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What is an estate freeze?

Estate freeze is an expression often used to describe various tools, techniques and strategies used to manage the size and growth of your estate, and minimize potential gift and estate taxes. You transfer an asset (through a variety of methods) to your beneficiaries with the main goal of removing any future appreciation of that asset from your gross estate and thus potentially reducing any estate taxes that may be due. The value of the asset is “frozen” at its fair market value (FMV) on the date of the transfer.

Example(s): John transfers appreciating real estate to James. The FMV of the property at the time of transfer is $200,000. John reports the transfer on his gift tax return using the value of $200,000. John dies 10 years later when the FMV of the real estate is $300,000.

Caution: Depending on the strategy used, the transfer may trigger capital gains tax or generation-skipping transfer tax (GSTT) and/or gift tax liability. However, federal gift tax/GSTT paid will be subtracted from estate taxes owed, if any. Also, the value of the property must be adequately disclosed on a gift tax return (Form 709). Otherwise, the IRS may revalue the property to its FMV on the date of your death.

Caution: Some estate freezing strategies depend on the attribution of a low value to the assets that are transferred from your estate by sale or gift. Congress has enacted several rules intended to restrict the methods used in valuing assets transferred out of your estate. Consult a tax advisor when structuring any estate freeze strategy to be certain that you do not run afoul of these rules.

Why use an estate freeze technique?

May minimize estate taxes
The main reason to use an estate freeze technique is to minimize your gross estate and possibly reduce estate taxes. By transferring appreciating assets now, you remove any future appreciation in those assets from your estate — you freeze the value of the assets at their FMV at the time of the transfer.

You may retain an income stream from or control over the transferred assets
Other reasons to use an estate freeze technique is that, if properly structured, you may remove assets from your estate and still retain either an income stream from or control over those assets.

Helps buyers purchase your assets
Another benefit to an estate freeze technique is that it may allow you to structure a sale of your assets for periodic payments instead of a single lump sum. By spreading the payments out over an extended period of time, the buyer may be able to better afford the purchase price.

May lower capital gains tax
Some estate freeze techniques that are sales allow you to recognize the gain over time, as the payments are received instead of at the time of the initial transfer. This may allow you to defer capital gains to years in which you may be in a lower income tax bracket.

Allows a business owner to raise cash
An estate freeze technique method may provide business owners with a way to turn business assets to cash while continuing to use the assets in the business.

Estate freezing techniques

The following are some of the more popular strategies that an individual may use to freeze the value of his or her estate:

Lifetime gift

A lifetime gift is probably the simplest form of the estate freezing techniques. It is an outright and total transfer of property to another individual or entity in exchange for nothing or for property of less value.

Family bank

A family bank is a term used when a group of family members (typically, the older, wealthier generation) pools assets for the benefit of other family members (typically, the younger generation). Generally, a family bank works as a lender. A family member may borrow funds under certain circumstances and pay the funds back for little or no interest. The bank is usually meant to be maintained for several generations.

A family bank can be structured in many ways, but if an irrevocable trust is used, it can be an effective estate freezing technique.

Irrevocable trust

Probably the most common form of the estate freezing techniques, the irrevocable trust holds the transferred assets for the benefit of your beneficiaries. It is vital that the trust be irrevocable — assets in a revocable trust may be includable in your gross estate for estate tax purposes at their FMV on the date of your death.

Income produced by assets in the trust is generally taxable to the trust (unless it is a grantor trust), which generally enjoys a smaller exemption and pays tax at a higher rate than individuals.

Caution: If the transferred asset is life insurance*, the transfer must take place at least three years before your death in order to remove the proceeds from your gross estate.*

Family limited partnership

A family limited partnership (FLP) allows you to transfer assets to a limited partnership entity. You retain the general partnership interest (as little as 1%) and give away the limited partnership interests (as much as 99%) to your heirs. Additionally, you may utilize certain valuation discounts when establishing the value of the FLP interests for gift tax purposes. Furthermore, the limited partnership interests will be protected from the future claims of creditors.

Private annuity

A private annuity allows one person (the seller) to transfer complete ownership of an asset to another person (the buyer) who makes an unsecured promise to make periodic payments to the seller during the seller's life or the combined lives of the seller and a second person (typically the seller's spouse). The purchase price of the annuity is the FMV of the property at the time of the transfer. Generally, this transaction avoids all federal transfer taxes because it is a sale, not a gift. However, a sale for less than FMV may result in a taxable gift for the difference between the purchase price and FMV. Also, if the annuity is joint and survivor, the present value of future payments made to the survivor may be includable in the estate of the first to die.

Installment sale

An installment sale is similar to a private annuity, except that the time period over which payments are made may be for any period to which the buyer and seller agree (as long as some payment is made after the taxable year in which the sale occurs). The present value of any unpaid installments may be included in the seller's estate if he or she dies before all of the payments have been made. Also, for income tax purposes, the gain on the sale is recognized by the seller only as the payments are received, but only if he or she is a cash basis taxpayer. The installment-sale income tax treatment is not available to taxpayers using the accrual method of accounting.

Gift-leaseback or sale-leaseback

With a gift-leaseback, you give away an asset to another party who leases it back to you.

A sale-leaseback is similar to a gift-leaseback. However, instead of gifting the asset (which must be a business asset), you sell it to another party who then leases it back to you. If structured properly, the seller may fully deduct the lease payments as a business expense for income tax purposes. Unlike some installment sales, the gain on the sale must be recognized at the time of the transfer.

Bargain sale

A bargain sale lets you sell an asset for less than its FMV to either a charitable entity or an individual. You use the property's FMV on the date of the sale for income tax reporting purposes. In the case of a charity, you may deduct the difference between the lower sale price and the FMV as a charitable deduction, as long as the sale is to a qualified charity. In the case of an individual, the difference between the lower sale price and the FMV is considered a gift, subject to gift tax.

Split interest purchase

In a split interest purchase, one party (usually the parents or grandparents) purchases an income (life or term) interest in an asset and a second party (usually the children or grandchildren) purchases the remainder interest in the same asset. Each party pays his or her actuarial share of the purchase price. During the life or term period, the two parties own the property concurrently. At the end of the period, the party with the remainder interest takes sole ownership of the asset.

Only the value of the life or term interest may be includable in the estate of the party who owns that interest, unless that interest is subsequently sold or has been given away at least three years before the owner's death.

Recapitalization

A recapitalization involves changing the capital structure of an existing closely held company. The company exchanges the existing stock for two classes of stock — preferred stock and common stock. The preferred stockholder generally receives dividends before the common stockholders and generally holds all the voting rights. The common stock represents the bulk of the equity in the company.

Under this estate freeze technique, you would hold the preferred stock and give away the common stock. The common stock will reflect any future increase in the value of the company; thus, growth can be transferred to your heirs.

Caution: Because of changes in the Internal Revenue Code that tend to increase the value that must be attributed to the common stock that is transferred as a gift, recapitalizations are not as attractive as they used to be.