The Unified Credit: Use It or Lose It

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This asset protection technique for estate planning can be valuable, even during a lifetime.

In this age of exotic estate planning vehicles such as GRATs, CLATs, CRUTs, and QPRTs, the financial planning professional often overlooks the most valuable estate planning tool available at his or her disposal, the $192,800 IRC Section 2505 Unified Credit Against Gift Tax (Unified Credit). The Unified Credit is one of the most generous tax benefits bestowed by the federal government on all U.S. citizen taxpayers. Unfortunately, this tax benefit is being wasted by many taxpayers.

The Fundamentals

The United States transfer tax system imposes an excise tax on the transfer of property from one taxpayer to another when the transfer is not in exchange for adequate consideration of money or money's worth representing the fair market value of the property transferred. The transfer tax is a "unified" tax made up of a gift tax and an estate tax subject to the same tax rate structure. The gift tax is imposed on lifetime transfers and the estate tax is imposed on transfers at death. The tax rate structure is progressive, subjecting the first $10,000 of taxable transfers to an 18% tax rate. The rates increase in relation to the amount of the taxable transfer until the maximum tax rate of 55% is reached for taxable transfers in excess of $3,000,000 (a 60% rate is actually applied to taxable transfers between $10,000,000 and $21,040,000—a 5% surtax is imposed on large transfers to phase out the benefit of graduated rates and the Unified Credit).

To alleviate the burden of this tax, U.S. taxpayers have been given a one-time Unified Credit of $192,800 to offset the imposition of estate or gift tax liability on a dollar-for-dollar basis. The Unified Credit represents an equivalent taxable amount of $600,000, which eliminates tax rates from 18% to 34%. Accordingly, taxpayers transferring less than $600,000 during the course of their lifetimes and at death will be able to use their Unified Credit to fully offset any transfer tax liability imposed on the taxpayer. Unfortunately, most clients of financial planning practitioners have or will have net assets in excess of $600,000, exposing their wealth to the possible application of transfer taxes. Because the tax is progressive, the client's transfer tax exposure grows as his or her net assets, or net worth, grow.

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EXHIBIT 1
Impact of Inflation on the Unified Tax Credit

Year	Inflation Rate 3%	Inflation Rate 5%
January 1, 1987	600,000	600,000
January 1, 1988	582,524	571,429
January 1, 1989	565,558	544,218
January 1, 1990	549,085	518,303
January 1, 1991	533,092	493,621
January 1, 1992	517,565	470,116
January 1, 1993	502,491	447,729
January 1, 1994	487,855	426,409
January 1, 1995	473,646	406,104
January 1, 1996	459,850	386,765
January 1, 2007	332,205	226,134

The Math

Those taxpayers who need the full Unified Credit to protect a portion of their assets from imposition of transfer tax typically wait to use the Unified Credit until death, when it is applied to offset the estate tax. But is it wise to wait until death to use the Unified Credit when the taxpayer knows that it will affect his or her assets? Probably not. In fact, because of the simple concept of the time value of money, waiting until death to use the Unified Credit may be tantamount to throwing it away.

The Economic Recovery Tax Act of 1981 (PL 94-455; ERTA) raised the one-time Unified Credit from $47,000 to $192,800. The full $192,800 was phased in over a period of six years with the full Unified Credit allowable for gifts made after 1986. Surprisingly, the Unified Credit *is not indexed annually for inflation*. As a result, today's Unified Credit is worth just a fraction of its value in 1987. Exhibit 1 illustrates the deterioration of the Unified Credit based on its value in January 1, 1987 dollars using assumed annual inflation rates of 3% and 5%.

The mere force of inflation will cut the benefit of the Unified Credit in half over 20 years. Few financial planning clients, however, have an investment asset portfolio that isn't outpacing inflation (hopefully they're getting good advice). More likely than not their investment portfolio not only will have beaten inflation over the long term, but will have also beaten average market returns. Consider an asset that yields a 15% annual rate of return, such as an aggressive growth mutual fund, or closely held stock. The tax cost of delayed use of the Unified Credit can be sobering, as illustrated in Exhibit 2.

Legislation was introduced last year as a part of Senator Robert Dole's sponsored American Family Owned Business Act that would have begun indexing the Unified Credit annually for inflation (as well as increasing it from $600,000 to $750,000). However, the proposal became a casualty of the political stalemate that occurred, resulting in President Clinton's veto of the tax package containing the proposal. It does not appear that indexing relief for the Unified Credit is going to become a reality any time soon. The President's most recent tax package, The Revenue Reconciliation Act of 1996, released on March 20, 1996 did not provide for either indexing or increase of the Unified Credit.

The Obstacle

Logically and empirically, it is obvious that current use of the Unified Credit as compared to testamentary use of the Unified Credit will result in substantial tax savings and shift of family wealth away from the government to natural heirs of the taxpayer. However, as many financial planners are already aware, clients will most likely forego current use of the Unified Credit, even after being confronted with the numbers and facts concerning the cost of waiting until death to use the Unified Credit.

How can this be? If presented with a proper analysis of the economic reality,

EXHIBIT 2
Tax Cost of Delaying Use of Unified Credit

	Not indexed for inflation	15% Appreciation rate	Cost of not gifting at 1/1/87	
	Transfer Equivalent	Closely Held Stock	Lost Value	55% Tax Rate Cost
01/01/87	600,000	600,000	0	0
12/31/87	600,000	690,000	90,000	49,500
12/31/88	600,000	793,500	193,500	106,425
12/31/89	600,000	912,500	312,500	171,875
12/31/90	600,000	1,049,400	449,400	247,170
12/31/91	600,000	1,206,800	606,800	333,740
12/31/92	600,000	1,387,800	787,800	433,290
12/31/93	600,000	1,596,000	996,000	547,800
12/31/94	600,000	1,835,400	1,235,400	679,470
12/31/95	600,000	2,110,700	1,510,700	830,885
12/31/96	600,000	2,427,300	1,827,300	1,005,015

why would clients consciously choose not to use the Unified Credit during lifetime at the cost of possibly millions of dollars in estate taxes? This question can most often be answered with two words: security and control. No matter how much sense it makes economically to use the Unified Credit during life rather than at death, the bottom line with most clients is that lifetime use of the Unified Credit equates to an irrevocable transfer of a substantial amount of assets to younger family members. Coincident with such a transfer is both a loss of a sense of security that such assets may provide the client with and a loss of control over assets that the client may not believe anyone else in the family is responsible enough to manage. Consequently, the client's decision is rooted in personal psychology and, right or wrong, logical or illogical, the cost of parting with the associated security and control is perceived to be greater than the cost of future estate taxes to be imposed on the client's assets.

Ironically, the financial planner, rather than the family therapist, may be in the best position to help the client overcome his or her fear of loss of security and loss of control with proper education, analysis, and planning. Thus, the planner can assist clients to preserve and protect significant amounts of wealth from erosion by transfer taxes while providing them with peace of mind concerning lifetime transfer.

Security

The first step that the financial planner can take in alleviating a client's fear of losing security related to assets that may be transferred is to use an analysis probably all too familiar to financial planners: the cash flow projection. The planner should contemplate preparation of a long-term cash flow projection for the client that considers the client's current asset and liability structure, income streams, and consumption patterns.

The planner may want to make conservative assumptions concerning the appreciation of assets and growth of projected income streams while making liberal assumptions concerning the client's consumption patterns, perhaps by increasing current annual consumption by an additional 25% with an assumption

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that such expenditures will grow at a rate greater than annual inflation. If the conclusion reached by such a projection is that the client barely has enough or does not have enough future cash sources to fund future cash uses than the planner can help the client properly conclude that current use of the Unified Credit wouldn't be prudent.

On the other hand, the conclusion reached by such a projection may be that the client will have more than enough future cash flow sources to fund future cash flow uses, resulting in annual excess net cash flow. This will exacerbate a growing estate tax problem and the planner may suggest additional analysis. A cash flow projection might then be prepared based on a "what if" scenario. In other words, the additional cash flow projection would be the same as the original except the client's asset structure would be reduced by a hypothetical amount transferred through use of the Unified Credit. Income streams associated with transferred assets would also be removed from the projection. If the "what if" projection concludes that the client will still have adequate annual net cash flow, the client may feel much more comfortable with the possible transfer of assets by use of the Unified Credit. In any event the client should always be advised that the projections are based on current assumptions and future results will change according to changes in assumptions. Projections can never guarantee actual results.

Control

Although current use of the Unified Credit involves lifetime transfer of assets, the transfer of value does not necessarily require transfer of control. Two notable vehicles currently exist as effective methods of transferring the value of a client's assets, and thus removing them from the clients taxable estate, without transferring control over the assets. These vehicles are the voting/nonvoting stock recapitalization of the closely held business and the family limited partnership.

The voting/nonvoting recapitalization of the closely held business is available for both C corporations and S corporations. Although S corporations are prohibited from having two classes of stock, differences in voting rights for a class of stock are disregarded.[1] Consequently, S corporations can have both voting and nonvoting common stock. Because owners of nonvoting stock in a closely held business typically cannot participate in management decisions of the company, owners of voting stock effectively control the company. Clients with closely held businesses can therefore consider exchanging voting shares of their company for a combination of voting and nonvoting shares. Nonvoting shares can then be transferred to family members resulting in a reduction of the client's estate. Because the client retains voting shares, he or she retains control of the company and its assets. The limitation of this vehicle is that it will only have application to clients with ownership of closely held businesses.

Clients who are not closely held business owners and who may have substantial investments in real estate or marketable securities may consider using a family limited partnership (FLP). This vehicle involves a transfer of the client's investments to a FLP in exchange for general partnership and limited partnership interests in the FLP (of course, the client will need cooperation from another partner to form the FLP, possibly a spouse). After forming the FLP the client can transfer limited partnership interests to family members while retaining control of the partnership and

1. IRC § 1361(c)(4).

its investments as general partner.[2] The transfer of a large value of limited partnership interests resulting in use of the client's Unified Credit will eventuate a reduction of the client's gross estate, producing future estate tax savings.

The client's fear of loss of control over assets may, therefore, dissipate after he or she is informed of either of these two transfer methods. Consequently, individuals can achieve significant tax savings by using the Unified Credit during life while maintaining some degree of control over transferred assets.

Conclusion

Traditional estate planning for use of the Unified Credit usually takes the form of an A/B trust, or Marital/Credit Shelter trust. This type of planning can be expensive. Because the Unified Credit is usually preserved until death under an A/B trust plan the benefit available from the credit shrinks every year, especially if the individual owns highly appreciating assets. Financial planning professionals should always explore current use of the Unified Credit with their clients. A proper analysis might motivate a client to abandon his or her costly A/B trust plan to enjoy the prospect of substantial tax savings resulting from lifetime use of the Unified Credit. ■

2. See R.M. Horwood, "Keeping It All in the Family," Personal Fin. Planning (Nov./Dec. 1995).

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