Increasing Assets For Future Generations

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Most people who have significant assets would like to make sure "adequate" assets are available for their children, grandchildren and even more distant generations. How can that occur with federal gift, estate and generation-skipping transfer tax rates of 40%, and possible additional state taxes? It isn't easy, but with proper planning and sufficient time these taxes can be reduced materially and assets available for future generations can be increased substantially. Here is a high-level explanation of ways to accomplish these dual goals.

Transfers of assets to individuals or trusts for their benefit are subject to a federal gift tax on transfers during life and a federal estate tax on transfers at death, to the extent the transfers are not otherwise excluded from tax or covered by an exemption. An additional generation-skipping transfer (GST) tax is imposed on transfers during life or at death that skip a generation and are not covered by a separate exemption. Various states also impose their own gift, estate or GST (collectively "transfer") taxes.

The current federal transfer tax rate is 40% on amounts above an integrated lifetime gift and estate tax exemption, adjusted annually for inflation, and above a separate GST tax exemption, also adjusted annually for inflation. Both of these exemptions are $5,340,000 for 2014.

Application of these two exemptions is complicated, but essentially the integrated lifetime gift and estate tax exemption applies to amounts gifted by an individual during life that are not otherwise excluded, any lifetime gift exemption not used during life is applied to amounts transferred at death that are not otherwise excluded, and any remaining exemption is available to be used by a surviving spouse (referred to as "portability"). Amounts gifted during life or transferred at death by an individual in ways that skip a generation are subject to the separate GST tax exemption, but portability is not available for this exemption.

Transfer tax rates, exemptions and planning strategies continue to receive attention by Congress. Proposals include tightening the availability of certain valuation discounts, restricting the use of grantor retained annuity trusts (GRATS), eliminating tax benefits grantor trusts can provide, eliminating tax benefits of selling assets to a family trust, and limiting the duration of GST-exempt dynasty trusts. Most of these proposals appear to be for new transactions and not retroactive for pre-existing transactions, but they all deserve careful attention.

As we work with wealthy families, we stress the importance of implementing as soon as possible strategies designed for their particular circumstances to maximize the likelihood that future generations will have the assets they want available to them.

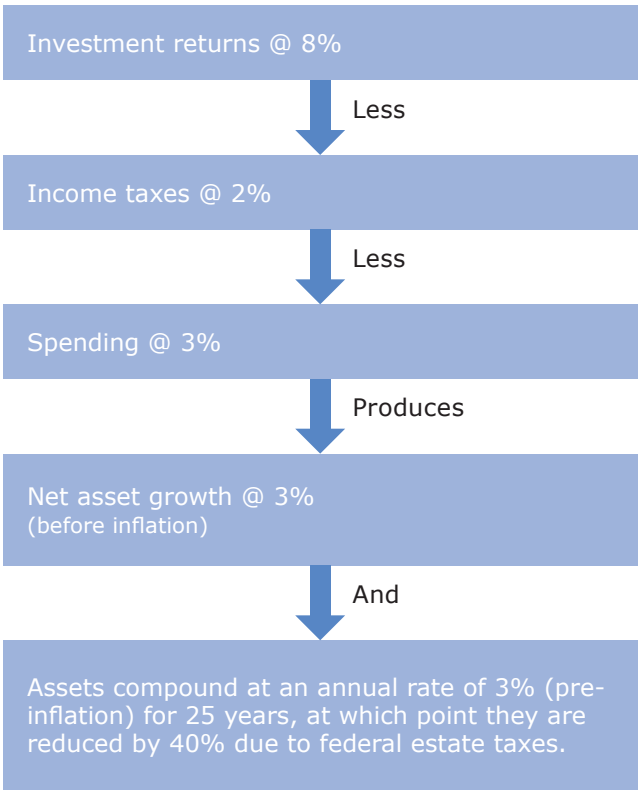
Generally, this involves the use of professional advisors who assist with:

- Determining personal goals, family goals and concerns about the effects of inherited wealth.
- Assessing the ability and willingness to part with specific assets and give up at least partial control of them.
- Developing an understanding of potential strategies.
- Implementing a unique wealth transfer plan that is responsive to the family's particular goals, concerns and assets.

Why Should You Care?

Transfer taxes and inflation combine to constrain the accumulation of inherited wealth and can be confiscatory over successive generations. Even when net worth grows at a rate that offsets the combination of spending, income taxes and inflation, transfer taxes can reduce wealth dramatically. For example:

Assume:



Result: In 25 years (one generation), after the payment of federal estate tax at a 40% rate, the assets will have a value of only about half of today's value (before adjusted for inflation).

After another 25 years (approximately two generations), inflation and estate taxes will reduce the real value of the remaining assets to only a fraction of today's value.

Benefit From Transferring Assets Using Excluded Gifts

Some gifts during life and transfers at death (bequests) are excluded from federal transfer taxes before the application of any exemptions. All gifts and bequests to qualified charities are excluded from federal transfer taxes, as are transfers to a spouse who is a U.S. citizen. Gifts to a spouse who is not a U.S. citizen are subject to an annual exclusion, which is $145,000 for 2014 (adjusted annually for inflation), and bequests are subject to special rules as well.

More importantly, for the purposes of transferring wealth to subsequent generations, significant amounts can be transferred over time using the following exclusions from federal transfer taxes:

Annual Exclusion Gifts: Each year an "annual exclusion" amount ($14,000 for 2014, indexed annually for inflation) given by any person (the "donor") to any person (the "donee") is excluded from federal transfer taxes. Married couples can give twice the amount ($28,000 for 2014) to any person each year.

Medical Expenses (including insurance premiums): All payments made by a donor directly to an institution that provides medical care or directly to a company that provides medical insurance to an individual, who is treated as the donee, are excluded from federal transfer taxes.

Tuition Expenses: All payments made by a donor directly to a qualifying domestic or foreign institution as tuition for the education of an individual, who is treated as the donee, are excluded from federal transfer taxes.

Lifetime gifts that are not excluded are taxed at the current gift tax rate (40%) once they total more than the gift tax exemption ($5,340,000 for 2014).

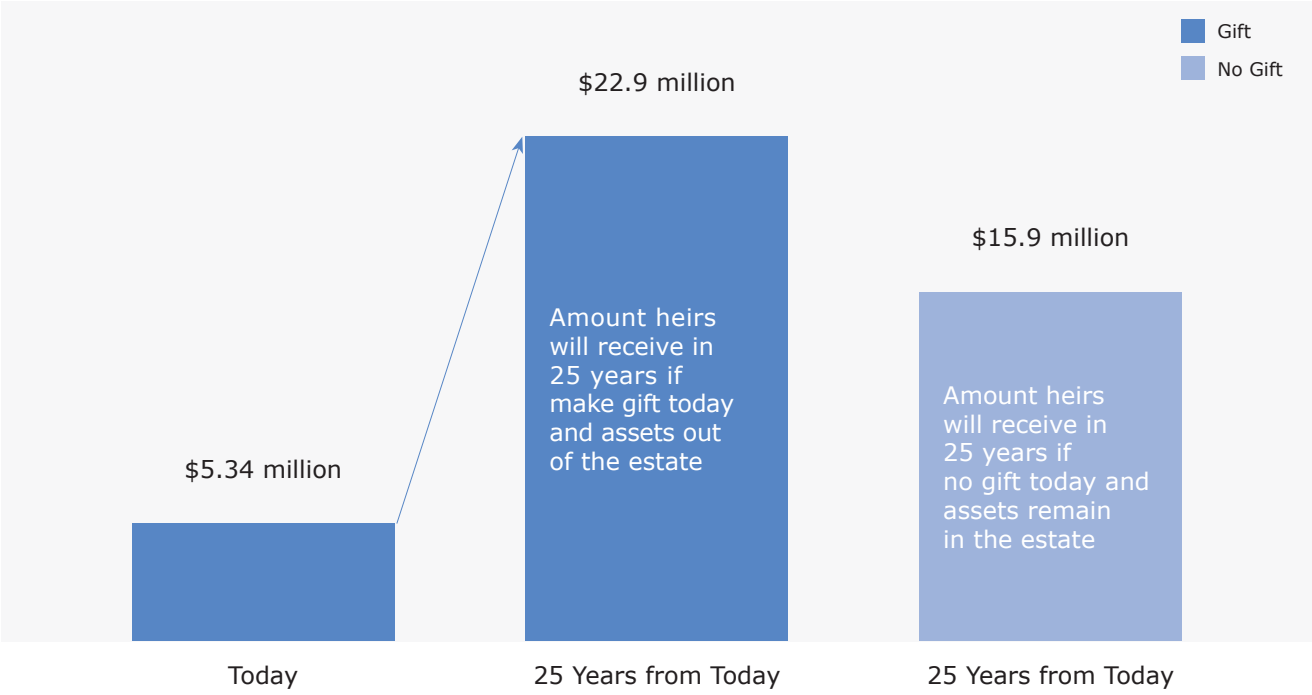
Benefit From Using The Lifetime Gift Tax Exemption Now

Using the lifetime exemption for gifts today is preferable to using the exemption for bequests at death. The benefit can be dramatic – because all future growth in value is outside of the estate – if the assets transferred experience post-gift appreciation over a number of years. For example:

Illustration of a Gift Today Using the Gift Tax Exemption

Assume:

- $5,340,000 gift today
- 6% annual after-tax growth for 25 years with no spending
- 40% federal gift and estate tax rates with $5.34 million exemptions currently and in 25 years
- No state gift or estate taxes
- Death in 25 years



Result:

Estate tax savings of approximately $7.0 million will be realized, resulting in over 40% more assets being available to heirs in 25 years.

Benefit From Making Generation Skipping Transfers Now

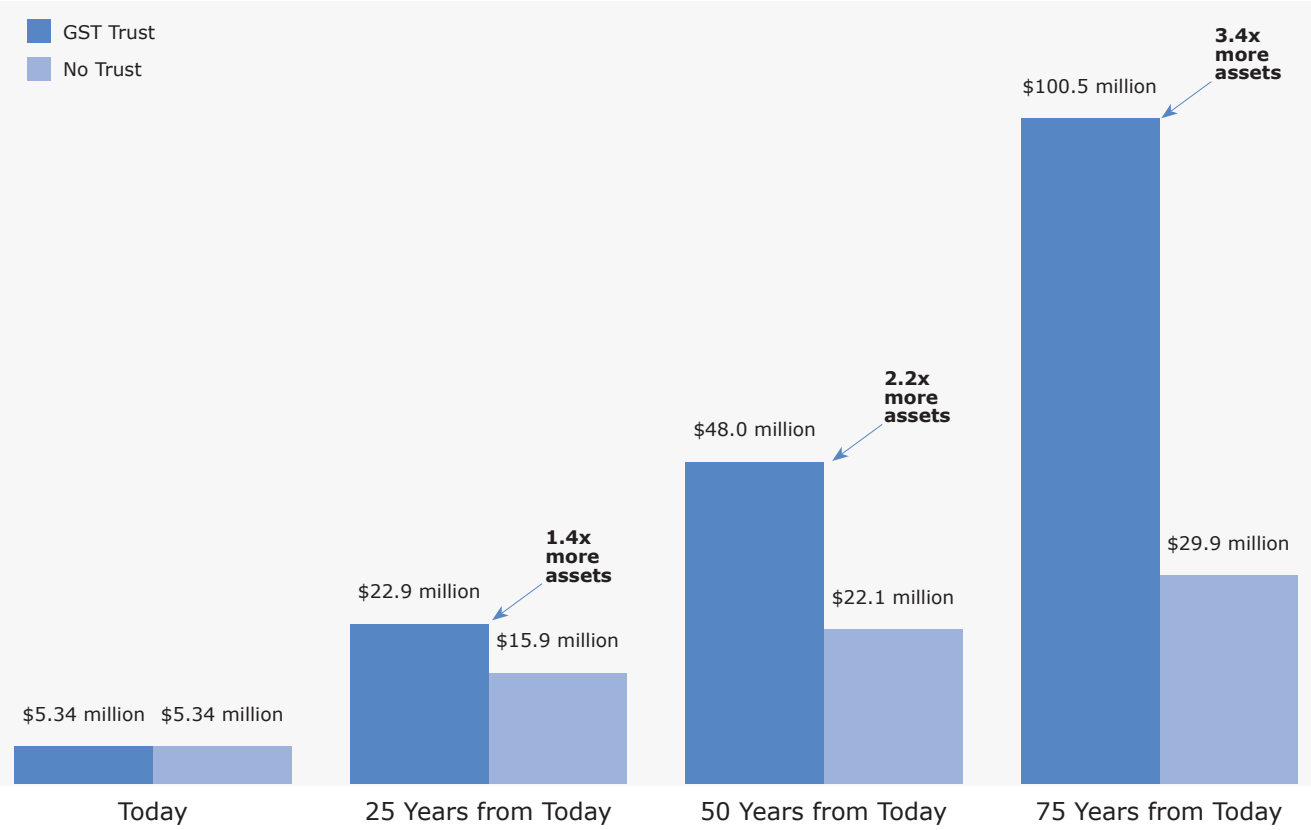
The GST tax is applied at each generation and it constitutes an additional gift or estate tax on transfers that exceed a GST exemption, skip children and go to grandchildren. Using the GST tax exemption in combination with the lifetime gift tax exemption, both of which are $5,340,000 for 2014, is a powerful long-term planning strategy.

A transfer today that qualifies for both the lifetime gift and GST tax exemptions removes the imposition of estate taxes at successive generations, which can produce a huge difference in the value of assets retained in the family. For example:

Illustration of the Benefit of Using Both the Gift Tax and GST Tax Exemptions Today

Assume:

- $5,340,000 gift today to a GST Trust
- 6% annual after-tax growth for 25 years with no spending
- 3% spending starting in year 26, resulting in 3% growth after taxes and spending in years 26-75
- 40% federal gift and estate tax rates with $5.34 million exemptions currently and in years 25, 50 and 75
- No state gift or estate taxes
- Deaths for parents in 25 years, children in 50 years and grandchildren in 75 years



Result:

Estate tax savings, plus growth of those savings will result in approximately 240% more assets being available to heirs 75 years from today.

How Long Can "Long-Term" Be?

Historically, trusts were required to terminate under a concept called the *law against perpetuities*, which limited a trust's life to 21 years after the death of the last person to die among a specified group of people living at the time the trust was created.

Over the last several years, numerous states have repealed the law against perpetuities and replaced it with state-specific "Dynasty Trust" laws that allow trusts located in their state to continue for hundreds of years or, in some states, indefinitely. These new Dynasty Trust laws allow GST tax-exempt gifts to avoid future estate taxes for the length of time specified in the state where the trust is located, creating the opportunity for a near-permanent estate tax shelter trust.

Not surprisingly, legislative proposals have been made to limit how long a trust can remain exempt from federal estate and GST taxes, with some calling for a 90-year maximum exemption for new GST Trusts created after the date of enactment. The threat that such a limit may be imposed is another reason to implement GST tax-exempt gift strategies now.

Appreciate The Many Non-Tax Benefits Of Trusts

Trusts are typically used to implement long-term strategies designed to save estate taxes, but they also enable important non-tax related goals to be achieved. Properly structured and administered, trusts can remain flexible and responsive to changing circumstances over multiple generations.

For example, trusts can:

- Provide a safety net for children and future heirs by establishing an asset base that can be used with discretion to help them in ways such as fund education costs, pay health care expenses, provide a down payment for a home, or support starting a business.
- Shelter assets to a substantial degree from beneficiaries' creditors, adverse financial impacts of divorce, or financial incompetence.
- Provide for unborn beneficiaries when a trust is created, potentially for multiple generations.
- Make assets available for use by a donor's spouse and his or her descendants.
- Utilize combinations of family and non-family individual trustees, corporate trustees and professional advisors to ensure a desirable combination of long-term tax benefits, productive investment management, prudent trust administration and adherence to family values and desires.

We encourage the use of flexible, carefully drafted trusts with discretionary distribution powers, rather than mandatory payouts. We also recommend the separation of fiduciary roles among carefully selected trustees and professional advisors, with the appropriate involvement of beneficiaries in the appointment of trustees and advisors.

Grantor Trusts Can Provide Additional Tax Benefits Now

A trust can be structured to achieve the gift, estate and GST tax benefits described above, yet continue to have its income taxed to the donor who funds the trust (also called a "grantor"), so long as the trust contains certain provisions and they are active. While those provisions remain active, the trust is called a "Grantor Trust" and:

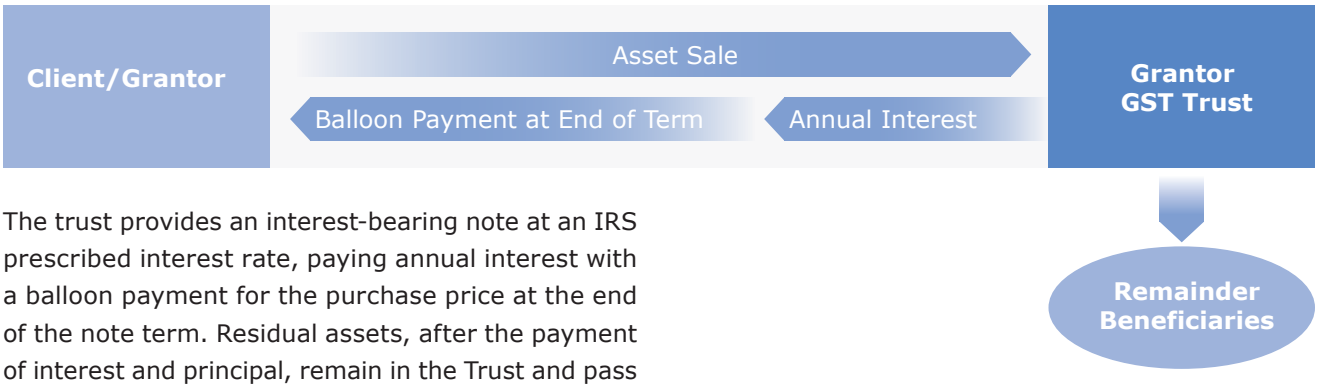
- The taxes paid by the grantor are not treated as a gift to the beneficiaries of the trust, resulting in a tax-free gift equal to the trust's income tax liability that reduces the grantor's future estate while the trust grows tax-free.
- Grantor Trusts can be structured so that the provisions causing the income to be taxed to the grantor can be made inactive, thereby "turning off" the taxation of the income to the grantor. When this occurs, the income is taxed to the trust and/or its beneficiaries, relieving the grantor of that burden and terminating the grantor trust wealth transfer strategy.

Understandably, legislative proposals have been made that would eliminate the beneficial treatment of Grantor Trusts described above for trusts created after the date of enactment. This potential change underscores why Grantor Trust strategies should be considered now.

Grantor Trusts can be funded using both the lifetime gift and GST tax exemptions in combination with other strategies. Here is an illustration of the benefits that can be achieved by combining exempt gifts with a sale of assets to a Grantor Trust:

Illustration of a Sale of Assets to a Grantor GST Trust

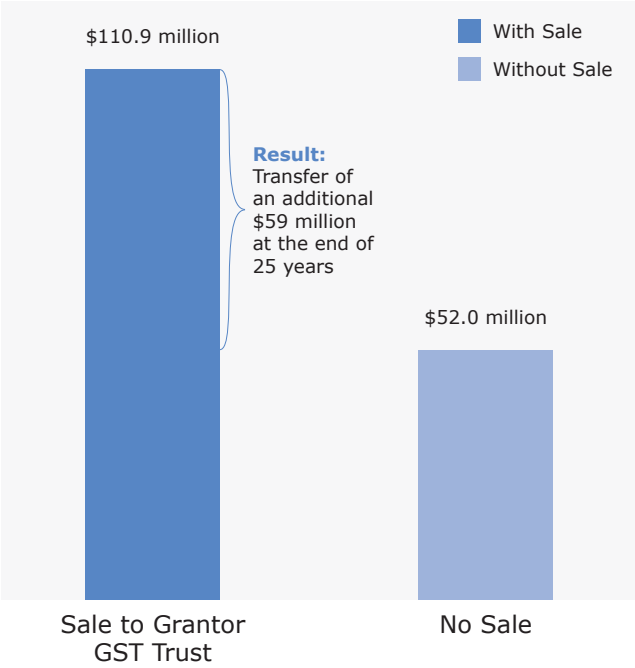
Objective: Grantor wants to retain the current value of an asset but is willing to give away the future appreciation.
Best when: Low interest rate environment at time of sale and asset appreciates substantially after the sale.



The trust provides an interest-bearing note at an IRS prescribed interest rate, paying annual interest with a balloon payment for the purchase price at the end of the note term. Residual assets, after the payment of interest and principal, remain in the Trust and pass to remainder beneficiaries free of gift and estate tax.

Assume:

- Existing Grantor GST Trust has $5.34 million in assets, maybe from prior gifts
- $10 million of assets sold to the Trust in return for a $10 million nine-year note paying 2% annual interest*
- Trust pays interest and principal when due
- Trust assets grow 15% pre-tax for 5 years, then 8% pre-tax for the next 20 years
- 40% federal gift and estate tax rates now and in 25 years
- No state gift or estate taxes



* Low current interest rates favor this strategy. A higher rate would be paid on the note if market rates of interest were higher, but the strategy would still be beneficial unless market rates were exceptionally high.

Conclusion

Estate taxes cannot be significantly reduced on current assets if both spouses die owning the assets. However, estate taxes that otherwise will be paid in the future can be reduced substantially by implementing strategies today that operate over time to transfer future appreciation out of the spouses' estates and make that value available to future generations.

Here is an illustration of how an integrated approach to multi-generational wealth transfer planning can transfer significant amounts of wealth to future generations, while achieving family and charitable objectives.

Wealth Planning in Action

The experience of a family that has been a Gresham client since the firm was established, and was a client of Gresham's founders for several years previously, illustrates the impact wealth planning can have over time. At the beginning of the relationship, the family had significant assets, of which 72% were held by Generation I and 28% were held by Generation II. Generation III, GST exempt trusts and charitable entities came into being over the ensuing years.

Over the years we introduced the family to various wealth transfer strategies and closely coordinated their implementation with a team of top legal, tax and philanthropic advisors. The wealth has grown substantially; the wealth transfer planning has resulted in a significant shift of the family's assets to Generations II, III and beyond; and, family estate tax savings of approximately $81 million (at 2014 tax rates) have been achieved and will continue to grow with ongoing planning and growth of the family's assets.

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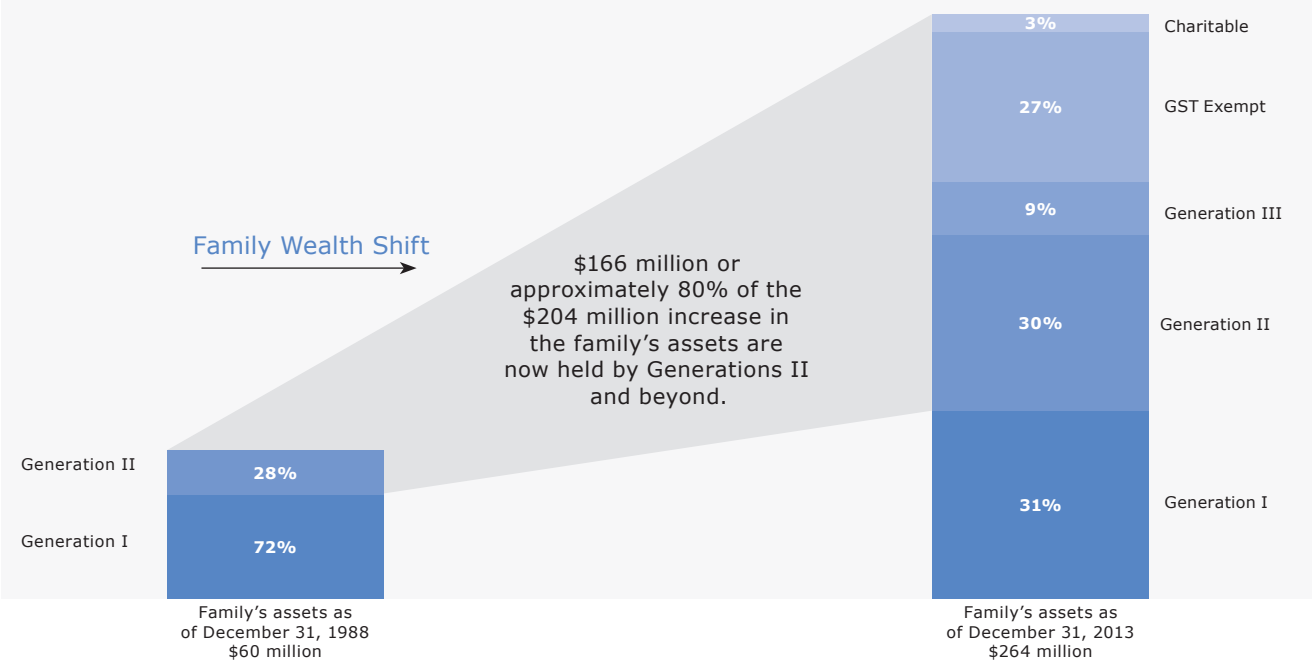
Please see Notes to *Wealth Planning in Action.*

Impact of Wealth Planning Strategies Over Time



Notes to *Wealth Planning in Action*

This illustration is not a performance advertisement. It reflects the results for a single Gresham client and is not indicative or representative of the results for any other Gresham client. During various periods other Gresham clients had results that were different than the results achieved by this client. This client was selected because the client is Gresham's oldest client for which data is available and because the client's objectives included wealth preservation, wealth creation, wealth transfer and philanthropic strategies over the period Gresham and its founders advised the client.

The illustration includes assets of the client that are not advised by Gresham. The client in the illustration received advice and counseling over the period from legal and tax professionals not affiliated with Gresham. The results shown reflect the tax planning and wealth transfer advice provided by other professionals in addition to the advice provided by Gresham. The wealth transfer results shown do not reflect or indicate Gresham's investment performance.

The increase in assets shown in the illustration are net of spending, taxes, charitable gifts and expenses, including Gresham's fees, over the period.

Over the period presented, investment markets were generally favorable. Past investment results are no guarantee of future investment performance. No assurance can be given that changes in tax or other laws will not have a material adverse effect on the availability of future planning strategies or planning results of the type utilized in the illustration.

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