

# Giving it away

*Unless you act to avoid them, transfer taxes are likely to consume some of the fortune you had intended for your loved ones.*

## FIRST IN A TWO-PART SERIES

**LOUIS S. HARRISON, J.D.**  
Lord, Bissell & Brook  
Chicago, Ill.

**B**ecause it touches just about everyone, the income tax is a familiar fact of life for most Americans.

But the federal government imposes other taxes as well. For instance, when you transfer property by gift, either during your life or at your death, you may be subject to transfer taxes. These are known specifically as the

estate tax, the gift tax and the generation-skipping transfer tax.

### Knowing the basics

Transfer taxes differ from the income tax. No matter how much income tax you pay during your lifetime, you may still owe transfer taxes when you give your property away.

Transfer taxes will not be a concern for most people because, for such taxes to apply, the amount given away must be given to certain people and must exceed a certain amount.

For example, in most cases the estate tax will apply only if you

die leaving an estate worth more than \$625,000, a figure that will increase gradually to \$1 million by 2006. If the value of your estate will be less than that, you needn't worry about the estate tax.

Congress has defined very broadly what assets are in your estate for determining whether you exceed the \$625,000 threshold.

For starters, your estate includes assets owned by you alone. If you die with a checking account, savings account or real estate in your name, these are considered your assets for purposes of determining whether the estate tax applies. Also, assets payable to your estate on your death—life insurance, for example—are included as part of your estate.

Unfortunately, other assets that you may not think of as yours

may also be included in the calculation. For example, if you have a joint bank account with your child and you make all the deposits to the account, the joint bank account is included in its entirety in your estate.

Also, if you own a life insurance policy on your life, then the full amount of the proceeds is included in your estate, even if the proceeds are payable to third parties, such as your children. The same is true of your retirement account, though it is payable to third parties.

For estate tax purposes, even assets that you may not own at your death could be included in your estate. For example, if you give away an insurance policy on your life shortly before you die, the proceeds from the policy will be included in your estate.

Further, if you transfer property  
(See **Giving** page four)

**Giving** (cont. from page three)

ty to a trust and retain some control over the trust (such as the right to revoke the trust), that property will be included in your estate. The same will likely occur if you do nothing more than name yourself trustee of an irrevocable trust.

If the value of your estate property exceeds \$625,000 (or the gradually phased-in larger amount), you could owe estate taxes. But there are steps you can take to reduce or even eliminate your estate tax.

**Choosing the right beneficiaries**

Though your estate exceeds \$625,000, you will not owe estate taxes if you leave your property to the right beneficiaries. One choice is your surviving spouse. Property you leave to your spouse, without any restrictions, will not be subject to estate tax.

But suppose instead of leaving property unconditionally to your spouse, you want to leave it with restrictions—such as in a trust for your spouse's benefit?

For example, you may not want to leave property outright to your partner in a second marriage because you want to ensure that the children of your first marriage receive any funds remaining after your second spouse dies.

One way to do this is to set up a trust and give your spouse the right to all income from the trust. The trust could provide that, on the death of your second spouse, any unused property goes to the children of your first marriage—or however else you wish to dispose of it.

You may have other reasons to set up a trust for your surviving spouse—to help your spouse with the administration of assets, for example. By its nature, the trust provides a special adviser, the trustee, to manage assets for your

spouse's benefit.

If you leave property in your trust for your spouse's benefit, that property may still be able to pass without incurring any estate tax. But there are important rules you must know.

**Which trusts qualify?**

Not every transfer in trust for a surviving spouse will be free of estate tax. You have to be careful about what the trust provides—the terms of the trust—to make sure the trust doesn't result in estate tax.

To avoid estate tax, the trust typically must contain the following terms:

- All income must be paid to the spouse during her or his lifetime.
- Only the spouse can receive trust property during her or his lifetime.
- The spouse must be able to require that property be invested so that it generates income.
- The spouse must have the right, in some cases only, to withdraw any property from the trust during her or his lifetime, or to specify where the property goes at her or his death.

**Leaning towards a charity**

Property that you leave to charity is also generally free of estate tax, but the charitable gift must meet certain requirements.

First, the charitable organization must be qualified for estate tax purposes. Such an organization will tell you whether it is qualified, and you may want to contact the organization before you sign your will or living trust.

Second, the gift must be made by your will or other document, such as a living trust, that passes property at your death. If you die without a will or living trust, your estate will not be entitled to exclude a charitable contribution from estate tax, even if your fami-

ly makes the contribution on your behalf.

For example, John dies without a will. Under state law, all of John's property, valued at \$5 million, passes to his daughter Angie. Angie knows that her father wanted \$1 million to go to his alma mater, Duke University.

To comply with John's expressed desires, Angie gives \$1 million of the \$5 million she receives to Duke. Unfortunately, the gift is not included in a document designed to pass John's property, so his estate will not be entitled to a charitable deduction.

**For married couples**

If your estate is likely to exceed \$625,000, you might conclude that

*If you leave property in your trust for your spouse's benefit, that property may still be able to pass without incurring any estate tax. But there are important rules you must know.*

you should leave all your property to your surviving spouse, either outright or in a qualifying trust to avoid estate tax. This certainly would succeed in eliminating the estate tax at your death if you die before your spouse.

But what happens when the surviving spouse dies? Unless she or he remarries and has a surviving spouse to pass the property to, an estate tax would then be owed on the surviving spouse's property that exceeds \$625,000.

To understand how this works, you need to know about an important element of the federal estate tax law. It's called the unified credit and it allows \$625,000 (scheduled to increase to \$1,000,000 by the year 2006) worth of property to be passed at

death without incurring federal estate tax.

This credit is available to each person, and it doesn't matter who gets the property. If your total estate is less than \$625,000, all your property could be given to someone other than your spouse and there still would be no estate tax.

The tax-saving plan for married couples uses the unified credits of both spouses. Each will or living trust would set up a trust upon the first spouse's death for the benefit of the surviving spouse. The trust would contain an amount of assets determined by formula, but the amount generally approximates \$625,000.

Income from the trust property could be paid, for example, to a widow during her lifetime, and the principal could be paid if needed for her health, support or maintenance. The widow also could be the trustee.

Upon her death, the trust property would be paid to whomever her husband had named as beneficiaries. Each will or living trust would provide that the balance of the estate, generally the amount in excess of \$625,000, be paid to the surviving spouse.

With this plan, the amount put into the trust at the first spouse's passing—\$625,000—is protected by the unified credit. The balance going to the surviving spouse is also free of estate tax.

What happens when the surviving spouse dies? The property in the trust created by the first spouse is not in the surviving spouse's estate so it generates no estate tax.

Also, the surviving spouse gets to use her unified credit to protect \$625,000 of the assets included in her estate.

For example, Bill owns a life insurance policy with a death benefit of \$700,000. Bill names his wife, Wendy, as the primary beneficiary of this policy. If Wendy survives Bill, she will get

\$700,000 from the life insurance firm.

Wendy in fact survives her husband and receives the \$700,000. Because Wendy is Bill's wife, no estate tax is paid on the amount. About a year later, Wendy dies, leaving the full \$700,000 but no other property.

At her death, only the first \$625,000 of the \$700,000 is free of estate tax. Wendy's estate will owe overall estate tax on the remainder.

This tax could have been avoided if Bill had left \$625,000 of the life insurance proceeds in a proper trust for Wendy. Bill's estate would owe no estate tax. At Wendy's death, the \$625,000 in the trust would not be in Wendy's

estate, so no estate tax would apply to that amount.

Only the remaining \$75,000 from the \$700,000 insurance proceeds would be subject to estate tax. And this \$75,000 is well under the \$625,000 that Wendy can shield from estate tax through use of her estate's unified credit. By using this strategy, neither Bill's nor Wendy's estate would owe estate tax.

### **Who owns what?**

If you use this plan, the way you and your spouse own property becomes important. To make the plan work, you may need to get rid of joint ownership. Ideally, you should each try to own roughly half of your total assets,

or at least \$625,000 each.

The goal is to use in full the unified credits that protect \$625,000 from taxes. The \$625,000 trusts are created under your wills or living trusts. As a result, \$625,000 needs to pass according to the terms of your will or living trusts.

Property with joint tenancy with rights of survivorship cannot be used because these assets will not pass to the trusts. Joint property passes directly to the surviving joint tenant, not under the terms of your will or living trust.

### **Give while you live**

Even with the plan outlined above, you might still find yourself owing estate tax. Of course,

if you're unwed, you have only one \$625,000 credit available to you—or your family's assets may exceed the \$1.25 million mark. In that case, you need to take other steps to further reduce estate tax.

The idea here is to give away property during your lifetime to avoid paying eventual estate taxes on the same property. But not all gifts bestowed in life are tax free.

Congress was concerned that people would avoid the estate tax simply by giving away property before death. So Congress created a tax on such give-aways: the gift tax.

*Part two of this series explores the nuances of the gift tax and the generation-skipping transfer tax.*

# Giving it away

*Part one of this series on transfer taxes focused mainly on estates taxes. In this second half of the series, the author takes a close look at the gift tax as well as the generation-skipping transfer tax.*

## SECOND IN A TWO-PART SERIES

**LOUIS S. HARRISON, J.D.**  
Lord, Bissell & Brook  
Chicago, Ill.

There is one big difference between the estate tax and the gift tax. Under the gift tax laws, you are allowed to transfer, without taxation, up to \$10,000 a year to a recipient known as the "donee."

No similar exclusion exists under the estate tax.

A "gift" for gift tax purposes is a transfer of property to a third party for which you receive nothing in return. Handing over \$100 to your son is a gift—the person making the transfer parts with control of the property. And once you give away property, you can never be sure of getting it back.

If you retain any right to have the property returned, it is not a gift and should not result in a gift tax. The property will be included in your estate for estate tax purposes, and you will have accomplished nothing toward saving estate tax.

Before making substantial gifts, you must decide what amount of property you need to live on for the rest of your life. You may decide, for example, that after retirement you can live comfortably with \$1 million in the bank, plus interest. Or you may conclude that \$600,000 is all you need.

You must be very comfortable with the idea that you will never again need the property that you're giving away. When you give away property, even to your children, there is no guarantee that you can ever get it back. If you give property to your children, for example, they may, in turn, give it to their spouse or to their own children. They may sell the property to an unrelated person. And if it's sold for cash, that money may be spent by the donee before you can get it back.

Once you determine the amount you can give away, you need to decide to whom it will be given. If you have three children and want them all to benefit equally, this decision will be easy. You can make yearly gifts to each of them in equal amounts.

On the other hand, if you want to treat them differently, or if you would prefer not to give them the money outright, then a gift in trust for their benefit may be preferable to an outright gift.

### Two donors are better than one

Each gift-giver, or donor, can take advantage of the \$10,000 exclusion per donee each and every year. You and your spouse qualify as two separate donors. Therefore, the two of you can give away a combined total of \$20,000 per donee. The more donees you have, the more money you can give away.

For example, Dorothy and

Bob have three children, two of them married. They also have four grandchildren. Their current estate is \$2 million. If Dorothy and Bob want their nine family members (three children, the spouses of two of those children and four grandchildren) to benefit, they could give away \$20,000 to each family member or \$180,000 a year.

There would be no gift tax. And at the end of five years, Dorothy and Bob would have given away \$900,000, without incurring a gift tax. In addition, if the property grows in value, that value also passes free of gift tax. And the total amount would not be subject to estate tax when Bob or Dorothy die.

*If used during life, the unified credit will shield from gift tax the first \$625,000 in taxable gift transfers.*

### Gifts in trust

If you don't want your children to have complete control over the property you give them as a gift, you should put the property in a trust. Be aware, however, that the trust must meet certain requirements to qualify as free from gift tax.

To qualify, the trust must allow the beneficiaries the right to withdraw gifts made to the trust. This exercise of this right of withdrawal is optional with the beneficiaries—in other words, they need not actually exercise it.

Further, you can specify that the right to withdraw gifts made to the trust expires at the end of a certain period, such as 30 days. If the beneficiary does not withdraw money from the trust with-

in 30 days from the gift, those funds stay in the trust subject to the trust's terms.

Those terms can be whatever you want. They may state, for example, that funds must be accumulated in the trust and held until your death before they are given to your beneficiaries.

### Unify your gift tax credit

If the amount you're giving away is not sufficiently reducing your estate tax, then you should consider additional strategies. One is to use your unified credit during your lifetime.

If used during life, the unified credit will shield from gift tax the first \$625,000 in taxable gift transfers. That amount is scheduled to increase to \$1 million by the year 2006. Using it during life, however, means in effect that the unified credit is not available at death.

The unified credit does not increase to offset inflation. And because investors usually can receive positive returns on their investments, the value of the \$625,000 that the unified credit shields against estate or gift taxes declines each year.

If, for example, an investor can get a return of 6 percent, \$448,320 will be worth \$600,000 five years from now. To maximize the benefit of the unified credit, you should use it during life, not at death.

Say, for example, that Bob makes gifts of \$625,000 and uses his unified credit to avoid paying the gift tax. Even if these assets increase in value to \$3 million 20 years from now, that \$3 million will not be part of Bob's estate. He will pay no estate tax on that amount.

On the other hand, if the \$625,000 gift is not made now, then those assets worth \$3 million at Bob's death will be part  
(See **Giving** page four)

**Giving** (cont. from page three)

of Bob's estate. Only \$625,000 of that amount will be shielded from estate tax by Bob's unified credit available at death.

By using up the unified credit amount now, Bob will have saved hundreds of thousands of dollars in estate taxes.

Charitable gifts do not use up your unified credit. Any amount you give to a qualified charity will be free of gift tax and have no effect on your \$625,000 unified credit. What's more, the amount given to charity will not be part of your estate for estates tax purposes.

**Generation-skipping transfer tax**

A new type of tax—neither a gift tax nor an estate tax—is the generation-skipping transfer tax, or the GSTT.

The GSTT may apply any time you make a gift, either in life or at death, to a grandchild or great-grandchild or in trust for one or the other. Remember that the government wants to collect a tax on each generation. It wants to collect an estate tax—if the estate exceeds a certain amount—at your death, at your child's death and at your grandchild's death.

If, for example, you give money to your son in trust for his life-

time, you can structure the trust so that it will not be subject to estate tax at his death. At your son's death, the property could then pass free of estate tax to his children.

Another option would be to give the property directly to a grandchild, skipping your child. Either way, you have skipped a generation—your son's—of estate tax.

Because property that skips a generation may pass free of estate tax, the government wants to collect some tax, any tax, when property passes from you to your grandchildren. The tax the government imposes is the GSTT. If it applies, the tax rate for GSTT is 55 percent.

There are important exceptions to the GSTT. First, each person is allowed to pass a total of \$1 million free of this tax. Second, if you make \$10,000 gifts directly to a grandchild during your lifetime, those transfers can be set up to avoid the GSTT.

If you intend to make a gift that skips a generation—or in trust to benefit a grandchild for his or her lifetime—you have to consider the GSTT. If you do not fall within one of the exceptions to the GSTT, you would be better off having your child pay an estate tax. The marginal estate tax rates are mostly lower than the GSTT rate.

**EDITOR'S NOTE****DMSOs and how they work**

*What dentists need to know about the contractual arrangements and legal issues surrounding dental management service organizations.*

**PETER M. SFIKAS, J.D.**

ADA general counsel and editor, ADA Legal Adviser

**I**ncreased publicity surrounding dental management service organizations, or DMSOs, warrants a review of the legal basis and background for these organizations.

Generally, DMSOs provide management services that support the dental treatment provided by a dentist or his or her group. These arrangements may be structured in a number of ways.

For example, a DMSO may provide comprehensive management services in exchange for a fee. Alternatively, it may buy the dental practice from the dentist and either employ the dentist directly or indirectly through an affiliated entity such as a profes-

sional corporation.

A DMSO may offer a dentist cash, a promissory note, stock in the DMSO or some combination thereof for his or her practice. DMSOs may be privately owned or publicly traded. A publicly traded DMSO will likely require that the stock not be sold for some period of time.

If the DMSO is not a public company at the time of the dental practice sale, any stock offered to the dentist will be speculative because the DMSO may never have an initial public offering. If the DMSO never goes public, there may be little or no value in the company stock.

One of the more important legal issues involving DMSOs is the corporate practice of dentistry, a doctrine that essentially forbids business corporations or nonden-

tists from practicing dentistry.

This prohibition can be found in many state dental practice acts.

These acts provide that owning, managing or operating a dental practice constitutes the practice of dentistry. The public policy rationale for this prohibition is to preserve the sanctity of the dentist-patient relationship.

Illinois is one state that has this prohibition. The Illinois Dental Practice Act provides that one who is a "manager, proprietor, operator or conductor of a place where dental operations are performed" practices dentistry. Utah recently enacted a statute that precludes any "directing or interfering with a licensed dentist's judgment" and the competent practice of dentistry.

On the other hand, some states—Wisconsin, for example—

expressly permit some degree of dental practice ownership by nondentists. Wisconsin's statute provides that a nondentist may control the operation of a dental practice so long as it is "in a manner in accordance with the professional standards of dentistry."

Some of these seemingly broad prohibitions on the corporate practice of dentistry have been recently interpreted by state attorneys general. The Ohio attorney general, for example, has said that a management company whose role does not directly or significantly affect a dental patient's health and well-being does not violate Ohio law.

This interpretation seems to conflict with the Ohio Dental Practice Act, which states that "any person shall be regarded as practicing dentistry who is a manager, proprietor, operator or conductor of a place" where dental operations are performed.

The attorney general looked to the nature of the services or the manner in which they are provided to determine whether the per-