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TO: OUR CLIENTS AND FRIENDS
FROM: JACKSON M. PAYNE
DATE: JANUARY 15, 2023
RE: FINANCIAL STRATEGIES FOR YOUR LIVES AND BUSINESSES

RETAINED LIFE INTERESTS

Clients have recently asked about the future impact on their federal estate tax of giving property away while retaining an interest in it. Wealthy taxpayers, for whom the large estate tax exemption amount does not fully cover the size of the estate, 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 likely be included in your estate.

Typically, the situation arises when the taxpayer transfers ownership of a substantial amount of his or her assets to a trust for the benefit of his or her family but keeps the right to the income from the trust property for as long as he or she 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 exemption provided by the estate tax exemption amount, taxable gifts will use up part (or all) of this exemption, which could have been available for your estate. However, because the increased exemption amount is only available through 2025 (the exemption is set to return back to \$5 million, adjusted for inflation, in 2026), you may want to consider using the larger exemption amount while it is available.

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 or she 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 the taxpayer 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.

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