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MEMORANDUM

TO: **Mr. Client**

FROM: **Dennis C. Reardon**

DATE: **January 16, 2013**

RE: **Spousal Access Trust/Irrevocable Grantor Trusts**
Income Tax and Estate Tax Implications

There are certain estate planning measures which may permit an individual to have a financial "win," with only the failure to win, but not a loss, as the downside risk of a planning technique. For instance, consider the transfer of Mrs. Client's existing life insurance policy to her new Irrevocable Trust. Mrs. Client must survive for three years in order for the insurance proceeds payable at her death to be excluded from her estate for federal estate tax purposes. However, if she dies within the three year period after the transfer of the policy is made to the Trust, the policy still qualifies for the estate tax marital deduction, in a similar manner to what would have happened if Mrs. Client had remained the owner of the policy and Mr. Client remained the beneficiary.

On the other hand, while gifts of nonvoting stock to the Spousal Access Trust and the Irrevocable Grantor Trusts offer tremendous opportunities for estate tax savings, they also carry the risk that no estate tax savings may occur and that the income tax consequences of the gifts *may* be worse than if no gifts were made.

To illustrate the point, let me offer two examples.

Example 1: Client wins. Suppose that Mr. Client owns a company which is worth $3 million, and that he has a $1 million cost basis in the company. Mr. Client gives stock to an Irrevocable Grantor Trust. By the time Mr. Client dies, the stock has grown to $8 million in value.

After his death, Mr. Client's executor sells the stock for $8 million. Here are the federal estate tax and income tax results, based upon current tax rates.

	With Plan	Without Plan
Estate Tax Savings	$2,000,000[1]	$0[2]
Income Tax Cost	$1,666,000[3]	$0[2]
Tax Savings	$334,000	$0

Example 2: Client loses. Same facts as Example 1, except that Mr. Client's stock is worth $4 million when Mr. Client dies.

	With Plan	Without Plan
Estate Tax Savings	$400,000[4]	$0[5]
Income Tax Cost	$714,000[6]	$0[5]
Tax Savings	($314,000)	$0

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[1]$5 million of asset growth not subject to estate tax at a 40 percent rate. ($5,000,000 X .4 = $2,000,000).

[2]No estate tax savings realized, but no capital gains tax either because basis is stepped up to its fair market value at Mr. Client's death.

[3]$7 million of capital gain ($8 million minus $1 million cost basis) is taxed at a 23.8 percent capital gains tax rate if stock is sold after death.

[4]$1 million not subject to estate tax at a 40 percent rate ($1,000,000 X .4 = $400,000).

[5]No estate tax savings realized, but no capital gains tax either because basis is stepped up to its fair market value at Mr. Client's death.

[6]$3 million of capital gain ($4 million minus $1 million cost basis) at a 23.8 percent capital gains tax rate.

I should add that the income tax risk is a function of a sale after death compared to the estate tax liability. If a lifetime sale occurs, the same income tax cost is incurred whether or not the Trusts were established. Conversely, if no sale occurs after death, no income tax cost is incurred. While death at a certain level of wealth automatically generates an estate tax, the income tax cost is incurred because of a voluntary decision that the sale is worthwhile.

In any event, the following is a formula that enables you to know how much growth is needed to break even, as compared to taking no estate planning action and selling the asset after death.

Issue: How much growth must be achieved so that estate tax savings will at least equal income tax costs?

Assumptions:

Fair market value of asset:	\$1,000,000
Basis of asset:	\$400,000
Capital gains:	\$600,000
Estate tax rate:	40%
Capital gains tax rate	23.8%

Solve for amount of growth to break even

X = amount of growth

$$.238\ (\$600{,}000 + X) = .4X$$
$$\$142{,}800 + .238X = .4X$$
$$\$142{,}800 = .162X$$
$$X = \$881{,}481$$