grantor for any income taxes paid, as that would not only defeat the aforementioned benefit but would also cause the trust assets to be included in the grantor's estate at death.

VI. GIFTS UTILIZING GIFT TAX EXEMPTION AMOUNT(S)

A. Maximizing Use of the Donor's Own Exemption Amount

In addition to tax free gifts, a client who wants to avoid paying gift tax based upon a desire to adopt a "wait and see" approach with regard to the estate tax reform may still want to consider using his/her gift tax exemption amount for some of the reasons discussed earlier, including as a means to hedge bets in light of the possibility of still having to pay estate taxes at death.

1. Ideal Candidates for Gifts.

Again, gifts with potential for significant future appreciation are ideal candidates for these gifts. Undivided interests in real estate or gifts of limited partnership interests are also ideal candidates since each is typically assigned a favorable valuation reflecting the limitations inherent to those particular forms of ownership. As a caveat, be sure a gift will not cause a donor's estate to become ineligible for certain Code Sections that would otherwise provide the donor's estate with desired relief (e.g. IRC Section 6166).

2. Incorporating Grantor Trusts as Vehicles for Facilitating Gifts.

A gift to a Grantor Trust can be a way to combine an effective use of a client's lifetime gift tax exemption amount with the means for facilitating what are effectively tax-free future gifts through the donor's payment of income taxes incurred on trust income. Again, a Grantor Trust is a trust established to receive gifts from an individual that has two basic characteristics. First, the trust is irrevocable and otherwise structured so that the assets that it owns are removed from the individual's estate for federal estate tax purposes. Second, the trust agreement grants certain powers to the individual donor, the trustee, or third parties that, although they do not cause inclusion of the trust assets in the donor's estate, they do cause the trust to be treated as a Grantor Trust for federal income tax purposes, thus requiring that the trust income be taxed to the donor (i.e. the donor reports the income on his or her income tax return and pays the related income tax).

The benefit offered by the Grantor Trust as a gift planning tool is that it allows the donor, through the payment of the income tax on the trust income, to remove the amount of the income tax payment from his or her taxable estate without having that income tax payment treated as a gift for gift tax purposes. The IRS confirmed in Revenue Ruling 2004-64 that the donor's payment of the income tax on the trust income from a Grantor Trust is not a gift by the donor.

Obviously, the success of this Grantor Trust technique requires that the individual donor have the cash flow capabilities of paying the income tax due on trust income even though he or she will not receive any of the cash related to that income. However, there is flexibility

in this regard as the trust agreement can provide that the donor's income tax payment responsibility be terminated at any time, after which time the trust will be responsible for paying its own income tax. However, a donor should be cautioned to consult a professional for guidance on the potentially significant negative tax consequences of doing so in the event a promissory note used in connection with a sale by the donor of an appreciating asset to a Grantor Trust is outstanding.

Additionally, if the donor has any intentions of pursuing a sale of an appreciating asset to a Grantor Trust (discussed below), he/she should seriously consider using a portion of her gift tax exemption amount in conjunction with a "seed gift" to the Trust designed to provide it with a "cushion" designed to negate the deemed existence of a retained interest by the grantor when he/she enters into the sale arrangement with the Trust. This concept is discussed in more detail below.

B. Using the Donor's Spouse's Gift Tax Exemption Amount.

As previously noted, a donor may not only make gifts equal to his/her gift tax exemption amount but may also make use of the donor's spouse's lifetime gift tax exemption amount as well through an election to gift-split on timely filed gift tax returns. This can be quite beneficial if the donor is significantly wealthier than the spouse (e.g., a second marriage and the donor has significantly more separate property than the spouse). Again, while a non-donor spouse may see no "cost" to the use of his or her annual exclusion amount for gifts by the donor spouse to his/her own children, the use of his or her gift tax exemption for gifts to step children may not be a good use of that limited exemption from the non-donor spouse's perspective.

VII. FREEZE GIFTS

Certain techniques, referred to as "freeze techniques," can be utilized once a client has exhausted his/her lifetime gift tax exemption amount, if paying gift taxes is to be avoided. Freeze techniques can also be used to optimize use of a client's gift tax exemption amount, provided the client has the necessary tolerance for adhering to the "maintenance" required for these techniques, as opposed to preferring the simplicity of a "no strings" gift. In any event, freeze techniques are effective tools designed to move post-gift appreciation and income associated with an asset (but not the value of the asset itself, which is expected to be returned to the donor through interest or annuity payments, depending on the chosen technique) out of the donor's estate and can be implemented with assets subject to favorable valuation rules (e.g., limited partnership interests). In other words, freeze techniques exploit potential mismatches between interest rates required for use in valuing transfers and the actual economic performance of the transferred asset.

A. Sale to Grantor Trust.

A technique that allows a donor to transfer value to a trust without having that transfer treated as a gift for gift tax purposes involves the donor selling an asset to a Grantor Trust in exchange for a promissory note. Ideally, the asset sold should have the potential for significant future appreciation but should be sold well in advance of that potential being realized.

This technique can be illustrated as follows:

1. Step One. Donor creates a Grantor Trust for the benefit of her child. The Trust is irrevocable and for federal gift and estate tax purposes has terms designed to cause the assets owned by the trust to be excluded from Donor's taxable estate. However, the Trust's income will be taxed for federal income tax purposes to the Donor and reported on her Form 1040 by virtue of terms specifically intended to effect that result. Generally, it is thought to be safer to avoid Crummey powers in a trust intended to be a Grantor Trust given the uncertainty with regard to the effect of lapsed withdrawal rights on the taxation of income and capital gains.

2. Step Two. Donor owns an interest in a Texas limited partnership and makes a "seed gift" of a 5% limited partnership interest to the trust. (Generally, it is recommend that a Trust used to purchase an asset in an installment sale be initially funded with assets at least equal to 10% of the value of the asset the Donor intends to sell to the Grantor Trust in order to avoid the IRS' characterizing the note as a retained interest in the Trust with respect to the Grantor.) The gift tax value of the 5% limited partnership interest is $60,000 (as the interest gifted was valued using a 40% discount and the assets owned by the partnership relating to the gifted partnership interest are worth $2,000,000). The Donor obtained an appraisal to determine the fair market value of the gifted partnership interest and reported that gift on a timely filed federal gift tax return. As Donor had previously made taxable gifts of $2,000,000 and used up all of her gift tax exemption in the process, Donor paid $27,600 in gift tax ($60,000 x 46%) with the gift tax return disclosing the seed gift. Ideally, the Donor would be able to skip this step of the example because she would have shrewdly used part of her gift tax exemption amount on the "seed gift" to the Grantor Trust, thereby providing it with the "cushion" necessary to proceed with this technique. Of course, if the technique backfires due to the assets' failure to appreciate as expected, those assets previously transferred into the Trust might ultimately be used to payoff the Trust's obligation under the note. Obviously, this result would be disastrous for the Grantor since it would mean the Grantor effectively wasted part of her gift tax exemption.

3. Step Three. Donor sold a 50% limited partnership interest to the trust for $600,000 in return for a promissory note. A contract for sale, an assignment, and security instrument were also executed. The size of the partnership interest sold was determined after considering how much the Donor was willing to part with and was based on a projected cash flow analysis. The total of the partnership interests gifted and sold represented a 55% limited partnership interest, which by virtue of the partnership agreement does not provide sufficient ownership to vest the Grantor Trust with managerial authority or the ability to force a liquidation of the partnership (either entirely or with respect to its limited partnership interest). Consequently, a 40% valuation discount is supportable. The $600,000 sales price (and, consequently, the principal amount of the note) was equal to the discounted fair market value of the limited partnership interest sold, as determined by an

independent appraisal. The promissory note called for annual interest payments of $30,315 (compounded semi-annually) on the last day of the year (June 30th of each year, as the sale was on July 1, 2006) and a $600,000 balloon payment of principal after 9 years. (If a more aggressive approach can be tolerated by the client, the note could also provide for annual interest payments to be payable in a balloon payment at the end of the term, although some practitioners feel this leaves the donor more vulnerable to an IRS challenge that the note is effectively a retained interest.) The interest rate on the note was the mid-term applicable federal rate (based upon semi-annual compounding) issued by the IRS for July, 2006, or 4.99%. The 9-year term was selected by the Donor based upon an expectation that it would allow sufficient time for the gifted and sold limited partnership interests to appreciate to the point where annual interest payments and ultimately the $600,000 balloon payment (discussed below) can be made and still leave a significant limited partnership interest remaining in the trust, representing the "payoff" for this technique. As the Trust is a Grantor Trust, Donor's sale of the 50% limited partnership interest to the Trust did not result in any gain recognition for income tax purposes and interest payments will not be taxable income to the Donor. The Trust took the same income tax basis in the sold and gifted limited partnership interests as that of the Donor. The OID rules did not apply since the Trust is a Grantor Trust.

4. Step Four. The Trust's share of partnership distributions provide a source of funds for the Trust to use to make the $30,315 annual interest payments. However, partnership distributions must be within the general partner's discretion and not subject to a prearrangement by the parties to accommodate annual interest payments due on the note. If distributions are insufficient in any year to pay the interest due on the note, interest payments should be made with other Trust assets (preferably not limited partnership interests, which would be necessarily valued at a discount). Alternatively, a renegotiation of the original note or an additional note providing for the deferred payment of an interest obligation may be appropriate. If interest payments are made through distributions of limited partnership interests, no capital gains should be incurred (as would normally be the result with an in kind distribution in satisfaction of a monetary obligation) because the Trust is still a Grantor Trust. The donor would take a carryover basis in a distributed limited partnership interest (i.e., a pro rata share of the basis associated with the 55% limited partnership interest initially gifted/sold to the Grantor Trust). The trust's net cash flow will be positively affected by the fact that the Donor will be responsible for paying the income tax on the trust income each year. In addition, the payment of the trust's federal income tax liability provides another benefit in that it allows the Donor to make gift tax (and GSTT, if GST exemption was allocated to the gifted limited partnership interest) free transfers to the trust each year.

5. Step Five. Assume interest payments were made with a combination of funds distributed by the partnership and actual limited partnership interests

(valued for such purpose at a discount) and that a 40% limited partnership interest is ultimately held in the Grantor Trust at the end of the 9-year term after the last interest payment is made but prior to satisfaction of the balloon payment. Assume that 40% limited partnership interest has a value at that time of approximately $960,000 (reflecting a 200% appreciation in the value of the underlying partnership assets since the initial sale). A 25% limited partnership interest valued at $600,000 is distributed to the Grantor in satisfaction of the $600,000 balloon principal payment, resulting in a 15% limited partnership interest valued at $360,000 (with an associated capital account balance of $600,000) remaining in the Grantor Trust. The 15% limited partnership interest valued at $360,00 remaining in the Trust reflects the (i) 5% limited partnership interest (valued at $60,000) that the Donor transferred to the trust by gift and paid gift tax on, (ii) the 50% limited partnership interest (valued at $600,000) sold to the trust by the Donor, and (iii) all appreciation on and income earned from those interests, reduced by the balloon principal payment and annual interest payments. In other words, the 15% limited partnership interest valued at $360,00 (including discounts) remaining in the Trust reflects the value that the Donor was able to transfer to the trust tax free, or the "payoff" to this technique.

The $600,000 balloon principal payment would be facilitated either through (i) an in kind distribution of a limited partnership interest (as assumed above), (ii) an initial sale of a limited partnership interest and remittance of sales proceeds, (iii) a partial redemption of the Grantor Trust's limited partnership interest and remittance of the funds received, or (iv) by use of a limited partnership interest as collateral for borrowed funds submitted in payment of the note principal. Keep in mind that if limited partnership interests are sold by the Trust to a third party to generate liquidity to make the balloon payment, the donor will pay any capital gains tax due on any gain recognized in the process. However, if a limited partnership interest is distributed in kind in satisfaction of the $600,000 balloon principal payment, no capital gains should be incurred (as would normally be the result with an in kind distribution in satisfaction of a monetary obligation) because the Trust is still a Grantor Trust. The donor would take a carryover basis in the distributed limited partnership interest (i.e., a pro rata share of the basis associated with the 55% limited partnership interest initially gifted/sold to the Grantor Trust).

6. Caveat. There is a great deal of uncertainty regarding the tax consequences in the event the Donor should die before the note is paid in full.

For income tax purposes, it is possible the IRS could take the position that death causes a realization of the Donor's gain, to extent the note is unpaid, and interest income to the Donor's estate when interest payments are received. If so, the Trust should ultimately receive an income tax basis adjustment for any capital gain recognized. Under the IRS' reasoning, the note would receive no basis step up at death

based upon its characterization as IRD. Other practitioners believe different results occur based upon a belief death should not be treated as a realization event for income tax purposes.

For estate tax purposes, most practitioners have historically assumed the unpaid balance of the note should be included in the Donor's estate (unless structured as a SCIN), plus any interest accrued at death. However, many practitioners are now questioning whether a note should be valued (like any other asset) at fair market value, which would logically be affected by factors such as an increase in interest rates between the date of sale and the date of death.

Bottom line: If the donor's health is failing, you should strongly consider paying off the note before the donor dies to avoid potentially adverse tax consequences.

B. Grantor Retained Annuity Trust. The Grantor Retained Annuity Trust ("GRAT") is another technique that allows the Donor to transfer assets to a trust with no, or minimal, gift tax consequences. The GRAT is similar to the sale of a potentially appreciating asset to a Grantor Trust, but there are substantial differences in both the tax and nontax characteristics of the two techniques. The funding and operation of a GRAT can be illustrated as follows:

1. Step One. 76 year old Donor creates a 5-year (a term the Donor is expected to outlive) Grantor Retained Annuity Trust for the benefit of her child in July, 2006. The trust is irrevocable and is a Grantor Trust for federal income tax purposes so the Donor will pay the related income tax on the trust income.

2. Step Two. Donor transferred a 25% limited partnership interest worth $600,000 to the trust in return for a fixed dollar annuity from the trust for five years. The annual annuity amount is $142,436.46 and is payable at the end of each of the five years during the term. In order to avoid gift tax penalties in the event of a valuation challenge by the IRS, the trust agreement provides for an annuity based upon a fixed percentage of the initial fair market value of the 25% limited partnership interest, as finally determined for federal gift tax purposes. As a result, if the value disclosed on the gift tax return were ultimately challenged successfully by the IRS, the grantor would receive a compensating amount from the GRAT (if still in existence) or the remainder beneficiary (if the GRAT has terminated). In effect, this valuation adjustment provision may "audit proof" the GRAT. In some cases, you might consider providing for the annuity to increase 20% each year, since doing so will generally ensure a greater performance than that achieved by a GRAT with a steady annuity payment, provided certain circumstances are applicable.

   The $600,000 value of the partnership interest was determined by an appraiser using a 40% discount, so the assets owned by the partnership

related to the transferred partnership interest are worth $4,000,000. The amount of the annuity was set so that the present value of the annuities paid over the five year term is just less than the value ($600,000) of the 25% limited partnership interest contributed to the trust. The interest rate required to make this calculation is the Section 7520 rate, which for July, 2006 is 6%. The gift component of the Donor's transfer to the trust is the value of the remainder interest in the trust (i.e., $600,000 minus the present value of the annuity payments retained by the Donor), which in this case is $.66. As a caveat, the IRS will not rule on a GRAT with a remainder interest having a present value less than 10% of the contributed value.

3. Step Three. The Trust's share of partnership distributions provide a source of funds for the Trust to use to make the $142,436.46 annuity payments. However, partnership distributions must be within the general partner's discretion and not subject to a prearrangement by the parties to accommodate annuity payments. If distributions are insufficient in any year to pay the annuity payment due for that year, the annuity must be made with other Trust assets (preferably not limited partnership interests, which would be necessarily valued at a discount). The GRAT cannot issue a promissory note in substitution for an annuity payment and, in fact, must be prohibited from doing so in the trust agreement. The donor would take a carryover basis in any distributed limited partnership interests (i.e., a pro rata share of the basis associated with the 25% limited partnership interest initially gifted to the Grantor Trust). The trust's net cash flow will be positively affected by the fact that the Donor will be responsible for paying the income tax on the trust income each year. In addition, the payment of the trust's federal income tax liability provides another benefit in that it allows the Donor to make gift tax free transfers to the trust each year. However, the GRAT is not exempt from the GSTT (and, generally, cannot be until the end of the annuity term) so there are no GSTT benefits from the trust.

4. Step Four. At the end of the five year period, the trust would own the portion of the partnership interest not distributed in satisfaction of the annuity payments and any cash it had accumulated over those years. The remaining partnership interest, any cash on hand, and future distributions from the partnership, would accumulate in the trust for the Donor's heirs. In the event the Donor should die before the end of the five-year annuity term, part or all of the trust assets may be includable in the Donor's taxable estate, as discussed below.

   Assume annuity payments were made with a combination of funds distributed by the partnership and actual limited partnership interests (valued for such purpose at a discount) and that a 12.5% limited partnership interest is ultimately held in the Grantor Trust at the end of the 5-year term. That 12.5% limited partnership interest has a value at that time of $600,0000 (rounded), reflecting a 200% appreciation in the value of the underlying partnership assets over the 5-year term of the GRAT, and, consequently, an

associated capital account balance of $1,000,000. The 12.5% limited partnership interest valued at $600,0000 (discounted) remaining in the Trust reflects the (i) 25% limited partnership interest (valued at $600,000, with a discount) that the Donor originally transferred to the trust by gift and (ii) all appreciation on and income earned from it, reduced by the annuity payments. In other words, the limited partnership interest valued at $600,0000 (including discounts) remaining in the Trust reflects the value that the Donor was able to transfer to the trust tax free, or the "payoff" to this technique.

5. Alternatives to Consider: Short-term GRATs may be worth considering given the decreased risk of the Donor's dying during the GRAT term and, consequently, causing partial or entire inclusion of the remaining trust property in his/her estate. As an added benefit, rolling short-term GRATs may result in profitable years more than making up for the short fall in the lean years. As a caveat, the IRS will not rule on a GRAT with a term less than 3 years.

C. Comparison of Sale to Grantor Trust/GRAT.

1. Estate Tax.

a. GRAT

If the Donor survives the term, the asset contributed to the GRAT will be excluded from the Donor's estate, although unconsumed annuity payments will be included.

If the Donor dies during the term, unconsumed annuity payments will be included in the gross estate, but the consequences with respect to the property held in the GRAT are less clear as discussed below. Whereas the note received in a sale to an IDGT can be paid off if the Donor's health is failing to avoid the possible negative tax consequences applicable in that event, the grantor's interest in a GRAT cannot be commuted (i.e., remaining annuity payments cannot be accelerated) to avoid such issues.

i. Possible Outcome #1.

All of the assets held in a GRAT may be excludable by analogy to a Seventh Circuit opinion predating the enactment of Section 2702. See Estate of Becklenberg v. Comm'r, 273 F2d 297,301 (7th Cir., 1959), rev'g 31 TC 402. In Becklenberg, the Seventh Circuit concluded a trust's obligation to pay the decedent $10,000 for the remainder of her lifetime was chargeable to the entire trust and not limited to the property she previously transferred to the Trust or the income earned by that property. As such, the Court concluded the annuity payments did not constitute retained income from the contributed property, which would have otherwise justified inclusion of the property in her gross estate.

ii. Possible Outcome #2

By analogy to authority applicable with respect to charitable remainder trusts ("CRATs"), part of the property held in the GRAT may be includable. Pursuant to Revenue Ruling 82-105, the amount of a CRAT includable in the grantor's estate is that portion of the trust property necessary to generate sufficient income to produce the retained annuity for life based upon the grantor's age immediately prior to death, taking into account the 7520 rate in effect at that time. If the 7520 rate applicable at death is less than that applicable at the creation of a CRAT, at least part of the CRAT assets would be excluded. Presumably, a similar analysis would be applicable with respect to assets held in a GRAT in the event the Donor were to die during the GRAT term. It further reasons that a GRAT with a term less than life should benefit favorably under this reasoning. However, the Tax Court has, on at least one occasion, failed to respect such a distinction in determining the proportion of trust property includable with respect to a trust from which the grantor retained an annuity for a term of years. See Pardee v. Comm'r, 49 TC 140, 150 (1967), acq., 1973-2 CB 3.

iii. Possible Outcome #3

Not surprisingly, the IRS' apparent position is that all of the GRAT property is includable under IRC 2039 if the Donor dies within the GRAT term. See PLRs 9451056 and 9345035. Arguably, this may not be a supportable position for the IRS if the Donor's estate is entitled to the remaining annuity payments for the retained term since in that event no trust beneficiary receives any payments as a result of surviving the Donor.

B. Sale to IDGT

The property transferred to the IDGT is excluded from the Grantor's estate, but the note (unless a SCIN) and any interest due will be included. Unconsumed payments previously made on the note are includable as well.

2. Gift Tax.

a. GRAT

If the annuity is set sufficiently high, a gift can be avoided or only a nominal gift made.

By regulation, an annuity payment can be determined by a percentage of the fair market value of the contribution, as finally determined for transfer tax purposes. If a GRAT is zeroed out or effects only a nominal gift, this adjustment feature can effectively "audit proof" a gift to a GRAT.

b. Sale to IDGT

An initial seed gift should be made unless a previously funded grantor trust is available to enter into the transaction. If the sale is for the subject asset's fair market value and interest on the note is payable at the applicable AFR (determined by the note's term), no gift should result.

Adjustment clauses applicable with respect to sales to IDGTs have inherent complications (e.g. generally the IRS disregards them) and are not expressly authorized by Regulation or IRS pronouncement.

3. Income Tax.

a. GRAT

No sale occurs. The Donor is taxable on the GRAT income during the term. After the GRAT has expired, the beneficiaries take a carryover basis in the transferred assets. If the Donor dies during the GRAT term, the assets may be entirely or partially included in the Donor's estate (see above), and to the extent included, will receive a step up (or step down) in basis.

b. Sale to IDGT

No sale is recognized for as long as the Trust remains a Grantor Trust. If the Donor dies while the note is outstanding, the income tax consequences are unsettled. The worst case scenario is the Trust takes a cost basis in the assets based upon the remaining principal payments made and the Donor's estate recognizes gain on the remaining payments and income on any interest payments remaining.

4. GSTT.

a. GRAT

GSTT exemption cannot be allocated until the expiration of the GRAT term due to the ETIP rules.

b. Sale to IDGT

Exemption can (and most often, should) be allocated to the seed gift on a timely filed gift tax return reporting that gift.

5. Key Valuation Rates

Basically, the success of transfer techniques such as sales to Grantor Trusts and GRATs is tied to the income and appreciation of the transferred assets exceeding the rate by which the payments back to the Donor is calculated. That excess, if any, is a tax free gift from the Donor to the heirs.

a. GRAT

For a GRAT, the benchmark rate is the Section 7520 rate in effect when the technique is implemented. For July, 2006, the 7520 rate is 6%.

b. Sale to IDGT

The benchmark rate that the assets sold to a Grantor Trust must exceed to be successful is the AFR applicable for the term of the note, which is typically lower than the 7520 rate (subject to exceptions in certain cases if the note term exceeds 9 years). Consequently, the sale to an IDGT generally produces a better result than a sale to a GRAT if the Donor survives the note's term. As of July, 2006, the AFR (compounded semi-annually) for a promissory note of less than three years is 4.99%, for a promissory note ranging from three to nine years is 4.99%, and is 5.22% for a note in excess of nine years.

6. Supportive Authority

a. GRAT

Expressly authorized by statute and Treasury Regulations.

b. Sale to IDGT

Based upon general authority from the IRS concluding transactions between a grantor and a grantor trust should be ignored for income tax purposes.

7. Common Concerns.

Of course, the analysis of the viability of these techniques relies on many factors other than just whether or not the transferred assets will produce appreciation and income that will exceed the benchmark rate. Some of those factors to consider include:

a. Facilitation of Payments.

If a limited partnership interest is involved, it may be dangerous to rely on a steady stream of pro rata distributions from the partnership to facilitate payments to the Donor since that may be viewed (understandably) by the IRS as evidence of a prearranged accommodation by the general partner and, consequently, as an invalidation of any discounts used in valuing the limited partnership interest transferred. Ideally, other liquid trust assets would be available for satisfying payments, but if not, it may be better to use limited partnership interests (valued at a discount) on occasion to satisfy payments due the Donor rather than run the risk of losing the benefit of the discount entirely.

b. Appraisals. The most accurate method of determining the discounted value of limited partnership interests is to have the value assessed by a qualified business appraiser. By engaging such appraiser for this function, you will maximize the discount that you can reasonably claim (as opposed to setting the discount yourself, which almost certainly requires that you use a conservative discount factor lower than that which would be employed by the appraiser) and provide you with a value that is supported by the appraisal report prepared by the appraiser and the integrity of that appraiser. Likewise determining the value of the assets owned by the partnership is an important element of the overall valuation process. With regard to those assets, the experience of the people who operate the partnership may enable them to be able to value those assets effectively, including appropriate discounts, more so than would be the case with respect to the partnership interests.

c. Gift Tax Statute of Limitations. The gift tax statute of limitations runs for three years, and once that statute has expired, the value of the gift reported on the federal gift tax return is generally final and beyond challenge by the IRS. In order for the statute of limitations to run with respect to a gift, that gift must be adequately disclosed on the gift tax return. In addition to the basic information required on the gift tax return, adequate disclose requires that certain gifted assets be valued based upon a "qualified appraisal" setting out a detailed description of the method used (and attaching a copy of the appraisal to the gift tax return).

D. Private Annuities

What do you do when your client's child calls you and tells you that your 70-year-old client has been diagnosed with lymphoma and has only a one- to two-year life expectancy? In addition to expressing compassion, you should also inform the client about a sale for a private annuity. Using this technique, the client sells her interest in an asset to a Trust for her descendants, in return for an annuity for her lifetime. The annuity must be unsecured and payment of the annuity cannot be tied to income from the property if adverse tax consequences are to be avoided. The annuity should be payable with full recourse to the obligor's other assets in order to avoid retained interest issues. Consequently, the obligor should be in sufficient financial health to fulfill his/her obligations under the arrangement. If the obligor is a Trust with insufficient other assets, consider seeking a guarantee by the beneficiary.

The private annuity is a useful federal estate tax saving tool because, by design, payments end when the transferor dies, and the entire value of the asset sold to the Trust is immediately removed from the transferor's gross estate. In other words, there is no estate tax in the transferor's estate from the transferred property because it belongs to the buyer from the moment the private annuity document is signed. Unconsumed annuity payments will be included in the transferor's estate for estate tax purposes.

The annuity amount is based on the IRS life expectancy tables, not on the seller's actual life expectancy. The client must have at least a 50% chance of living at least one year, or the tables may not be used. This type of sale artificially lowers the income tax basis of the sold assets, since the basis of an asset sold for a private annuity will be limited to the amount actually paid under the annuity contract. Therefore, it is usually best used for selling a limited partnership interest where there is no Section 754 election in effect. By doing so, the basis of the assets inside the partnership would not be diluted.

The income tax consequences associated with a private annuity are complicated and beyond the scope of this presentation but should be carefully considered prior to recommending this technique to a client.

E. Self-Canceling Installment Notes ("SCINs")

1. The Basics, Including Transfer Tax Consequences.

A SCIN is a debt obligation which will terminate upon the earlier of the term of the note or the death of the seller-debt instrument holder, with any remaining balance payable by the purchaser-debtor automatically cancelling if the seller dies before the end of the term. In order

to compensate the seller for the risk of cancellation and, consequently, avoid the original sale from being recharacterized as a partial gift, the SCIN must have a risk premium, which can be in the form of a higher interest rate or a higher sale price. As a caveat, if the seller's life expectancy is less than the term of the note, the IRS takes the position that the transaction is to be taxed for income tax purposes as a private annuity, typically resulting in the denial of any deduction for interest paid.

Thus, a SCIN can be an effective estate planning tool because if a senior family member sells an asset to a junior family member in exchange for a SCIN, any remaining balance on the SCIN at the time of the senior family member's death will not be includable in his or her gross estate for estate tax purposes. The treatment of the SCIN for estate tax purposes differs from the treatment of a traditional installment note, which would be includable in the estate of a decedent if still outstanding.

2. COSTANZA V. COMMISSIONER.

Duilio Costanza, the decedent, owned an Italian restaurant and small office plaza in Flint, Michigan. The properties were appraised in 1991 at a value of $830,000. In 1992 after consultation with his attorney, the decedent sold the two properties to his son Michael for their 1991 appraised value. The decedent planned to return to his native Italy and retire.

The SCIN provided that Michael would make monthly installment payments to the decedent over an 11 year period. The SCIN had an initial interest rate of 6.25% which increased 0.5% each year until it reached 8.75%. The long-term AFR at the time which the SCIN was executed was 7.34%. The obligation under the SCIN was secured by a mortgage on both properties. The SCIN and the mortgage were both dated December 15, 1992, but the parties did not actually execute the documents until late December, 1992 or early January, 1993.

Payments under the terms of the SCIN were supposed to commence on January 1, 1993; however, Michael did not make a payment until March 8, 1993 when he wrote three checks for the monthly payment amount, each dated January 1, 1993, February 1, 1993, and March 1, 1993. Michael never made any other payments on the SCIN.

The decedent, who had been suffering from heart disease for several years, underwent a second bypass surgery on May 11, 1993 and died the next day. Medical experts testified that when the SCIN was entered into between the decedent and Michael, the decedent had a life expectancy of between five and 13.9 years.

The estate filed the estate tax return and listed the SCIN as an estate asset, but reported a value of $0. The IRS then issued a notice of deficiency stating that the value of the properties, less the three payments made by Michael should be includable in the decedent's estate because their was not a bona fide sale for full and adequate consideration. Alternatively, the IRS asserted that even if the SCIN was valid, there was a bargain sale and that the decedent's adjusted taxable gifts should be increased by the amount of the bargain component.

The Tax Court sided with the IRS in finding there was no bona fide sale for full and adequate consideration. The Tax Court found the following facts persuasive:

- The documentation evidencing the transaction were all executed after December 15, 1992;
- The terms of the SCIN required Michael to make monthly payments beginning January 1, 1993 but no payments were made until March 8, 1993 at which time the checks were backdated to match the payment dates; and,
- no payments were made on April 1, 1993 and May 1, 1993.

The Sixth Circuit found that the Tax Court erred in its findings that the SCIN was not a bona fide transaction. The Sixth Circuit found that the issue of backdating the documents a few weeks was inconsequential. In doing so it relied on the testimony of the decedent's attorney who said that he needed to pick a date on which to begin the amortization schedule while the documents were being circulated for signature.

As for the issue of making three payments on March 8, 1993, the Sixth Circuit accepted Michael's testimony that it was the decedent's wish that he be paid quarterly as opposed to monthly. There was also no evidence to indicate that either Michael or the decedent had any reason to suspect that the decedent would die so soon after executing the SCIN. The Sixth Circuit also took into account the fact that the payment was secured by a mortgage as further evidence that there was a bona fide sale. Most importantly, the Sixth Circuit rejected the IRS' argument that a sale in exchange for a SCIN is inherently not a bona fide sale because the sole motivation for the sale is the expectation that the seller will die during the note term. The Sixth Circuit did remand the case to the Tax Court to address the issue of whether or not there was a bargain sale.

3. Income Tax Consequences.

The income tax consequences associated with a SCIN are complicated and beyond the scope of this presentation but should be carefully considered prior to recommending this technique to a client.

F. Private Annuities v. SCINS

Both SCINS and Private Annuities present excellent estate tax reduction strategies in a low interest rate environment. From the perspective of the senior generation family member, a private annuity may be preferable if he or she needs the income stream from the sale to provide retirement income. The private annuity will continue for the life of the senior generation family member even if he or she outlives their actuarially determined life expectancy.

A SCIN may be more attractive to the junior family member if the junior family member has investment income which he or she can offset with the investment interest expense deduction generated by the SCIN payments, as opposed to the private annuity interest payments which must be capitalized. Also, the SCIN provides more flexibility in structuring payment terms. A SCIN can be structured to provide for unequal payments which may be beneficial to the junior family member who is managing cash flow. Also, if the junior family member plans to use the asset acquired in a trade or business or dispose of the asset in a taxable transaction in the near future, the

SCIN could be structured so that the risk premium to the senior generation family member is reflected in a purchase price above fair market value with a lower interest rate. By structuring the SCIN in this manner, the junior family member would receive a higher income tax basis for depreciation and sale purposes.

VIII. TAXABLE GIFTS

It may still make sense to make taxable gifts using one or more of the techniques previously described if the donor is (i) not expected to live until anticipated estate tax reforms may be implemented, (ii) expected to have a taxable estate even after anticipated estate tax reforms may be implemented, or (iii) inclined to hedge his/her bets by at least making gifts of low value assets with significant appreciation potential.

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PLANNING WITHIN THE FROZEN GIFT TAX EXEMPTION

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