

Retained life interests

Dear Reader:

You recently asked about the future impact on your federal estate tax of giving property away while retaining an interest in it. Many taxpayers are interested in such moves—hoping to get the property out of their estates while keeping some strings attached. Under the estate tax rules, however, this is a dangerous approach: the entire value of the property at the time of your death will be included in your estate. Even though federal tax legislation enacted in 2001 repeals the estate tax, the repeal is not effective until 2010. In the meantime, the rules on giving property away while retaining an interest in it remain in force.

Typically, the situation arises when the taxpayer transfers ownership of a substantial amount of his assets to a trust for the benefit of his family but keeps the right to the income from the trust property for as long as he lives. This arrangement splits the property interest into the taxpayer's life interest and the beneficiaries' remainder interests. Valuation tables establish the value of each interest, based on the age of the taxpayer and a reasonable interest rate.

As for the tax results, first, the granting of the remainder interest to the beneficiaries is a taxable gift in the year in which the trust is set up even though they will not receive the property until the future. It is taxable in its entirety, but because it is a gift of a future interest, it does not qualify for the annual gift tax exclusion. Although you will not actually have to pay any gift tax until your lifetime gifts total more than the \$1 million exemption provided by the unified credit, taxable gifts will use up part (or all) of this credit, which could have been available for your estate. (The amount exempted from *gift* tax by the unified credit remains at \$1 million through 2009, but the amount exempted from *estate* tax by the unified credit is \$3.5 million in 2009).

Second, even though you were treated as giving away the remainder interest, the entire value of the property is included in your estate at your death. (To mitigate the tax cost of this inconsistent treatment, your estate is allowed a credit for any gift taxes paid during life with respect to the gift.)

Retained interests. Note that merely retaining the right to the income even if you never use that right (i.e., never receive any income from the property) will cause the property to be included in your estate.

Additionally, if you keep the right to the income for a designated period of time instead of for life, or until a specified dollar amount is reached, the property still comes back into your estate if you in fact die before the period ends or the amount is reached. For example, if you retain the right to income for just two years, the property is included in your estate if you die before the two-year period ends. Similarly, if you retain the right to the first \$15,000 of income from the transferred property, the property is included in your estate if you die before receiving the entire \$15,000.

Even if you do not retain the right to receive the income yourself, the property may be included in your estate if you retain powers over it, e.g., the power to designate the beneficiaries or their interests.

Real estate. The retained interest rules are also commonly triggered when a taxpayer transfers the ownership of noncash property like a residence to children or others but

retains the right to live in it for life. In this case, retaining the use or enjoyment of the transferred property for life will cause the property to be included in the estate in its entirety. Even if there is no formal agreement granting the taxpayer the right to continue living in the home, if he in fact continues to do so for life, the IRS may find an implied right was retained.

The three-year rule. If a taxpayer transfers property but retains a life interest, inclusion in the estate can be avoided by his giving up the life interest. However, under a special rule, even if the retained interest is given up, the property will be included in the estate if the transferor dies within three years from the time the interest was given up.

If you would like to discuss this area in the context of your overall estate plan or have any additional questions, please call me at your earliest convenience.

