Wealth transfer and gifting strategies

A guide to lifetime gifts

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Wealth transfer and gifting strategies

Unless you plan carefully, a large share of your wealth could eventually be lost to taxes. Well-planned lifetime gifts to family, friends, and charity may help to reduce your family's overall income tax burden and save estate taxes.

Making gifts may help you preserve more of your wealth for your family and other heirs — and help ensure that your property passes to the people and organizations you want to have it. You also receive the added benefit of seeing others enjoy your gifts.

This guide will help you explore the advantages of a planned program of lifetime giving and understand gifting strategies available to you. Your Merrill Lynch advisor together with an experienced trust specialist at Merrill Lynch can work with you and your attorney to determine if a program of lifetime gifts is appropriate and, if so, how to integrate it into your estate plan. They can also assist you in choosing trust services that can help you to maximize the benefits of your gifts — now and in the future.

Transfer tax basics

A basic understanding of how the federal transfer tax system works is helpful in establishing an effective lifetime giving program. The system encompasses three types of tax — gift, estate, and generation-skipping transfer — each imposed on the value of property. As with federal income tax, various deductions and credits are allowed in computing transfer tax liability.

Gift and estate tax credit

A two-part credit system permits you to transfer a certain amount of assets (commonly referred to as the "exemption amount") estate and gift tax free. At the beginning of 2013, the exemption amount was permanently set at $5 million with an annual adjustment for inflation. For 2017, the inflation-adjusted amount is $5.49 million.

The lifetime gift and estate tax exemption amounts are unified; lifetime gifts reduce the amount available to offset estate taxes at the time of your death. For example, if you make lifetime gifts totaling $2 million, the gift tax exemption shelters the transfers from gift taxes, but reduces the estate tax exclusion available at your death from $5.49 million to $3.49 million.

The unlimited marital deduction

If you are married, you generally can take advantage of gift and estate tax marital deductions to give your spouse an unlimited amount of property free of both gift and estate tax — provided your spouse is a U.S. citizen. The property may pass either outright or in trust, during your lifetime or at death. So, if you give your entire estate to your surviving spouse in a manner that qualifies for the marital deduction, no estate tax will be due on your estate at death. However, when your spouse dies, the property your spouse inherited outright from you will be included in his or her estate for estate tax purposes. Keep in mind that leaving assets outright to a spouse enables your spouse to control their future disposition and use.

The generation-skipping transfer tax

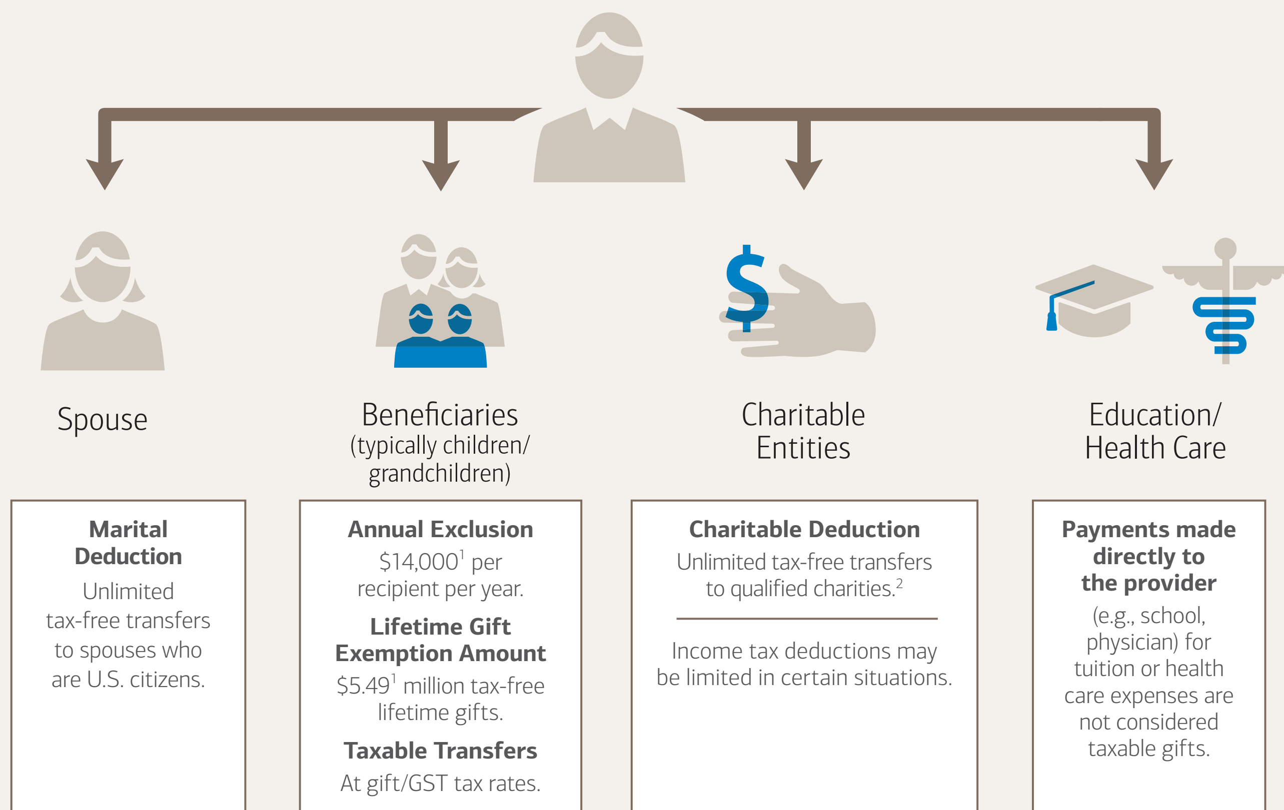
The generation-skipping transfer (GST) tax can come into play if you want to leave your property in a way that will benefit your grandchildren or other individuals who are more than a generation younger than you are. The GST tax is paid in addition to regular estate or gift tax and applies to transfers made through a trust as well as direct transfers.

The GST tax exemption, which is cumulative and adjusted annually for inflation, is $5.49 million for 2017. If you and your spouse agree to "split" the transfers, you can give twice the exemption amount ($10.98 million for 2017) without incurring the GST tax. The GST tax generally does not apply to transfers to a grandchild whose parent is deceased.

An overview of the federal gift tax system

To pass assets tax efficiently, you will want to take advantage of exclusions and exemptions when possible. The idea is to use exclusions and exemptions, as well as taxable transfers, to pass the most value per gift tax dollar paid. Which strategy offers the most value for you will depend on your long-term objectives.

Components of a wealth transfer plan



Federal gift, estate, and GST tax exemption amounts and highest tax rates

Calendar Year	Exemption Amount			Highest Gift, Estate, and GST Tax Rate
	Gift Tax[3]	Estate Tax[3]	GST Tax[3]	
2011	$5 million	$5 million	$5 million	35%
2012	$5.12 million	$5.12 million	$5.12 million	35%
2013	$5.25 million	$5.25 million	$5.25 million	40%
2014	$5.34 million	$5.34 million	$5.34 million	40%
2015	$5.43 million	$5.43 million	$5.43 million	40%
2016	$5.45 million	$5.45 million	$5.45 million	40%
2017	$5.49 million	$5.49 million	$5.49 million	40%

[1] Indexed annually for inflation.
[2] This applies to gifts to private foundations as well as public charities.
[3] In 2013, the gift, estate, and GST exemption amount was permanently set at $5 million with an annual adjustment for inflation.

Outright gifts

Making lifetime gifts removes the value of the gifted property from your estate, along with any post-gift appreciation that may occur.[4] The easiest gift-giving alternative is to give money or property directly to the individuals you want to benefit.

Annual exclusion gifts

In 2017, you can give any number of people up to $14,000 each in cash or other property ($28,000 if your spouse joins in the gift) without triggering any gift tax. This annual exclusion is available in addition to the lifetime gift tax exemption and is periodically adjusted for inflation.

Suppose you make annual gifts of $14,000 a year to each of your three children and five grandchildren. Over five years, you can give them $560,000 tax free. Having your spouse join in your annual gifts will increase your tax free gift total for the period to $1,120,000 and reduce the value of your estate for estate tax purposes by $1,120,000 — or more if the property appreciates. Assuming no appreciation, with the federal estate tax rate now at 40%, these gifts could save as much as $448,000 (40% x $1,120,000) in estate taxes.

[4] State gift taxes are not taken into consideration in this discussion. Currently, only one state, Connecticut, imposes a state gift tax.

Capital gains considerations

While making lifetime gifts can be a powerful strategy for reducing estate tax, you will need to consider potential capital gains and 3.8% surtax exposure. If the recipient later sells the gifted property, the capital gain generally would be measured by comparing the amount you paid for the property (your cost "basis") to the recipient's selling price. This is commonly referred to as "carryover basis." The gift recipient's taxable capital gain would therefore include the property's appreciation both before and after you made the gift. Depending on the recipient's income level, the gain could be subject to the 3.8% surtax as well. Fortunately, the current 20% federal tax rate on long-term capital gains is only half of the estate tax rate of 40%.

Inherited property

Inherited property is treated differently than lifetime gifts. For capital gains purposes, the basis of most appreciated property is "stepped-up" to its fair market value at the time of the owner's death. So, if you leave property to your daughter and she later sells it, she will be responsible for capital gains tax only on any appreciation generated after your death.

Gifts to minors

While outright gifting strategies using the gift tax annual exclusion and strategies using the unlimited exclusion for medical and tuition payments can be very effective for some transfers, you may want more control over gifts you make to children who are minors. Most young children are not prepared to handle large sums of money. A trust that will hold and manage these sums until the child is more mature may seem like a good idea. However, gifts of "future interests" (gifts that the recipient is not able to use or enjoy until some time in the future) do not qualify for the annual exclusion.

That is why many individuals establish a Crummey Trust as a vehicle to hold annual exclusion gifts to minors or others who may be unable to manage their own financial affairs. Named after the case in which Crummey provisions were first authorized, a Crummey Trust includes a provision that allows the beneficiary to withdraw contributions within a limited period of time after they are made, typically 30 to 60 days. That right is sufficient to create a present interest and allows contributions to qualify for the $14,000 annual gift tax exclusion.

For a minor beneficiary, you would need to give an adult who has not made gifts to the trust authority to exercise the withdrawal power. If the assets are not withdrawn during the specified period of time, they remain in the trust, subject to the terms governing future use. As a practical matter, the power to withdraw is rarely exercised because the intent is to keep the assets in the trust for future use.

EXAMPLE

Allen creates a Crummey Trust to fund his young nephew Eric's college education. The trust agreement contains a provision that allows Eric, or his parents before he reaches the age of 18, to withdraw funds contributed to the trust within a 30-day window. If the right to withdraw a contribution is not exercised, the contributed funds and the earnings on them, remain in the trust until distributed in accordance with the trust's other provisions. As a result, gifts that Allen makes to the trust will qualify for the annual exclusion.

Education and medical expenses

Would you like to help a child, grandchild, niece or nephew with college expenses, or a good friend or elderly parent with medical expenses? Careful planning can help ensure that everyone gets the most out of your gifts.

Unlimited exclusion

The tax law allows you an unlimited exclusion from gift and GST tax for certain tuition and medical payments made on behalf of others. To qualify for the exclusion, you must make the tuition or medical payments directly to the educational institution or medical provider. Payments for medical insurance qualify for the exclusion. Payments for dormitory fees, books, supplies, and similar school expenses do not.

*Section 529 plans**

Section 529 college savings plans provide a tax-advantaged way to invest for the qualified higher-education expenses of a family member. When you contribute to a Section 529 plan, you invest for a designated beneficiary. Typically, the beneficiary can be anyone — a child, grandchild, niece, nephew, or friend. Any earnings in an account grow on a tax-deferred basis and withdrawals, including any earnings,

* See important information on the back cover.

are federal (and possibly state) income tax free as long as the assets are used for qualified higher education expenses, as defined in the Internal Revenue Code. Some states allow residents to deduct plan contributions, up to certain annual limits. When the designated beneficiary reaches college age, the funds in the account can be withdrawn to pay qualified higher education expenses, such as tuition, fees, room and board, books, supplies, and certain equipment.[5] Withdrawals for such qualified expenses are not subject to federal (or, typically, state) income tax. However, any earnings withdrawn that are not used for such expenses are subject to federal income tax and may be subject to a 10% additional federal tax as well as state and local income taxes.

What happens if the designated child does not attend college? You have the option of changing the designated beneficiary of the account to another family member, as defined in the Internal Revenue Code, without incurring taxes. Or you can withdraw account assets at any time, but the earnings portion of the nonqualified withdrawals are subject to taxes as previously mentioned.

Using the gift tax annual exclusion

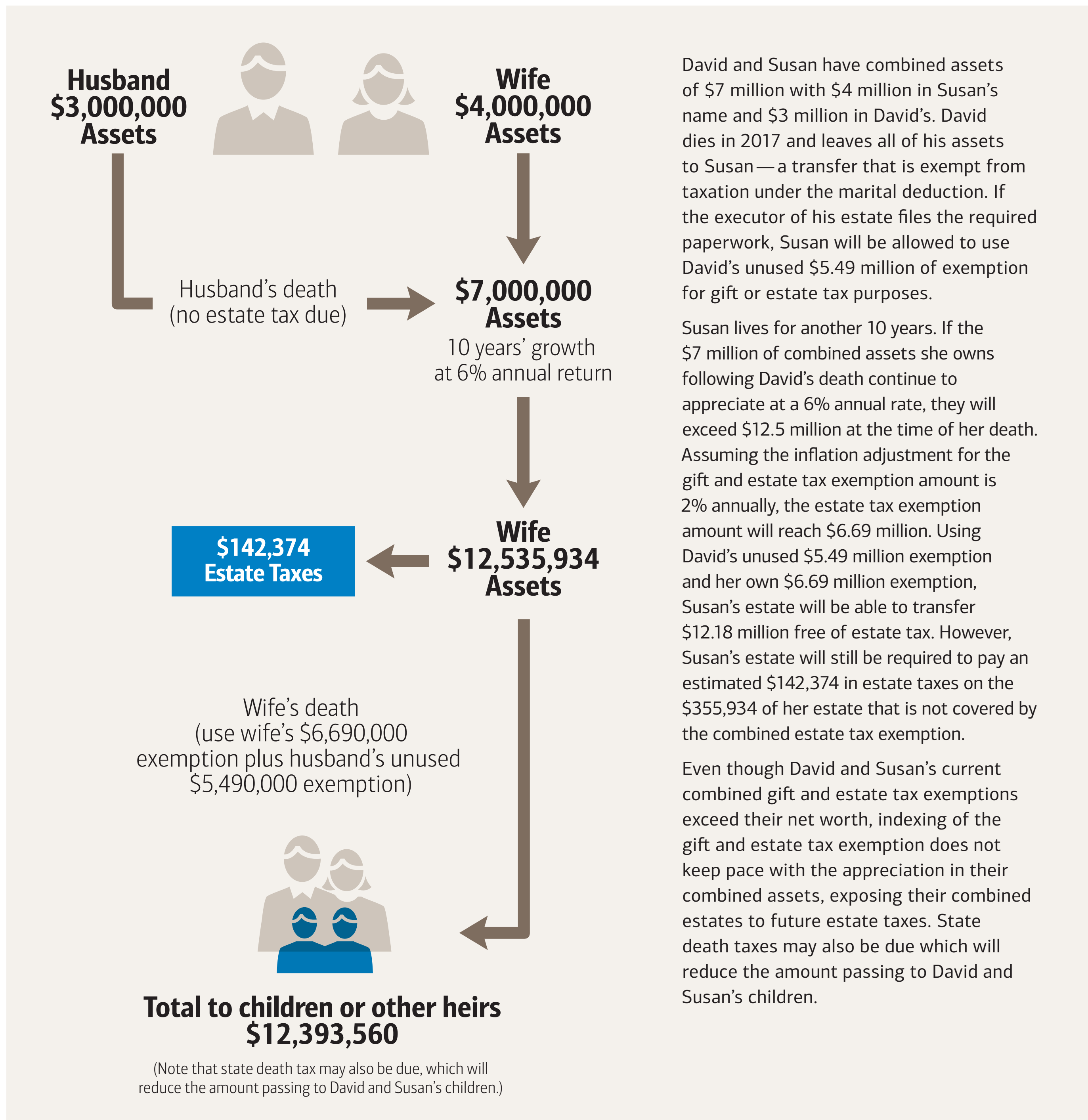
Money you invest in a Section 529 plan qualifies for the $14,000 ($28,000 for married couples) gift tax annual exclusion. A special tax provision lets you contribute up to $70,000 in one year ($140,000 for married couples) per beneficiary in a five-year period, gift tax free, as long as there are no further gifts to the beneficiary in the same five-year period. For contributions between $14,000 and $70,000 ($28,000 and $140,000 for married couples splitting gifts) made in one year, if the account owner dies before the end of the five-year period, a prorated portion of the contribution may be included in his or her taxable estate for estate tax purposes.[6] Thus, you and your spouse could contribute as much as $140,000 in one year to Section 529 plans for each of your children or grandchildren, free of any gift and GST tax. As for estate taxes, the money you contribute to a Section 529 plan generally is removed from your estate for estate tax purposes.

[5] The beneficiary must be attending an accredited institution at least half-time for room and board to be considered an eligible expense.

[6] Contributions between $14,000 and $70,000 ($28,000 and $140,000 for married couples splitting gifts) made in one year can be prorated over a five-year period without you incurring gift taxes or reducing your federal estate and gift tax credit. If you contribute less than $70,000 ($140,000 for married couples splitting gifts), additional contributions can be made without incurring a federal gift tax liability, up to a prorated level of $14,000 ($28,000 for married couples splitting gifts) per year. Gift taxation may result if a contribution exceeds the available annual gift tax exclusion amount remaining for a given beneficiary in the year of contribution. Please consult your tax and/or legal advisor for such guidance.

Portability

Under provisions commonly referred to as "portability," you may utilize any portion of your deceased spouse's unused federal estate tax exemption for gift or estate tax purposes.[7] This allows you and your spouse to take full advantage of your combined estate tax exemptions, which may be particularly helpful if one of you owns significantly more assets than the other.



David and Susan have combined assets of $7 million with $4 million in Susan's name and $3 million in David's. David dies in 2017 and leaves all of his assets to Susan — a transfer that is exempt from taxation under the marital deduction. If the executor of his estate files the required paperwork, Susan will be allowed to use David's unused $5.49 million of exemption for gift or estate tax purposes.

Susan lives for another 10 years. If the $7 million of combined assets she owns following David's death continue to appreciate at a 6% annual rate, they will exceed $12.5 million at the time of her death. Assuming the inflation adjustment for the gift and estate tax exemption amount is 2% annually, the estate tax exemption amount will reach $6.69 million. Using David's unused $5.49 million exemption and her own $6.69 million exemption, Susan's estate will be able to transfer $12.18 million free of estate tax. However, Susan's estate will still be required to pay an estimated $142,374 in estate taxes on the $355,934 of her estate that is not covered by the combined estate tax exemption.

Even though David and Susan's current combined gift and estate tax exemptions exceed their net worth, indexing of the gift and estate tax exemption does not keep pace with the appreciation in their combined assets, exposing their combined estates to future estate taxes. State death taxes may also be due which will reduce the amount passing to David and Susan's children.

[7] Of the states that impose a death tax, only Hawaii and Delaware have provisions that allow portability of that state's exemption.

Relying on portability

There are several reasons why relying on portability may not be the best solution — even if the combined value of the assets that you and your spouse hold is less than your current combined $10.98 million exemption amount.

IRS inflation adjustment

As shown in the illustration on page 8, even if your current combined gift and estate tax exemption amounts exceed the value of your assets, you could still wind up owing estate tax if your assets appreciate at a rate that is higher than the inflation adjustment applied to the exemption amount. In addition, the unused exemption passing to a surviving spouse is fixed at the year of death. It is not adjusted for inflation, increasing the possibility that the value of your assets will exceed your available estate tax exemption in the future.

Prior deceased spouses

As a surviving spouse, you are only allowed to use the unused estate tax exemption of your last former spouse to die. You will not be able to use any unused estate tax exemption of any prior spouse.

GST tax exemption

Although portability allows you to pass on any unused estate tax exemption amount, portability does not apply to the GST exemption. Therefore, as a surviving spouse you could only use your deceased spouse's unused exemption amount to transfer assets to children estate and gift tax free. Any transfers to grandchildren in excess of your unused GST exemption amount would be subject to GST tax. Taking full advantage of your combined GST exemptions (currently $10.98 million per couple) may require gifting during your lifetime — most commonly to a trust.

State tax implications

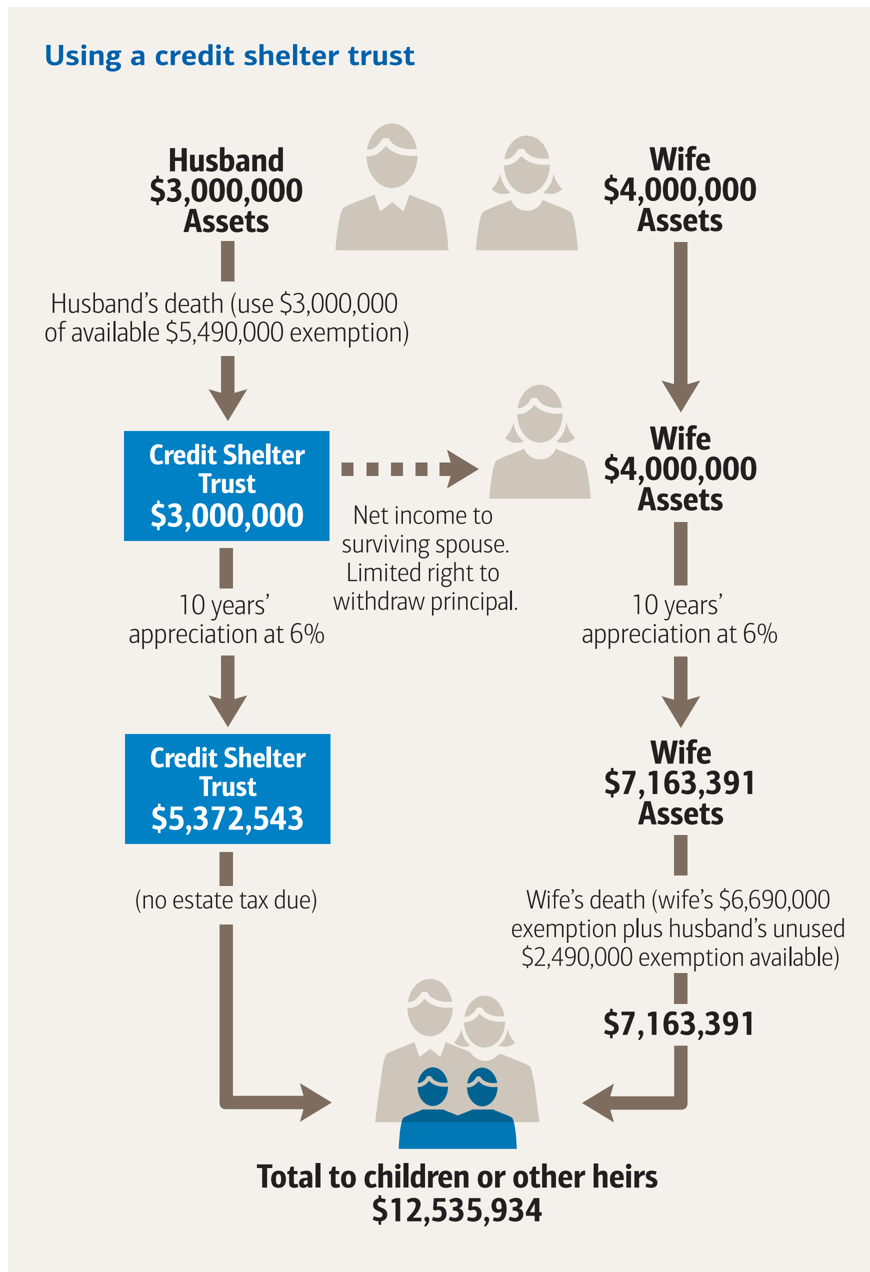
It is important to remember that only two states — Hawaii and Delaware — have portability provisions that apply to state transfer taxes. If you live in a state that imposes state estate taxes you may find it advantageous to make lifetime gifts to minimize your overall state transfer taxes. Lifetime gifting also removes future appreciation on the transferred assets from your taxable estate. Currently only one state — Connecticut — imposes both gift and estate taxes. If you reside in another state, you may want to consider whether it is appropriate to make lifetime gifts to take advantage of this opportunity to reduce state estate taxes.

Control over distribution and use of assets

For many individuals, the ability to protect assets and control their distribution and use is as important as minimizing taxes. This may be true for you if you have children from a prior relationship or are concerned about an heir's ability to manage inherited wealth responsibly. Although portability may be helpful in reducing transfer taxes, you may need a trust to ensure that your assets are distributed and used as you envision.

Credit shelter planning

If your assets appreciate faster than the inflation adjustment applied to the gift and estate tax exemption, you may find it useful to incorporate a credit shelter trust in your estate plan to minimize or eliminate estate taxes.



Credit shelter and bypass trusts

Credit shelter, or bypass, trusts are a popular way to use your available estate tax exemption, remove appreciation from your taxable estate and that of your spouse and direct how your assets will be used by heirs. The chart (left) illustrates how they often work.

EXAMPLE

David and Susan, the couple from the example on page 8, incorporate credit shelter trusts in their estate plans. Instead of leaving his assets to Susan using the marital deduction, David directs that an amount up to his available estate tax exemption be placed in a credit shelter, or bypass, trust created through his will or revocable trust. Any assets in excess of that amount will pass outright to Susan free of tax using the unlimited marital deduction. The credit shelter trust may be structured to pay Susan a lifetime income interest and give her a limited discretionary right to receive trust property.

Upon David's death in 2017, his estate will use $3,000,000 of his available $5,490,000 estate tax exemption to fund the credit shelter trust, leaving $2,490,000 of his unused estate exemption available for Susan's use, as long as a timely portability election is made. During the 10 years until Susan's death, her assets, along with those in David's credit shelter trust, continue to appreciate at 6% annually. The credit shelter trust will hold $5,372,543 in assets and

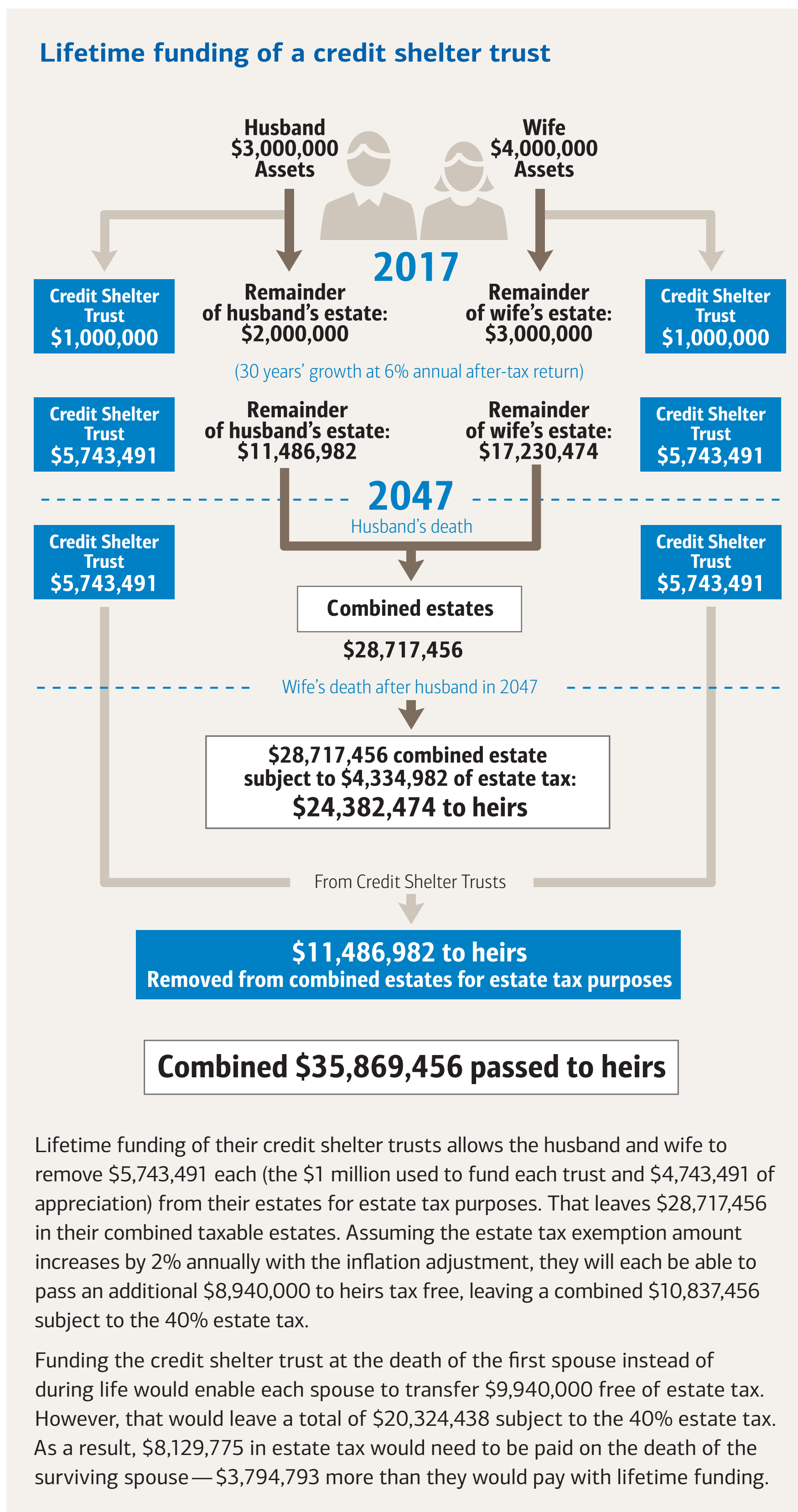
Susan's estate will have $7,163,391 in assets. Assuming the annual inflation adjustment for the estate tax exemption is 2% per year, Susan's available estate tax exemption in 2027 will be $6,690,000 million. That, combined with David's $2,490,000 unused exemption, will be sufficient to completely shelter federal estate taxes on Susan's estate. As a result, David and Susan's entire combined $12,535,934 will pass tax free to their children or other heirs before taking into account any state death taxes.

Lifetime funding

While credit shelter trusts are often funded at the first spouse's death, you and your spouse may each find it advantageous to create and fund a credit shelter trust during your lifetime. Funding now allows you to remove growth from your taxable estates.

As shown in the illustration to the right the husband and wife each use $1 million of their $5.49 million gift tax exemption to fund an irrevocable trust.

Lifetime funding of a credit shelter trust



Lifetime funding of their credit shelter trusts allows the husband and wife to remove $5,743,491 each (the $1 million used to fund each trust and $4,743,491 of appreciation) from their estates for estate tax purposes. That leaves $28,717,456 in their combined taxable estates. Assuming the estate tax exemption amount increases by 2% annually with the inflation adjustment, they will each be able to pass an additional $8,940,000 to heirs tax free, leaving a combined $10,837,456 subject to the 40% estate tax.

Funding the credit shelter trust at the death of the first spouse instead of during life would enable each spouse to transfer $9,940,000 free of estate tax. However, that would leave a total of $20,324,438 subject to the 40% estate tax. As a result, $8,129,775 in estate tax would need to be paid on the death of the surviving spouse — $3,794,793 more than they would pay with lifetime funding.

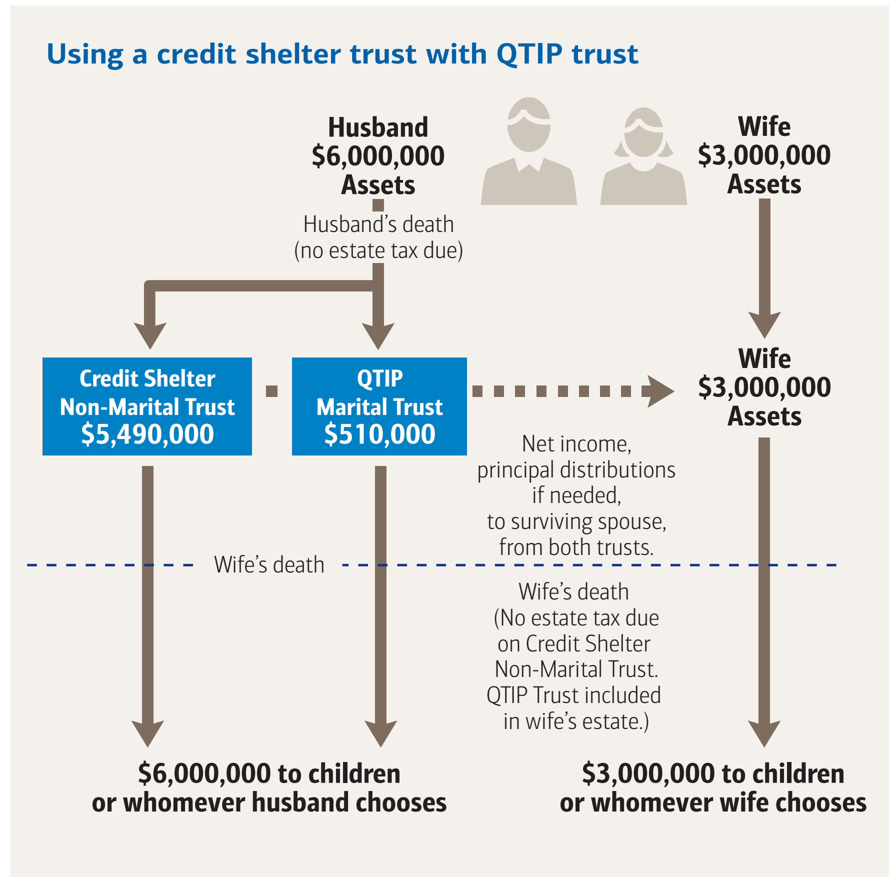
With a QTIP trust, you can give your spouse a lifetime income source and choose who will receive the property in the trust after your spouse's death—your children or grandchildren, for instance.

QTIP trusts

Qualified terminable interest property (QTIP) trusts are another way to transfer property in a tax-advantaged manner. With a QTIP trust, you can give your spouse a lifetime income source and choose who will receive the property in the trust after your spouse's death — your children or grandchildren, for instance. Your executor or personal representative can elect to claim the marital deduction for the trust property.

For the trust property to be eligible for the QTIP election, your spouse must be entitled to trust income payments for life and the assets may not be distributed to anyone other than your spouse while your spouse is alive.

QTIP trust assets will be included in your spouse's estate, and estate tax may have to be paid on the assets, but the trust property must be distributed as you have directed in your QTIP trust instrument. Thus, you retain ultimate control over who receives it.



The two-trust estate plan

Many individuals choose to create a two-trust estate plan using both a credit shelter trust and a QTIP trust. This plan saves estate tax in the same way a credit shelter trust alone does. However, with a two-trust estate plan, the assets that pass to your spouse under the marital deduction are also placed in a trust, rather than left to your spouse outright. This marital trust may be a QTIP trust or it can be another trust qualifying for the marital deduction.

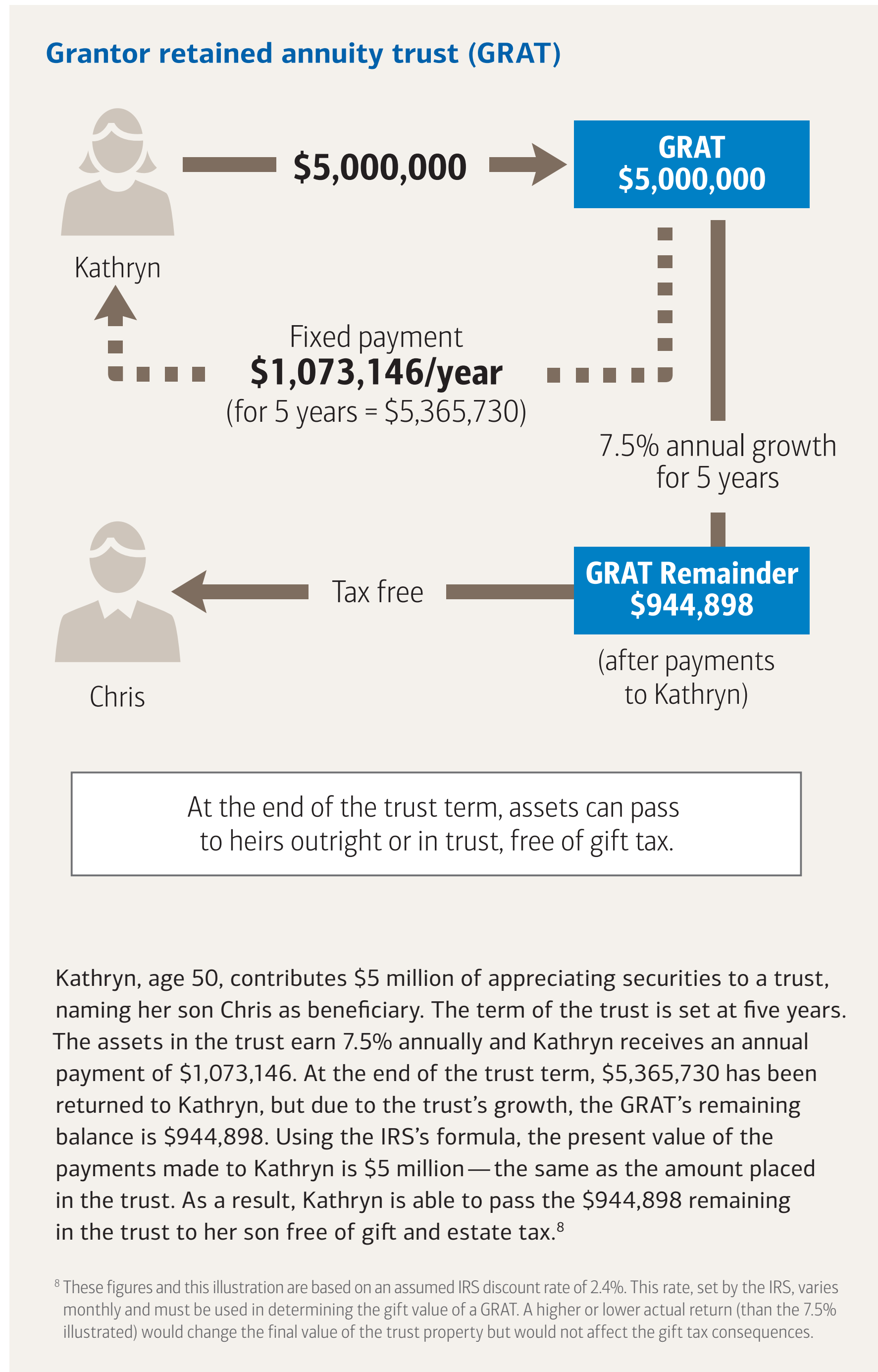
Other gifts in trust

You may find that you need more sophisticated tools to accomplish your lifetime giving objectives and may want to consider using other types of trusts.

Grantor retained annuity trusts

Grantor retained annuity trusts (GRATs) offer an opportunity for transferring property at a low gift tax cost. To establish a GRAT, you can transfer property that is likely to appreciate, such as securities, into a trust. You retain the right to receive an annuity from the trust for a set period of years.

Provided you outline the payment period, when the trust term ends, the property remaining in the GRAT—including any appreciation—will pass to the trust beneficiary(ies) free of additional gift tax. You may be able to structure the GRAT so that the present value of your annuity interest is roughly equal to the value of the property transferred to the trust, resulting in little or no gift tax upon the trust's creation.



Kathryn, age 50, contributes $5 million of appreciating securities to a trust, naming her son Chris as beneficiary. The term of the trust is set at five years. The assets in the trust earn 7.5% annually and Kathryn receives an annual payment of $1,073,146. At the end of the trust term, $5,365,730 has been returned to Kathryn, but due to the trust's growth, the GRAT's remaining balance is $944,898. Using the IRS's formula, the present value of the payments made to Kathryn is $5 million—the same as the amount placed in the trust. As a result, Kathryn is able to pass the $944,898 remaining in the trust to her son free of gift and estate tax.[8]

[8] These figures and this illustration are based on an assumed IRS discount rate of 2.4%. This rate, set by the IRS, varies monthly and must be used in determining the gift value of a GRAT. A higher or lower actual return (than the 7.5% illustrated) would change the final value of the trust property but would not affect the gift tax consequences.

Intentionally "defective" grantor trusts

Like GRATs, intentionally "defective" grantor trusts (IDGTs) are often used to freeze the value of appreciating assets for transfer tax purposes at their value on the date of transfer to the trust.

With an IDGT, you create an irrevocable trust for the benefit of, say, your children and grandchildren. Under the trust agreement, you retain certain powers that cause the trust income to be taxed to you—rather than to the trust at a potentially higher income tax rate—yet still allow the value of the trust property to be removed from

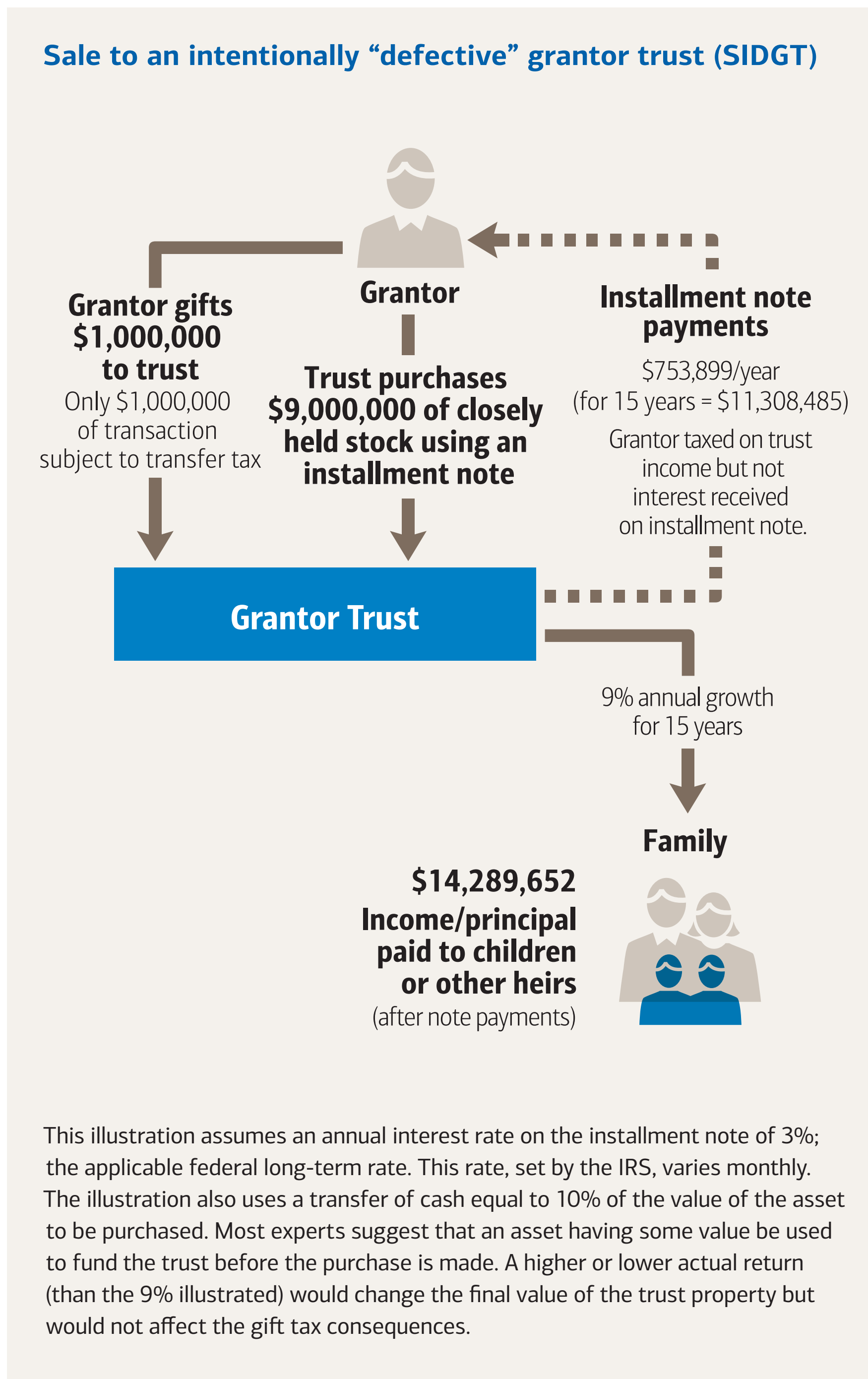
your estate for estate tax purposes. The trust property can grow transfer and income tax free, with the income tax you pay annually on that growth essentially equivalent to making additional tax free gifts to the trust beneficiaries. You may be able to enhance the advantages of an IDGT by selling property to the trust rather than fully funding it outright. Here is how the strategy works.

EXAMPLE

Kevin, age 60, creates an IDGT to benefit his grandchildren. He funds it with property equal to at least 10% of the value of rapidly appreciating property — a closely held business, for example — he wants to sell to the trust. He allocates a sufficient portion of his GST tax exemption to cover the value of the property he has placed in the trust. Then, he sells the appreciating property to the trust and takes back an installment note with an interest rate that is the lowest rate that he can be charged without it being considered a below-market rate loan for tax purposes.

If the total return on the property sold to the trust exceeds the interest rate on the trust's note to Kevin, the excess assets will pass to his beneficiaries tax free. In addition, because Kevin and the trust are considered one taxpayer for income tax purposes, he will not be taxed on the interest payments he receives from the trust and will not recognize capital gain (or loss) on the sale to the trust. If the trust later sells the property, Kevin will have to recognize the trust's gain (or loss).

Sale to an intentionally "defective" grantor trust (SIDGT)



This illustration assumes an annual interest rate on the installment note of 3%; the applicable federal long-term rate. This rate, set by the IRS, varies monthly. The illustration also uses a transfer of cash equal to 10% of the value of the asset to be purchased. Most experts suggest that an asset having some value be used to fund the trust before the purchase is made. A higher or lower actual return (than the 9% illustrated) would change the final value of the trust property but would not affect the gift tax consequences.

A dynasty trust is created to benefit several generations and often works best when it is funded with a lifetime gift equal to the amount of your, or your and your spouse's, GST tax exemption.

Dynasty trusts

As the name suggests, a dynasty trust is created to benefit several generations. Dynasty trusts are usually structured to last for as long as state law permits. So, depending upon state law, your trust potentially could provide for distributions to your children for their lives, then to grandchildren for their lives, and then to future generations until the trust expires.

A dynasty trust often works best when it is funded with a lifetime gift up to the amount of your — or your and your spouse's — GST tax exemption ($5.49 million each if funded in 2017). The appreciation and accumulated income generated by the trust property can be transferred for the benefit of several generations without any reduction by transfer taxes.

The benefits of lifetime funding that apply to dynasty trusts are the same as those that apply to the lifetime funding of credit shelter trusts as illustrated on page 11. In fact, a credit shelter trust can function as a dynasty trust, thus avoiding estate and GST taxes for the life of the trust — which may be for hundreds of years.

Leveraging with life insurance

Dynasty trust property could be used to purchase a life insurance policy on the life of the person who created the trust. On his or her death, the trust receives the insurance proceeds. If the trust is set up properly, the insurance proceeds avoid both estate and GST tax. The benefits can be even greater if a married couple creates the trust and a second-to-die life insurance policy is purchased. Generally, the premium cost of a second-to-die policy is less than that of a regular policy. For the same amount of premium, a larger amount of coverage can be purchased with a second-to-die policy.

EXAMPLE

Ken and Joanne make a lifetime gift of $10.98 million to a dynasty trust. The $10.98 million is exempt from both gift and GST tax (assuming both use their $5.49 million 2017 gift and GST tax exemptions). The trust document authorizes the trustee to invest $5.49 million in financial assets and use the other $5.49 million to buy second-to-die life insurance. On the death of the surviving spouse, the trust will receive the life insurance proceeds. These proceeds and the other trust property will continue to appreciate without additional gift, estate, or GST tax until the trust ends.

Qualified personal residence trusts

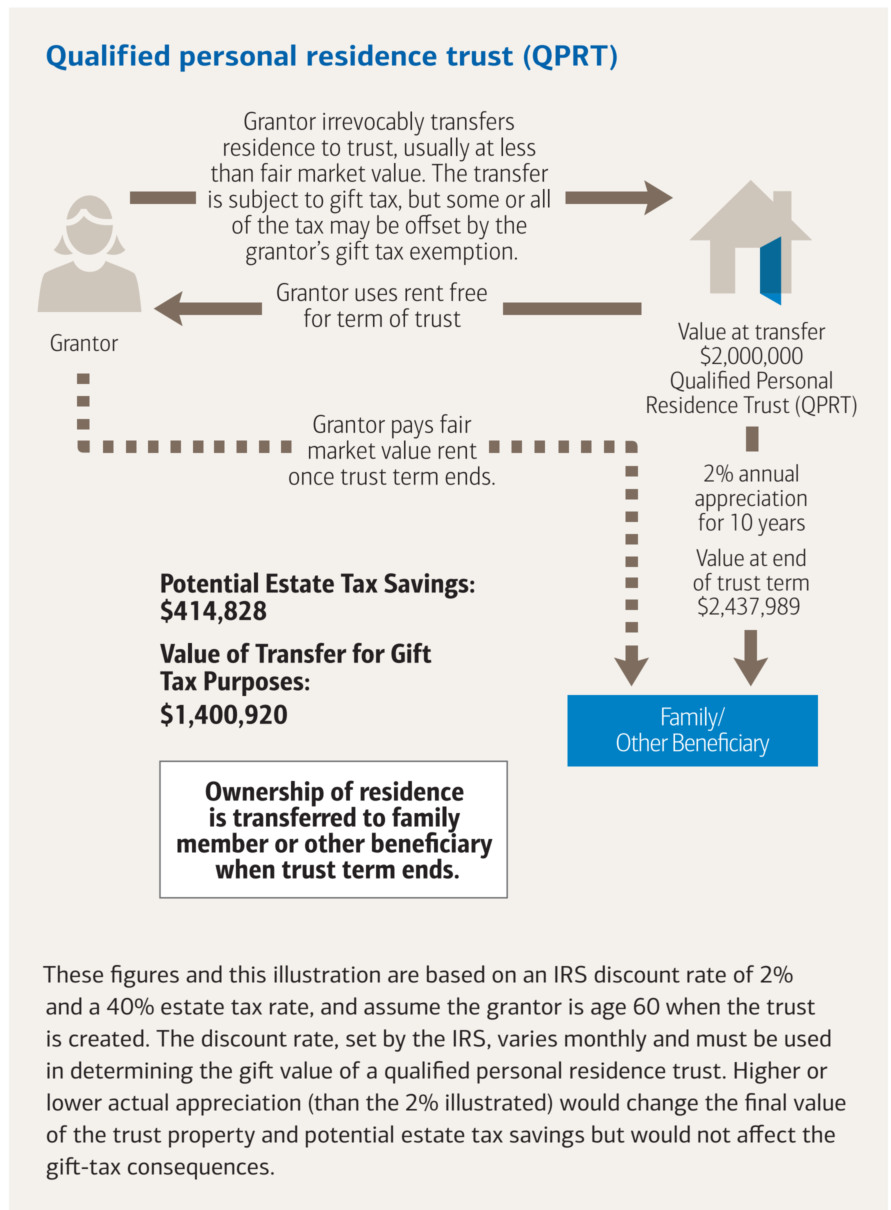
A qualified personal residence trust (QPRT) can help you pass your home on to your children or other beneficiaries in a tax-advantaged manner. You or a family member can serve as trustee. With a QPRT, you irrevocably transfer a personal residence to an irrevocable lifetime trust. You retain the right to use and occupy the residence for a fixed period. At the end of the period, the residence passes to your children (or another beneficiary) outright, or in further trust. The residence placed in the trust need not be your principal residence — a second residence (a vacation home, for example) qualifies. Provided you outlive the term of the QPRT, when the QPRT ends, the property remaining in the QPRT — including any appreciation — will pass to the trust beneficiary(ies) free of additional gift tax.

While the transfer of the home to a QPRT is a taxable gift, the value of your right to live rent free in the home for the fixed term is subtracted from the value of the home for gift tax purposes. So, the amount of the taxable gift may be much less than the fair market value of the home. In addition, you can use your lifetime gift tax exemption to offset some or all of the gift tax.

If you wish to remain in the home after the trust terminates, you must pay fair market rent to the new owner.

It is important to remember that, from a legal perspective, you are giving away your home. A QPRT can provide limited flexibility, but your overall control over the residence is restricted.

Qualified personal residence trust (QPRT)



These figures and this illustration are based on an IRS discount rate of 2% and a 40% estate tax rate, and assume the grantor is age 60 when the trust is created. The discount rate, set by the IRS, varies monthly and must be used in determining the gift value of a qualified personal residence trust. Higher or lower actual appreciation (than the 2% illustrated) would change the final value of the trust property and potential estate tax savings but would not affect the gift-tax consequences.

Charitable gifts

Lifetime gifts to charitable organizations, like gifts to family and friends, can help others and help minimize transfer taxes on your estate.

Direct gifts of appreciated property

When you give cash, securities, or other property to a qualified charitable organization, you can claim a federal income tax deduction for your gift (subject to certain limitations, depending on the type of charity, the type of assets or your income level). Choosing to make your gift in appreciated property, such as stock, instead of in cash may enhance your tax benefits.

EXAMPLE

Several years ago, Sharon bought stock for $20,000. Her shares are now worth $50,000. If she sells her shares, she will have to pay capital gains tax on the $30,000 of appreciation, which would reduce her available gift amount to $44,000 (assuming a 20% capital gains tax). If Sharon donates the shares directly to a public charity, she will not have to pay any capital gains tax. The charity will receive the stock's full value, and she can claim a $50,000 charitable deduction on her income tax return (subject to any applicable tax law restrictions).

However, making direct gifts may not fully meet all of your planning objectives. You and your family may wish to make charitable gifts to realize the tax deduction but postpone the actual receipt by the charities. Or you may wish to retain the ability to realize future income from, or use of, the gifted property. So you may want to look at making your charitable gifts through vehicles such as donor-advised funds, trusts, or foundations. For example, using a charitable trust to make your gifts may give you a current income tax deduction and/or remove property from your taxable estate for estate tax purposes.

Charitable lead trusts

If you are currently making regular gifts to a favorite charity — or would like to — you may find a charitable lead trust an attractive way to make your gifts. The cash or other property you transfer to a charitable lead trust is used to make payments to a charitable organization. When the trust term ends, the trust property passes to the person you have named as the trust's remainder beneficiary — your child or grandchild, for instance. Or you can provide for the property to be returned to you.

The initial value of the remainder gift, if any, going to your beneficiaries is taxable. After making all required charitable payments, any assets remaining in the trust pass to the remainder beneficiaries without further gift tax. And you may be able to structure a charitable lead trust so that your remainder gift can pass transfer tax free without having to use much, if any, of your gift tax exemption. The key is balancing the annual amount

paid to the charity with the applicable IRS discount rate (essentially, the rate of return the IRS assumes the remainder gift property will earn).

EXAMPLE

Carlos transfers $1 million to a charitable lead trust that will pay a favorite charity $70,000 a year for 15 years and then pass the property remaining in the trust to his son. If the IRS discount rate is 3% but the trust property actually earns an average annual return of 7.5%, Carlos will be able to transfer $1,130,592 to his son transfer tax free with the use of only $164,347 of his gift tax exemption amount. A higher or lower actual return would increase or decrease the final value of the trust property but would not affect the gift tax consequences.

Charitable remainder trusts

With a charitable remainder trust, you transfer property to a trust set up for the charity of your choice. The trust pays you, you and your spouse, or someone else you have chosen, distributions for a set period or during the beneficiary's(ies') lifetime. The trust terminates at the death of the last non-charitable beneficiary (or earlier if that is what the trust specifies), and the charity(ies) receives the property.

Creating a charitable remainder trust during your lifetime enables you to take an immediate income tax deduction. The amount is the present value of your future gift to charity— basically, the gift's current fair market value, less the actuarial value of all the expected payments as calculated using an IRS table. The trustee of your charitable remainder trust can sell appreciated property you have transferred to the trust without immediately recognizing any capital gain, leaving the full amount of the sale proceeds available for reinvestment. If you designate someone other than you and/or your spouse to receive the periodic distributions during the life of the trust, the gift will be subject to gift taxes.

Donor-advised funds

A donor-advised fund is a charitable fund administered by a charitable organization. Using a donor-advised fund lets you retain the ability to recommend how you would like your gift to be used or distributed. While your recommendations typically will be followed, the sponsoring organization has the final authority to approve and make distributions.

Your gift gives you an immediate income tax charitable deduction, even if the fund does not make grants until a later time, and reduces the value of your estate, potentially saving future estate taxes. It can also be a way to instill a sense of philanthropy in future generations. You can name your children or grandchildren joint and successor advisors.

Private foundations

A private foundation allows you even more control over how your charitable gifts are used and can help you engage other family members. Typically, an individual or a family forms a private, or family, foundation to support scientific, educational, or other charitable projects. The person or family who creates the foundation contributes the initial funding and may make subsequent donations.

When you create a foundation, you retain authority to determine how the foundation's funds will be used and how long the foundation will last. Private foundations are subject to stringent federal and state tax, compliance, investment and grant-making rules. As a result, many people choose to rely on an experienced professional administrator to assist them with their foundations.

Like other lifetime charitable gifts, contributions to a private foundation can provide income tax and estate tax savings. Along with these tax benefits and the advantage of continuing to have some control over your gift property, a private foundation offers you and your family an opportunity to work together toward common causes. You can teach younger family members about philanthropy and how to oversee the investing and asset management. In turn, the younger generation can carry on family goals after the older members of the family are gone.

Wealth replacement

Using life insurance on your life payable to a family member or other loved one to replace the value of the property given to a charity through a charitable remainder trust or other gift transfer allows you to make a tax-advantaged gift to charity without reducing the amounts passing to your family.

It is advisable for someone else to own the policy to keep it out of your estate for estate tax purposes. For substantial amounts of life insurance, you may want to create an irrevocable life insurance trust to help beneficiaries manage the proceeds and potentially reduce estate taxes.

The next step

Everyone's situation is different. Some of the strategies discussed may be suitable for you and your family; some may not. Your Merrill Lynch advisor together with trust and insurance specialists at Merrill Lynch can provide you with more information and help you design a lifetime giving program.

When a trust is needed

When your wealth transfer plans include a trust, your Merrill Lynch advisor and trust specialist will work closely with their trust professional colleagues at U.S. Trust. As one of the nation's leading trust organizations, U.S. Trust brings deep fiduciary knowledge and experience managing a wide range of trusts. Your team of Merrill Lynch and U.S. Trust® professionals will work with you and your tax and legal advisors to move your wealth transfer plans from concept to implementation, integrating them with your overall financial strategy. U.S. Trust can provide comprehensive trust administration to help you to realize your vision for the future.

Trust investments

A wide array of innovative investment options and portfolio solutions are offered through Merrill Lynch open-architecture investment advisory programs that have oversight from U.S. Trust. In addition, U.S. Trust offers the ability to manage and integrate nonfinancial assets into your overall wealth management and transfer plans. That capability can provide important alternatives for addressing your wealth transfer and gifting goals.

Contact your Merrill Lynch advisor

Contact your Merrill Lynch advisor to learn more about the role that Merrill Lynch and U.S. Trust can play in helping you refine and address your wealth transfer and gifting goals. With your Merrill Lynch advisor's guidance, you can harness the intellectual capital of experienced trust professionals from U.S. Trust along with trust, insurance and investment professionals from Merrill Lynch, all of whom work together to help meet your unique needs.

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Before you invest in a Section 529 plan, request the plan's official statement from your Merrill Lynch advisor and read it carefully. The official statement contains more complete information, including investment objectives, charges, expenses and risks of investing in the plan, which you should carefully consider before investing. You should also consider whether your home state or your designated beneficiary's home state offers any state tax or other benefits that are available only for investments in such state's 529 plan. Section 529 plans are not guaranteed by any state or federal agency.

Investing involves risk. There is always the potential of losing money when you invest in securities.

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