THE FUTURE OF ESTATE PLANNING - 2012 AND BEYOND

By

Edward L. Perkins, JD, LLM (Tax), CPA

I. The New Estate Planning Reality

A. The Return of the Federal Estate Tax, et al.

1. The Estate Tax Returns

After a one year repeal, the Tax Relief Act of 2010 reinstated the federal estate tax for at least for 2011 and 2012, and if elected, for 2010. During those years, the highest marginal estate tax rate will be 35%, and the exemption amount (termed the “Basic Exclusion Amount”) is increased to $5 million per individual for 2011, and will be indexed for inflation thereafter. In 2012 has already been increased to $5,120,000.

2. The Gift Tax Returns

Starting in 2011, the gift tax exemption reunified with the estate tax exemption. This means that a $5,120,000 Basic Exclusion Amount is also be available for gifts. Prior to 2010, an individual was entitled to a $3.5 million exemption for their estate, but only $1 million for gifts. Starting in 2011, the highest marginal gift tax rate is the same as the highest estate tax, i.e. - 35%.

3. Generation Skipping Tax

The Tax Relief Act also impacted the generation-skipping transfer tax or “GST”. The GST exemption has now also risen to $5,120,000 million rather than the $1 million it would have been without the amendments made by the Tax Relief Act. The GST tax rate for transfers made in 2011 and 2012 will, like the estate and gift tax, also be 35%.

4. Portability

An interesting change made by the Tax Relief Act which will no doubt have an impact on federal estate tax planning is the concept of “portability”. This means that the Basic Exclusion Amount which is unused by the estate of the first of a married couple to die may now be carried over and used, with an interesting twist, by the surviving spouse’s estate. The increased level of the Basic Exclusion Amount coupled with the addition of portability to the planning equation, brings into question what specific impact the Tax Relief Act changes will have on federal estate tax planning - specifically, whether traditional estate planning already in place should be amended in favor of simpler plans and also what form estate planning should take going forward. These questions will be the subject of the first section of this program.

B. 2013 and Beyond

1. What Is!

Unless Congress acts before the end of 2012, the changes to the federal estate, gift, and generation skipping tax expire at the end of this year. If Congress does nothing the Basic Exclusion Amount will revert to $1,000,000, and the highest tax rate will revert to 55%. Portability will also go away.

2. What Might Be!

Of course much of this depends upon the outcome of the presidential election. Both Presidential candidates have voiced their opinion on the future of the federal estate tax. Governor Romney favors outright repeal. President Obama's recommendation's as reflected in the budget proposals for 2013 includes the following: (1) $3.5 million exemption for estate and GST purposes, and $1 million dollar exemption for gifts, (2) a 45% maximum rate for all three taxes, (3) portability will be made permanent, (4) modification to the rules which apply to valuation discounts, (5) minimum term for grantor retained annuity trusts of ten years, (5) a limit of 90 years to the duration of generation skipping trust, and (6) coordination of the grantor trust income tax rules and the transfer tax rules which apply to such trusts.

No matter which candidate is elected it is doubtful they will get their way in total. President Bush tried unsuccessfully during his term in office to repeal the estate tax. On the other hand over the last decade no budget proposal in the estate and gift tax area has been enacted. The final answer probably lies somewhere in between.

II. Questions to Address

A. The Equation has Changed.

The changes enacted by the Tax Relief Act, require a reexamination of some of the basic tenants of estate planning. To further add to the confusion barring any further action by Congress, the Basic Exclusion Amount will reset at $1,000,000, after 2012, the top rate will be 45%, and portability will cease to be available. Among those questions are the following:

- What is the recommended estate plan for 2012? Should current documents be amended now?
- Are gifts recommended in 2012?
- If a client died in 2012 – What should you do?
- What is the recommended estate plan for 2013 and beyond?

B. What is the Recommended Estate Plan for 2012?

1. The Credit Shelter Trust

Prior to the estate tax repeal of 2010 and the Tax Relief Act, the Credit Shelter Trust was an essential part of the estate plan of a married couple with an aggregate estate valued in excess of the Basic Exclusion Amount. Under such planning, the Credit Shelter Trust was often structured to reduce or avoid the federal estate tax by taking advantage of the estate tax marital deduction and the Basic Exclusion Amount in the most efficient way possible[1]. The planning objective was simply to insure that the estate

[1] *Qualifying testamentary transfers to a surviving spouse are not taxed by reason of the estate tax "marital deduction". The amount of the marital deduction is only limited by the value of the assets funding the qualifying transfers. Taking advantage of the marital deduction is not necessarily an entirely good thing from an estate tax point of view, however. Under IRC Sec. 2056, and the so-called "terminable interest rule" in order to qualify for the*

assets were allocated in such a way so that the Basic Exclusion Amount of the first of a married couple to die was fully utilized. The excess value passed pursuant to a gift qualifying for the estate tax marital deduction. If this plan was implemented assets with a value up the level of the Basic Exclusion Amount could pass without estate tax to the Credit Shelter Trust upon the death of the first spouse, and if the Trust was properly structured, without estate tax again on the death of the survivor as well[2].

The primary estate tax advantage realized by implementing a Credit Shelter Trust lay in the fact that it allowed the aggregate estate of the married couple to take advantage of both spouse's Basic Exclusion Amount when transferring assets to their heirs. As a result, a married couple could theoretically transfer assets with a value up to twice the Basic Exclusion Amount to their heirs without federal estate tax.[3] Prior to the Tax Relief Act, this was generally only possible through the use of a Credit Shelter Trust. After the enactment of the Tax Relief Act, the question of whether the Credit Shelter Trust is still a necessary part of a married couple's estate plan comes into question because of two important changes made to the federal estate tax: (1) the addition of "portability", and (2) the increased level of the Basic Exclusion Amount.

2. <u>Portability</u>

a. How does it work?

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federal estate tax marital deduction assets must pass to a surviving spouse in way which essentially makes them includable in the surviving spouse's estate. This can be accomplished by assets passing outright to the surviving spouse or to certain qualifying trusts such as a "QTIP" trust. Because of this aspect of the estate tax marital deduction - it is sometimes said that the marital deduction is not a true deduction at all - it only defers taxability until the death of the survivor. Therefore from an estate planning point of view it is considered good practice only to take advantage of gifts that qualify for the marital deduction to the extent they reduce the taxable estate to the level at which no estate tax is incurred, i.e., the Basic Exclusion Amount. The balance of the estate should be transferred in a way which while benefiting the surviving spouse for their lifetime will not cause inclusion in the surviving spouse's estate for federal estate tax purposes – that way was, in the past, through the Credit Shelter Trust. Because of the" terminable interest rule" assets passing to a Credit Shelter Trust do not qualify for the marital deduction even if the surviving spouse is the only trust beneficiary and are as a result subject to the federal estate tax. However if the value passing to the Credit Shelter Trust does not exceed the Basic Exclusion Amount no tax would actually be incurred.

[2] *Basically, as long as the surviving spouse's rights to principal in the Credit Shelter Trust are limited by an ascertainable standard such as "health, education, maintenance, and support", and the surviving spouse does not hold a general power of appointment over the trust at death - the survivor can still benefit from the trust during their lifetime and not risk inclusion of the assets held by the trust in their taxable estate.*

[3] *This was the result because the assets in the Credit Shelter Trust avoided taxation in the estate of the first of the married couple to die by reason of the Basic Exclusion Amount available to that spouse's estate. On the death of the surviving spouse assets held by the Credit Shelter Trust again passed free of estate tax to heirs because of the manner in which the Credit Shelter Trust was structured. By reason of the Credit Shelter Trust an amount equal to the Basic Exclusion Amount together with appreciation could pass through both spouses' estates to named beneficiaries free of estate tax – one Basic Exclusion Amount. In addition the assets which were taxable in the survivors estate were sheltered by that Spouse's Basic Exclusion Amount – a second Basic Exclusion Amount. This is compared to an outright transfer of assets from the estate of the first spouse to the survivor. In that case the marital deduction would eliminate the estate tax in the first spouse's estate but would insure their taxability in the estate of the surviving spouse without the benefit of the shelter which could have been provided by a Credit Shelter Trust. As a result the entire estate would be taxable in the surviving spouse's estate sheltered only by the Basic Exclusion Amount available to the surviving spouse's estate. See Examples One and Two.*

What exactly is "portability"? Under the Tax Relief Act the Basic Exclusion Amount that is not utilized when the first of a married couple passes away may now be available or "portable" to reduce the federal estate tax of the surviving spouse. Specifically, the Tax Relief Act provides that, in the case of the estate of the surviving spouse, the Basic Exclusion Amount is equal to what is termed the "Applicable Exclusion Amount". That amount is equal to the sum of (1) the "Basic Exclusion Amount" (i.e., currently $5,120,000 indexed for inflation) and (2) the "Deceased Spouse's Unused Exclusion Amount".

The "Deceased Spousal Unused Exclusion Amount" is defined as the "Unused Exclusion Amount" of the "last deceased spouse" - in other words the Basic Exclusion Amount still available to the estate of the individual who was the last husband or wife of the surviving spouse before they died. This definition makes it irrelevant how much property the surviving spouse actually inherited from their husband or wife, or whether the surviving spouse inherited any property from that spouse at all. The only question is how much of the Basic Exclusion Amount was utilized by the deceased spouse's estate when they died.

Example: Assume that Bill dies first in 2011 and leaves his entire estate to Ruth outright. Ruth would inherit Bill's assets without federal estate tax by reason of the marital deduction. The property in his estate is not taxed. As a result Bill's Basic Exclusion Amount is not used and the Deceased Spousal Unused Exclusion Amount is $5,000,000. Provided Ruth does not remarry, upon Ruth's death the Applicable Exclusion Amount available to her estate is $10,120,000 (i.e., the sum of the Deceased Spouses' Unused Exclusion Amount of $5,000,000, and the Basic Exclusion Amount of $5,120,000 available to her estate).

b. Why the Credit Shelter Trust is still the Better Option

(1) Overview

One of the primary objectives of both the Credit Shelter Trust and portability is to ensure that both spouses can take advantage of their Basic Exclusion Amounts of $5,120,000. The Credit Shelter Trust achieves this objective by funding the trust from the estate of the first spouse to die. As illustrated above portability allows the estates of married couples to utilize the Basic Exclusion Amount available to each spouse's estate without the need of implementing a Credit Shelter Trust or other sophisticated planning as part of their estate plan. *Does this make Credit Shelter Trust Planning obsolete?* Let's compare the two.

(2) Dependability

The Credit Shelter Trust - In order for a Credit Shelter Trust to accomplish the objective of allowing both spouses' estates to each take full advantage of the Basic Exclusion Amount, several things must be done properly. First, the proper documents implementing the Credit Shelter Trust must be in place prior to the death of the first of the married couple to die, and second, the first spouse to die must have sufficient assets in their name alone to fund the trust in an amount up to the Basic Exclusion Amount. Obviously, if a Credit Shelter Trust is not adopted by the first spouse to die it cannot achieve the intended result. However, even when a Credit Shelter Trust has been adopted, if the first spouse to pass away does not own

sufficient assets to fund the trust to the level of the Basic Exclusion Amount, the full advantage to be realized by adoption of the Credit Shelter Trust will be lost[4].

Portability - As alluded to above one problem with portability is that amount of the Unused Exclusion Amount available to the surviving spouse's estate is dependent upon the Unused Exclusion Amount of the "last deceased spouse". The planning issues with this requirement are obvious.

Consider this example: Assume the same facts as the immediately preceding Example above.

Example: Assume that Ruth remarries after Bill's death to Harry. Harry has his own children to whom he wishes to leave his entire estate. Harry predeceases Ruth and in his will leaves his entire estate of $5,000,000, to his surviving children. His executor claims Harry's entire Basic Exclusion Amount of $5,000,000. In this case Ruth's Applicable Exclusion Amount is only $5,120,000, her own Basic Exclusion Amount of $5,120,000, limited to her own Basic Exclusion Amount. Because of the fact that Harry utilized his entire Basic Exclusion Amount upon his death the "Deceased Spouse's Unused Exclusion Amount" is zero (-0-). She gets no benefit from Bill's Unused Exclusion Amount of $5,000,000.

A second issue with portability is that in order to claim the Unused Exclusion Amount, the executor of the estate of the deceased spouse must have filed an estate tax return which computes the Unused Exclusion Amount and make an election that such amount shall be taken into account. The amount of the exclusion considered "unused" will be dependent upon the values stated on that return. The statute requires that this return be timely filed and the statute of limitations to audit the return is suspended. This raises the question of whether all estates no matter what their size should file a federal estate tax return or risk not having the Unused Exclusion Amount of the first spouse to die being available to the surviving spouse's estate. Suppose for example at the time of Bill's death the combined estate was only $4,000,000, and no estate tax return was filed when Bill died. By the time Ruth dies the estate is now worth $6,000,000. Can her estate still claim Bill's Unused Exclusion Amount to shelter estate tax? The answer seems to be no – since as stated by the statute a timely filed estate tax return is required.

Finally and perhaps most significant, absent action by Congress the availability of portability will be eliminated at the end of this year.

(*3)* *Shelters Appreciation from Estate Tax*

The Credit Shelter Trust - The Credit Shelter Trust can only be funded on the death of the first spouse with an amount equal to the Basic Exclusion Amount without incurring the federal estate tax. However on the death of the survivor it is not only that value but also the appreciation realized on that value that will pass estate tax free.

Portability - The Basic Exclusion Amount of the survivor is indexed for inflation. However the value of the Deceased Spouse's Unused Exclusion Amount is not indexed. As a result that amount will be fixed at the time of his or her death. As a result the appreciation on that causes assets inherited from the first spouse to exceed the Deceased Spouse's Unused Exclusion Amount will not be sheltered from estate tax.

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[4] *Assume the same facts as Example One above, except that assume that Ruth held all of the estate assets. In this case, again assuming Bill dies first, then upon Bill's death no assets would pass into the Credit Shelter Trust, and no benefit would be achieved by its adoption.*

(4) Asset Management

The Credit Shelter Trust - Since the assets passing to the Credit Shelter Trust are held by a trust, they will be administered by the Trustee. Depending on the identity and expertise of the Trustee this may allow the surviving spouse to take advantage of that management expertise.

Portability - Since assets held by the surviving spouse will be held by that spouse outright no management of the assets will be available.

(5) Asset Disposition

Credit Shelter Trust - Assets passing to the Credit Shelter Trust will be disposed of according to the terms of the trust as determined by the settlor spouse.

Portability - If assets pass to the surviving spouse that spouse will control their ultimate disposition.

(*6) Asset Protection*

Credit Shelter Trust - The assets held by the Credit Shelter Trust cannot be attached by the creditors of the trust beneficiary if the trust contains a valid spendthrift clause.

Portability - Assets passing to a surviving spouse outright will be subject to the debts and liabilities of the survivor. Therefore no asset protection will be available.

(7) GST Planning

Credit Shelter Trust – In the past many estate plans have employed a strategy designed to ensure that generation transfer tax exemption of the first of a married couple to die is not wasted. This strategy involved creating a sub trust to the credit shelter trust plan which would be fully exempt from GST Tax. Since the decedent would be considered the "transferor" of the share of the estate passing to this sub trust of the Credit Shelter Trust, the decedent's GST Exemption would be allocable to this share. In addition a second sub trust could be created within the marital trust share if necessary, and by a "reverse QTIP election", the decedent would be considered the "transferor" of this share as well. Since, the generation skipping tax exemption is not portable this type of GST planning is only possible if a Credit Shelter Trust is part of the estate plan.

Portability - If the estate plan relies on portability to shelter the estate from estate tax, the estate runs the risk that avoidable GST could be incurred.

(8) Availability of Step Up in Basis.

Credit Shelter Trust - Assets passing into a Credit Shelter Trust will qualify for a step up in basis equal to fair market value on the first spouse's death but not upon the death of the surviving spouse.

Portability - If the entire aggregate estate of the married couple is held outright by the surviving spouse at the time of his or her death, then the entire aggregate estate will qualify for a step up in basis upon the surviving spouse's death.

(9) Conclusion

Both the Credit Shelter Trust and portability allow the estates of both the husband and wife the opportunity to take full advantage of the Basic Exclusion Amount in each of their estates. One advantage of portability over the Credit Shelter Trust planning lies in the fact that it also allows the entire aggregate

estate to receive a basis step up at the survivor's death. However, as currently stated in the law, portability only applies to the estates of decedents who die in the 2011 and 2012, and as discussed above, the Credit Shelter Trust affords other distinct planning advantages over portability which may make it a better planning alternative.

Therefore, in most cases, the adoption of a Credit Shelter Trust as part of the estate plan is still recommended. Essentially portability should only be relied upon to correct problems which result from under funding the Credit Shelter Trust upon the death of the first spouse – either because no Credit Shelter Trust was never implemented or because the estate of the first spouse to die did not have sufficient assets in their name alone at death to fund the Credit Shelter Trust. The Credit Shelter Trust should remain the favored estate plan for married couples with estates in excess of the Basic Exclusion Amount.

C. What is The Appropriate Estate Plan for 2012?

1. Overview

If Credit Shelter Trust is still recommended the following questions must be addressed:

- For which estates?
- What is the form of the document?
- Are there any additional provisions to consider?

In addition other issues involving the estate plan such as when to recommend the Irrevocable Life Insurance Trust and when to recommend aggressive gift planning should also be addressed.

2. For Which Estates?

The old adage in estate planning was that if the potential combined taxable estate of a husband and wife exceeded the Basic Exclusion Amount, a Credit Shelter Trust planning was appropriate. The reasoning being that if the entire estate passed outright to the surviving spouse their sole Basic Exclusion Amount would not be sufficient to shelter the estate from the federal estate tax. Therefore, Credit Shelter Trust planning was required to ensure that the Basic Exclusion Amount was utilized to shelter the combined estate from the federal estate tax.

In 2012, it is difficult to predict at what level the Basic Exclusion Amount will finally be fixed. In addition, the possibility of that the federal estate tax will be repealed should also be considered. One thing that we do know for sure is that if Congress does not act before the end of this year the Basic Exclusion Amount will reset at a $1,000,000, level, with no portability. With that in mind the more conservative approach in 2012 is to recommend Credit Shelter Planning for married couples with a potential combined taxable estate of $1,000,000 or more. To better understand the logic behind this conclusion, consider this hypothetical:

Steve and Carol have a combined potential taxable estate of $5,000,000. Under the current law the Basic Exclusion Amount of $5,120,000 will be adequate to shelter the estate from federal estate tax even if the entire estate is taxable in the hands of the survivor. Therefore a simple estate plan providing outright disposition of the estate to the survivor would seem adequate. However, if this plan is adopted and Congress does allow the Basic Exclusion Amount to reset at a $1,000,000 level, with no portability, and a

55% Marginal tax rate, this plan, if left unamended, would potentially expose $4,000,000 to estate tax upon the death of the survivor. Consider the other extreme. What if a Credit Shelter Plan was adopted and the federal estate tax was repealed – what would the result be then? In the worst case the estate would wind up being held in a Credit Shelter Trust for the benefit of the survivor.

3. In What Form?

Therefore assuming that a Credit Shelter Trust is for many estates the favored estate plan the question becomes "What form should it take?" It is clear that that one key feature should be flexibility; that is flexibility within the document to adapt to a higher or lower Basic Exclusion Amount, or even complete repeal of the federal estate tax.

a. Formula Clauses

Prior to 2010, if Credit Shelter Trust was part of the estate plan of a married couple it was often structured to reduce or avoid the federal estate tax by taking advantage of the estate tax marital deduction and the Basic Exclusion Amount in the most efficient way possible. The proper allocation between the Credit Shelter Trust and the marital deduction share was normally created by formula, generally either a formula that defined the marital deduction gift and the amount allocated to the Credit Shelter Trust in terms of the marital deduction gift (a "minimum marital deduction formula"), or a formula that defined the marital deduction gift and the Credit Shelter Trust in terms of the Basic Exclusion Amount (a "credit shelter formula"). In either case the result was much the same, an amount up to the Basic Exclusion Amount passed to the Credit Shelter Trust and the excess passed pursuant to the marital deduction gift. If the surviving spouse is, as is the case in many estate plans, the sole beneficiary of both shares then the amount at which the Basic Exclusion Amount is set, whether $5,120,000 or some other figure, should not present any concerns.

However if the Credit Shelter Trust benefits individuals in addition to or other than the surviving spouse, allocation between the two shares created by the new higher level Basic Exclusion Amount remains consistent with the planning objectives of the testator. This may involve a formula clause which caps the share passing to the Credit Shelter Trust to a certain amount or percentage of the estate, or perhaps divides the shares on a percentage basis, rather than based on the Basic Exclusion Amount.

b. The QTIP Trust

One way to build flexibility into the plan is to utilize a single QTIP Trust. Under this alternative, the plan would involve disposition of the residual estate to a single trust which qualifies as a QTIP trust. Upon death of the first of the married couple to die the residual estate of that spouse would pass to that trust. The executor could then decide by election the portion of the trust that would qualify for the estate tax marital deduction and the credit shelter share, based upon the level of the Basic Exclusion Amount at that time.

c. The Disclaimer Trust

Another way to build flexibility into the plan is to implement a so-called "Disclaimer Trust". Under this plan the disposition of the residual estate is made to the surviving spouse outright, with the right to disclaim any or all of the residual estate in favor of the Credit Shelter Trust. This arrangement would allow

the surviving spouse to determine the proper allocation between the marital (i.e., the share passing outright), and the Credit Shelter Share.

d. Alternative Disposition in the Event of Repeal

Finally, the document might provide for an alternative disposition, perhaps outright and not in trust, in the event of the repeal of the federal estate tax.

4. <u>Additional Considerations</u>

a. Provisions Designed to Obtain Basis Step Up

The primary disadvantage of the Credit Shelter Trust as compared to portability is that assets held by the Credit Shelter Trust are not stepped up on the death of the second of a married couple to die. In situations where the surviving spouse's Applicable Exclusion Amount exceeds the value of that spouse's estate transferring low basis property from the Credit Shelter Trust to the surviving spouse in order to allow for a basis step up in their hands may be advantageous. In order to allow for this possibility the document could contain one or more of the following provisions.

The document could contain a liberal distribution provision which allows the trustee to distribute appreciated property to the surviving spouse in the trustee's discretion unlimited by an ascertainable standard. A more drastic version of this power might allow complete termination of the trust. Of course only a trustee independent from the trust beneficiary should hold such a power.

In both cases the distribution or termination will remove the property from the trust and place it in the hands of the surviving spouse. Another alternative that could avoid this result is simply allowing the third party to grant the surviving spouse a general power of attorney over the trust. The granting of the power will allow for the property in the trust to be taxable in the surviving spouse's estate and obtain a basis step up. If the power is unexercised the property would remain in the trust subject to disposition under the trust terms.

b. Simultaneous Death Provisions

Under the concept of portability the "Deceased Spousal Unused Exclusion Amount" is defined as the "Unused Exclusion Amount" of the "last deceased spouse" - in other words the Basic Exclusion Amount still available to the estate of the individual who was the last husband or wife of the surviving spouse before they died. Under the Uniform Simultaneous Death Act in situations where husbands and wives die in a common occurrence, in probating their respective estates each is presumed to have survived the other – therefore no portability. Care should be taken that a clause be included in the documents reversing this presumption and designating one of the spouse's as the survivor in the event of death in a common occurrence.

Here is a sample clause:

"If my spouse and I shall die under such circumstances that the order of our deaths cannot be readily ascertained, my spouse shall be deemed to have predeceased me. No person, other than my spouse, shall be deemed to have survived me if such person dies within 30 days after my death. This article modifies all provisions of this will accordingly".

D. Must pre 2011 Documents be Amended?

The question of whether pre-2011 documents should be amended may depend upon whether the documents contain one or more of the provisions discussed in this section. Certainly, formula allocation clauses should at the very least be examined to determine if they still fit a client's disposition plan, and if not should be amended.

III. Are Gifts Recommended in 2012?

A. Overview

The question of whether a gift giving program should be adopted in 2012 as a part of the estate plan is addressed in this section. The question should be addressed first in terms of whether gifts make sense in the context of the estate in question or whether they should be accelerated to take advantage of the higher exclusion amount and lower rates available in 2012.

B. The Essential Question – Are gifts a Good Option in the Context of this particular estate?

The case for making inter vivos gift transfers of interests in property lies in the opportunity to reduce the value that is ultimately subject to transfer tax. Lifetime transfers can achieve a meaningful and permanent reduction of that value in several ways. First, if the property is appreciating property, a lifetime transfer will remove any post transfer appreciation from the taxable estate. In addition, if the property is income producing property, the post transfer income will also be removed. Another aspect of the gift tax that is often not considered is the fact that the tax paid on inter vivos gifts is effectively removed from the tax base, while in the case of the estate tax, the tax is included and taxed in the tax base. Finally, there is the ability to discount the taxable value transferred by taking advantage of the annual exclusion and certain discounting techniques, discussed below.

The primary disadvantage in making lifetime gifts to be considered is the loss of the step up in basis that occurs when assets are retained in the taxable estate until death. In situations where the estate tax incurred is less than the tax benefit of a step up in basis, an inter vivos transfer may not be advisable. Because the top estate tax rate is 35% and capital gains are currently only taxed at 15%, larger estates may have difficulty finding such a benefit. However, since $5,120,000 of the value from every estate is not taxed, potentially $10,240,000 for a married couple, it is the effective tax rate that is relevant. Further, because of the nature of the unified transfer tax system, an inter vivos transfer of property does not avoid the transfer tax but simply taxes the current rather than future value.

Also to be considered is that some techniques require an add back of value to the estate. The grantor retained income trust requires that qualified income interest be retained by the grantor. In the case of the sale to a defective grantor trust the private annuity received in the exchange must have an actuarially determined value equal to the value transferred. In some cases the value added back actually exceeds the value removed eliminating or reducing the value of the gift planning.

C. The Availability of the Annual Exclusion and Gift Splitting.

1. <u>The Annual Exclusion</u>

The Internal Revenue Code allows for an exclusion from gifts of $13,000,[5] per donee per year (this is called the "annual exclusion") for gifts of “present interests.”[6] As a result, a single transferor may deduct $13,000 from the taxable transfers made to each transferee each year. The value that qualifies for the annual gift tax exclusion is never taxed. Over time, following a plan of annual gift giving can remove significant value from the taxable estate by taking advantage of the annual exclusion. In order to qualify for the annual exclusion, the property interest transferred must constitute a gift of a "present interest." A present interest must grant the donee the immediate right to use, possess, and enjoy the gifted property. An outright gift will constitute a gift of a present interest, but a transfer of property in trust may or may not constitute a gift of a present interest, depending on the terms of the trust.

2. Gift Splitting

Through a concept known as “gift splitting,” a married couple can utilize the annual exclusion of both spouses in regard to a particular donee, even if only one spouse makes the actual transfer. Therefore, if in a particular tax year, a wife makes a $26,000 gift to a particular donee and the husband makes no gift, the couple is allowed under “gift splitting” to treat the wife’s gift as made one-half by each spouse. As a result the wife would be treated as having made a $13,000 gift to the donee, and the husband would also be treated as having made a $13,000 gift to the same donee. Both the wife and the husband would then be allowed to offset the gift with a $13,000 annual exclusion.

Gift splitting does not increase the number of annual exclusions that are available to a married couple; it simply allows the transferring spouse to take advantage of the unused exclusions of a non-gifting spouse. If the other spouse had also made gifts to the same donees in the same year only the amount of their unused exclusion would be available for gift spitting.

Example: Mr. C has three children. Each year he gifts them $26,000 a piece. His wife makes no gifts. Mr. C is entitled to take one annual exclusion of $13,000 for each gift he has made to each of his children; and by reason of gift splitting he is entitled to a second $13,000 exclusion per donee. As a result none of the gifts are taxable.

3. The Chance to Remove Future Appreciation

By making a gift of a property interest the taxable value of the transferred interest is limited to the value of that interest at the time of the transfer. Any post transfer appreciation is removed from the taxable estate. Under the right circumstances an inter vivos gift may remove significant value from the taxable estate.

Example: Mr. D owns stock in MNO, Inc. Its current value is $5,000,000. He gifts all the stock in MNO to his children. Mr. D lives for another 15 years. At the time of his death MNO, Inc. is worth $12,000,000. As a result of the lifetime gift $7,000,000 of value is never taxed.

4. Removal of Tax Paid from the Tax Base

An aspect of the gift tax that is often not considered is the fact that the tax paid on inter vivos gifts is effectively removed from the tax base while in the case of the estate tax the tax is included and taxed in

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[5] This figure is adjusted for inflation.

[6] A “present interest” is an interest that the donee has the present right to enjoy the ownership of the transferred property.

the tax base, provided the gift takes place within three years of the death of the transferor. Here's an example:

Example: Mr. E has an estate of $20,000,000. If he makes a lifetime gift of $10,000,000 – the resulting gift tax of $1,706,250 is removed from his taxable estate. On his subsequent death only the $8,293,750, remaining in his estate will be taxed resulting in an estate tax and additional transfer tax of $2,902,812. This would leave net $15,390,937 for the heirs .If on other hand he made no lifetime transfers the entire $20,000,000 will be subject to the estate tax on his death, the estate tax would be $5,206,250, leaving the heirs with $14,793,750, after tax.

5. <u>The Chance to take Advantage of Preferential Transfers</u>

There are several ways that an inter vivos transfer can be made other than a straight gift of the property. These alternative methods may result in transfer tax savings. Four of those options are discussed in this section: (i) the Grantor Retained Annuity Trust, (ii) the sale to an Intentionally Defective Grantor Trust in exchange for a private annuity, the sale to an Intentionally Defective Grantor Trust in exchange for a Self-Canceling Installment Note, and (iv) the Qualified Personal Residence Trust.

a. The Grantor Retained Annuity Trust

(1) Overview

Pursuant to a Grantor Retained Annuity Trust ("GRAT"), an owner transfers his or her ownership interest in the property to an irrevocable trust retaining a current income interest in the trust for a specified term (anticipated to be shorter than the grantor's life expectancy). At the end of the term, the GRAT terminates and the remainder interest in the trust property passes to designated heirs either outright or in further trust.

(2) Subtraction Method

Under §2702 of the Internal Revenue Code, the value of the gift of property transferred to the GRAT is determined by the "subtraction method," i.e., by subtracting the present value of the retained income right from the fair market value of the property transferred. If the term is long enough and the level of retained income interest are set high enough the value of the retained right to income can be equal to the value of the interest transferred. In that case the value of the gift will be zero.

(3) Qualified Interests

Under §2702, retained income interests are valued at zero unless they are "qualified interests." Section 2702(b) defines three types of qualified interests: (1) an annuity trust interest (i.e., an income interest equal to a fixed amount or fixed percentage of the initial fair market value of the property transferred); (2) a unitrust interest (i.e., an income interest equal to the fair market value of the property transferred determined on an annual basis); and (3) any non-contingent remainder interest if all of the other interests in the trust consist of either unitrust or annuity trust interests.

(4) Advantage

As a basic principal, if the qualified income interest zeros out the value of the gift value equal to the value removed from the estate will be added back through the qualified payments. While this may seem

pointless, the transferor has at least frozen the value of the property transferred and can defer the tax on the value of that property until death.

(5) Example

Here's an example of how this works: assume Mr. G's interest in UVW, Inc is worth $1,000,000. Assume further that Mr. G makes a transfer of the entire interest to a GRAT retaining the right to a $117,230 annual distribution from the GRAT for 10 years. Under the §2704 of the IRC the gift value of this transfer would be determined to be as follows .

Assumed Value	$1,000,000
Assumed Term	10 years
Income Interest Retained	$ 117,230
Gift Value	-0-
Gift Tax Due	-0-
Estate Tax	-0-

(6) Other Considerations

(a) Effect of Qualified Interest

There are certain other aspects of the GRAT planning which should be pointed out. In our example, assuming a trust term of ten years, in order to "zero out" the gift tax, the owner must actually be paid the annual payments of $76,986. It is assumed that the funding for this payment comes from distributions in relation to the property held by the GRAT. While the annual distribution of $76,986 from the GRAT is not taxable, because a GRAT is for income tax purposes a "grantor trust", the owner will be taxed on the income earned by the assets held by the GRAT.

(b) Survival Requirement

In addition, in order for the GRAT to realize the tax benefits described, the owner must actually survive for the period during which he or she has retained the distribution rights from the GRAT. If the owner dies within that period, the value of the interests held by the GRAT will be included back in his taxable estate, thereby possibly reversing the tax benefit initially created by the GRAT.

(c) Basis of Transferee

Finally the transferee will receive a carry over basis rather than a basis step in the property transferred a GRAT.

b. Sale – Private Annuity

(1) Overview

An alternative to a transfer by gift to a GRAT is the sale to an "Intentionally Defective Grantor Trust" (IDGT) in exchange for a lifetime annuity payment. Under this option, the owner would first establish an irrevocable trust. The trust is intentionally designed to be a grantor trust, i.e. it is drafted with provisions which make it a grantor trust making any income earned by the trust taxable to the grantor. Because in the

view of the IRS the trust needs to have economic substance before it can validly issue debt, the owner then transfers funds with a value equal to approximately 10% of the value of the interest to be sold to the IDGT. This amount is taxable as a gift to the remainder beneficiaries of the trust.

After the IDGT is established and funded, the owner then "sells" his or her interest in the business to the IDGT in exchange for an annuity payable for life (i.e. a "private annuity"). Normally a sale creates taxable income to the seller based on the gain realized. In the case of the IDGT, however, because the trust is designed to be "grantor trust," the sale is not considered taxable (the IRS essentially looks at the grantor trust and the trust creator as one taxpayer) and the gain realized on the "sale" is not recognized for tax purposes.

(2) Gift Tax Consequences

In order to avoid gift tax consequences, the private annuity must be set at a sufficient level that it is equal in value to the interest transferred. In this case because the transfer is an exchange for fair value in money and moneys worth, there are no gift tax consequences resulting from the transaction. Upon the death of the transferor the private annuity terminates and there is nothing left to be taxed in the transferor's estate. From an estate tax point of view, the property interest is removed from the taxable estate without gift or estate tax consequences. The owner on the other hand, receives a lifetime annuity funded by distributions from the property to the IDGT, which will add value back to the estate, at the same time the interest in the property is being removed.

(3) Advantages

The advantage of the IDGT/Private Annuity is that, unlike the GRAT, there is no danger of assets being pulled back into the estate if the owner dies prematurely. However, because the number of payments is unknown, if the owner survives past his life expectancy the aggregate value of the overall payments may be greater than the actual value of the property transferred. On the other hand, they may be significantly less if the owner dies prematurely. The private annuity works particularly well if the owner's actual life expectancy is greater than 18 months but shorter than normal. Generally the IRS allows the use of its actuarial tables to determine life expectancy in determining the value of the private annuity, however if the owner/transferor's life expectancy is less than 18 months his or her actual life expectancy will be used.

(4) Other Considerations

Like the GRAT, discussed above, the owner must actually be paid the annuity payments, and like the GRAT, while the annuity payment not taxable, because an IDGT is for income tax purposes a "grantor trust", the owner will be taxed on the income earned by the assets held by the IDGT. Finally, the transferee will receive a carry over basis rather than a basis step in the property transferred by an IDGT.

c. Use a Self Canceling Installment Note or SCIN

(1) Overview

Under this planning option the transaction is the same as that described in regard to the private annuity except that instead of a private annuity the transferor receives an installment note in the exchange

that cancels by its terms at the time of the transferor's death (i.e. a "self cancelling installment note" or SCIN). Again, to avoid income tax consequences, the sale is made to an IDGT.

Generally, the SCIN is established for a term just short of the life expectancy of the seller, but it can be any period as long as it is less than the client's life expectancy. This will relieve the problem of uncertainty associated with a private annuity, i.e. the greatest amount that can be paid under the note can be calculated. The SCIN, however, shares the advantage of the private annuity in that the obligation to make annual payments ends at the death of the transferor. Another benefit is the unpaid balance of the SCIN is not included in the client's estate should he or she die prior to it being paid in full.

(2) Drawbacks

There are certain drawbacks associated with utilizing a SCIN which should be pointed out, however. In order to avoid gift tax, the amount of the note and the interest rate provided under the note must be set at reasonable premium in relation to the value of interest exchanged. Since the amount of the note and the interest rate are a function of actuarial determinations based on the life expectancy of the transferee, if the client's actual life expectancy is shorter than his actuarial life expectancy the IRS may challenge the transaction. Finally, upon the death of the client, the deferred gain may be recognized as income in respect of a decedent by the estate.[7]

d. Qualified Personal Residence Trust

(1) Overview

In order to implement a QPRT, the transferor transfers legal ownership of the residential property (or properties) to the QPRT. Under the terms of the QPRT, the transferor will have the right to continue to live in and manage the residence for a specified period of time (the term of the trust). In addition, the transferor will still be primarily responsible for all costs associated with the property, including the mortgage, insurance, and taxes. If the transferor place funds into the trust for these expenses, the trust will pay them with those funds.

At the end of the trust term, assuming the transferor survive the trust term, the property will pass to the trust beneficiaries the transferor named in the trust agreement. The trust agreement can provide that the property passes to the beneficiaries outright or that the property is to be retained in further trust for them. At this point, the transferor can continue to occupy the residence, but a lease arrangement should be made with the beneficiaries at a fair market rental price since they will be the owners of the property. The transferor can reserve his or her right to lease the residence at the time the transferor establishes the QPRT.

(2) Tax Benefit

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[7] The Tax Court has disagreed with this opinion, but the Eighth Circuit overturned that decision and sided with the IRS. As such, it appears that upon the death of the client, their estate must recognize the deferred gain.

The primary advantage of the QPRT is the potential for estate and gift tax savings. When the transferor transfers the residence to the QPRT, the transferor is making a gift to the trust which may result in gift tax. The same result would occur if the transferor were to give the property directly to the transferor's children. The advantage of a QPRT is that it significantly reduces the amount of federal gift tax that would normally apply.

The gift tax that the transferor pays as a result of any gift is based upon the value of the interest transferred. Therefore, if the transferor transfers a residential property outright to his or her children, the gift tax will be based on the entire value of the property. Assuming that the value of the property is $1,000,000, the gift tax rate would be 35% and the tax liability due on the gift would be $350,000. The QPRT works as a tax savings device by reducing the value of the interest that is transferred. Once contributed to the QPRT, the residence is theoretically divided into two interests: the interest the transferor retain for a term (the "retained interest"), and the interest that is gifted to the beneficiaries (the "remainder interest"). Since the transferor will be keeping the retained interest, and gifting only the remainder interest, the gift tax is based only on the value of the remainder interest rather than the value of the entire property.

Example - Assume the transferor, at age 71, transfer a $1,000,000 residence to a QPRT for a retained term of ten (10) years. The value of the retained interest would be approximately $927,000 and the value of the remainder interest would be approximately $73,000. Therefore, the gift tax would only have to be paid on the $73,000, not the full $1,000,000 as in the previous example.[8] *Therefore the tax on transfer is reduced from $350,000, to $25,550. In addition, any appreciation in the property after the transfer to the trust will also pass tax free. At the end of the ten year period, the property would either be distributed to the beneficiaries or held in further trust for their benefit. No further estate or gift tax is incurred upon this transfer.*

(3) Final Comments

The remainder interest that is gifted is valued according to rules and regulations set out under the Internal Revenue Code. The idea behind valuing the remainder interest is that even though the beneficiaries will receive the entire property at the end of the trust term, it is worth less than if they were to receive the whole interest today because they have to wait until the end of the trust term. The rules and regulations take into account many different factors including the transferors' ages, certain interest rates, and the term of the trust. The factor which the transferor can control is the length of the trust term. The longer the transferor makes the trust term in the trust agreement, the greater the value of the retained interest, and the lesser the value of the remainder interest. A lower value for the remainder interest results in lower gift tax. The risk in choosing too long a term for the QPRT is that if the transferor does not survive the term, then the QPRT will terminate and the entire property will come back into his or her estate rather than passing to the designated beneficiaries. In this case, the entire value of the property will be subject to the estate tax as if the transferor had never implemented the QPRT at all.

6. <u>Greater Opportunity to Take Advantage of Valuation Discounts</u>

a. Overview

A valuation "discount" is a reduction in the otherwise determined value of an equity interest in an ownership interest in an entity, such as a corporation, partnership or limited liability company. One significant advantage of making a lifetime transfer of property which involves an interest in business or

[8] Since the unified estate and gift tax exemption is currently $5,000,000, you will actually incur no of-of-pocket gift tax until your lifetime gifts exceed that amount.

income producing property is the ability to utilize valuation discounts which are often difficult to obtain through a testamentary transfer. This section discusses this planning opportunity and will also discuss some of the more significant discounting techniques which are available to the planner.

b. Valuation Discounts

Generally there are two discounts which may be appropriate when valuing an equity interest in a closely-held business entity, the discount for "lack of marketability" and the "minority interest" discount. The "lack of marketability" discount is based on the premise that equity in any closely-held business cannot be readily sold on an established market. The lack of marketability discount is generally available whether the interest is transferred at death or by inter vivos gift. The "minority interest" discount is a discount in the value of an interest in a closely held business representing a lack of control in terms of vote. The "minority discount" is based on the premise that a non-controlling or "minority" interest has less value than an interest representing an otherwise equal interest that has the ability to vote.

c. The "Minority Discount"

In order to understand why taking advantage of a minority discount is more readily available through an inter vivos transfer, one must first appreciate a fundamental difference between how the gift tax is determined as compared to the estate tax. *The gift tax is based on the value of the property interest received by the transferee while the estate tax is based on the value of the property interest held by the estate.* This difference can significantly affect the taxable value of the interest transferred - but why does this make a difference? Consider the hypothetical situation:

EFG, Inc. has an aggregate value of $4,000,000. Mr. F holds all the issued and outstanding stock of EFG, Inc. – which consists of 100 shares of voting common stock. Mr. F wishes to transfer those shares to his four children in equal gifts of 25 shares a piece. If he retains all 100 shares in his estate and makes the gift at death – the taxable value for federal estate tax purposes will be determined by valuing the 100 shares of EFG, Inc. stock as a block – the interest held by the estate. The result will be that the stock will have a value equal to the $4,000,000 value of EFG, Inc.

If on the other hand Mr. F transfers the stock in four inter vivos gifts of 25 shares to his children the determination of taxable value will be based on the value of four separate gifts of 25 shares – the property interest received by the transferee. The difference is that each such gift viewed alone represents a minority interest in the corporation and for valuation purposes may be entitled to a "minority discount" of 30% to 40% off its otherwise pro rata value of the corporation.[9] Assuming a 30% discount, as a result for gift tax purposes the gift of the 100 shares of EFG, Inc. stock will be determined as follows:

Value of ABC, Inc.	*$ 4,000,000*
	X .25
Pro rata Value of 25 shs	*$ 1,000,000*
Reduced by .30 minority discount	*- 300,000*
Value of 25 Share Gift	*$ 700,000*
	X 4

[9] At one time the IRS took the position that gifts which looked at individually represented a minority interest should be valued without a minority discount when made within a family. In light of numerous contrary decisions in the courts, the IRS abandoned this position in Rev. Rul. 93 -12.

Total Gift Value *$ 2,800,000*[10]

What this means in practical terms is that the lifetime gift of an entire controlling equity position in a closely held business made in fractional shares each representing a minority position can take advantage of minority discounts, while a testamentary transfer of the same interests to the same donees may not. Since many owners of family owned businesses own all or close to all of the issued and outstanding equity this can be a valuable planning tool.

d. The Opportunity to Create Minority Discounts

The result in the preceding subsection assumes that the gift of 100 shares of stock is transferred in four separate gifts of 25 shares, each individual gift representing a less than controlling interest. If all 100 shares of voting stock were transferred pursuant to an inter vivos gift to *one donee* no minority discount would result and the full value of the stock, i.e $4,000,000 would be taxed. It is possible to create a "minority discount" in an interest, even in stock which possesses a disproportionate right to income and distribution proceeds. In addition the recapitalization can achieve such discounts while allowing the owner to retain control over the business entity during his or her lifetime.

Here's how it is done. Ownership of equity ownership in a business, whether stock in a corporation, a partnership interest, or a membership interest in a limited liability company, represents three basic rights: (i) the right to distribution of income, (ii) the right to participate in the distribution of the net assets of the entity in liquidation, and (iii) the right to vote. Most family owned corporations have only one class of stock: voting common stock. Generally, each share of common will be entitled to a pro rata share based on the number of shares outstanding of the income, net assets, and vote – that is if there are 100 shares of stock outstanding each share would be entitled to one percent of the income and net assets and one vote out of 100. Pursuant to the plan of recapitalization, the equity structure both changed to provide both voting and non-voting stock. The voting interests could be entitled to a very small percentage of the cash distributions and the net proceeds in liquidation, *but all of the management control.* On the other hand the non-voting interest may be entitled to a significant portion even most of the right to cash distributions and net proceeds in liquidation, *but none of the management control.* Because the non-voting interest has no right to participate in management decisions, its value for gift tax purposes is considered a "minority" interest and will be discounted for purposes of transfer tax valuation by 30% to 40%.

The following example will illustrate just how this works:

Assume all of the outstanding stock of a closely held family corporation, LMN, Inc. (represented by 100 shares of voting, common stock) has a current fair market value of $10,000,000, and all of the stock is owned by Mr. G. Mr. G wishes to transfer his ownership interest in LMN, Inc. to his son. An outright gift of the stock to his children will result in a taxable gift equal to the full value of LMN, i.e., $10,000,000.

<u>*Step One*</u>

[10] This conclusion assumes that the gift of 100 shares of stock is transferred in four separate gifts of 25 shares each – each individual gift representing a less than controlling interest. If all 100 shares of voting stock were transferred to one individual donee no minority discount would apply and the full $4,000,000 value would be taxed.

Under the recapitalization plan however the capitalization of the corporation is changed to 1 share of voting common and 99 shares of non-voting common. After the recapitalization the one share of voting common stock is entitled to 1% of the cash distributions from the corporation, 1% of the net proceeds in liquidation, but all of the vote and therefore all of the management control. The 99 shares of non-voting stock is entitled to 99% of the cash distribution from the corporation, 99% of the net proceeds in liquidation, but no vote and as a result none of the management control.

Step Two

The next step is for Mr. G to transfer the 99 shares of non-voting stock to his son, either outright or in trust. This transfer is a taxable gift. The 1 share of voting stock is retained by Mr. G. Logically, the gift tax value of the transfer of the non-voting stock should be equal to 99% of the fair market value of the corporation (i.e., $9,900,000), since that is the value that the shareholders holding the non-voting stock would be entitled to in liquidation of the corporation. When the stock is recapitalized before the transfer, however, this is not the outcome. Because the non-voting stock interest has no right to participate in management decisions and because it is not tradable on a recognized securities exchange, its value for gift tax purposes is discounted for "minority" and "lack of marketability". These discounts will together result in the gift tax value of the 99 shares of non-voting stock being reduced by 35%. As a result, $9,990,000 in real fair market value can be transferred at a gift tax value of only $6,435,000. Due to the discounts, the difference of $3,465,000 is never taxed.

e. The Family Limited Partnership.

A "Family Limited Partnership" is a means of transferring property to heirs which attempts to take advantage of the discounts due to "minority" and "lack of marketability," by first transferring assets, sometimes non-business property, to a limited partnership. Under the FLP, a limited partnership is first created. As a next step, the assets are transferred to the FLP by a senior family member, in exchange for a 1% general partnership interest and a 99% limited partnership interest in the FLP. By design, the general partnership interest is entitled to 1% of the cash distributions from the FLP, 1% of the net proceeds in liquidation, and, by law, all of the management control. The limited partnership interest is entitled to 99% of the cash distribution from the partnership, 99% of the net proceeds in liquidation, but by law none of the management control. For the next step, the senior family member transfers the 99% limited partnership interest to chosen heirs, either outright or in trust. This transfer is a taxable gift. The 1% general partnership interest is retained. Like the recapitalization described above, the gift tax value of the transfer of the limited partnership interest should be subject to a discount for "minority" and "lack of marketability."

Particularly when no-business assets, such as marketable securities, are transferred to the FLP, the IRS has sought to challenge the validity of the discounts for estate and gift tax purposes with varying success. Often the challenge is based upon the application of Code Section 2036(a)(1), which provides that the value of the estate includes property transferred by lifetime gift when the transferor retains the right to the possession, enjoyment or income from the property or the right to control the possession, enjoyment or income from the property, until death. The Service has been most successful when the factual background of the contested case includes one or more of the following facts: (i) the transferor transfers most of his or her assets to the FLP, (ii) the transferor continues to use the property transferred as if it is his or her own, (iii) the transferor commingles personal and partnership assets, (iv) the transferor takes disproportionate distributions from the FLP, or (v) uses the entity funds for personal expenses. The IRS has also had some success when the transferor has failed to observe the legal formalities of the FLP, such as maintaining separate bank accounts.

IV. A Method of Analysis and a Transfer Strategy

A. Overview

The advantage achieved by making lifetime gifts lies in the opportunity to remove the value in the taxable estate. Since the estate tax and gift tax rates are equal that removal in value must be realized either in the form of: (i) taking advantage of the annual gift tax exclusion, (ii) removal of any future appreciation in value, (iii) removal of the gift tax incurred from the tax base, (iv) removal of the income realized by reason of ownership of the transferred property after the transfer, or (v) taking advantage of permanent valuation discounts. The tax benefit achieved by removing the value cited must be weighed against the fact that with certain techniques, e.g., GRATs, private annuities value, and sales to IDGT, for example value is also added back to the estate. In addition, the value of the loss of basis step up which occurs when property is gifted during lifetime rather than transferred by testamentary transfer must also be considered.

There is no one planning method that will result in the best result in every case. The planner must undertake an analysis of each alternative in order to determine the appropriate method of transferring the interest considering the situation and the objectives of the client. In the case of an estate having little realistic exposure to the federal estate tax, lifetime gifts of property to lower generation heirs make little sense in terms of reducing taxes. Any reductions in taxable value which can be achieved by making lifetime transfers will produce no tax benefit to such an estate, and the loss of step up in basis available for assets retained in the taxable estate will potentially increase the heir's income tax on the sale of inherited property.

For estates whose potential value at the point it will be subject to estate will in all likelihood exceed a level at which federal estate tax will be incurred the planner must determine the tax reduction that can be achieved through lifetime gift planning as compared to the value potentially added back and the cost of loss of basis step up. The following Case Study is as much to suggest a method of analysis as well as to highlight the advantage and disadvantages of the planning options.

B. The Method of Analysis

1. <u>Overview</u>

The object of the suggested method of analysis is to first determine and then compare: (i) the net after tax value that will actually pass to the next generation under each alternative transfer strategy considered, to (ii) simply retaining the assets in the estate. In making the determination which method will produce the greatest net after tax value, it is necessary to have the facts of the particular case in hand and also to make certain assumptions.

2. <u>The Facts</u>

You should know the following facts:

- *The current fair market value of the property interest to be transferred, and its potential to appreciate.*

- *The level of income produced by the property interest transferred.*
- *The fair market value of the owner's assets other than the property transferred, and their potential to appreciate.*
- *The manner in which the assets held by the owner will be disposed under his or her estate plan.*
- *The Transferor's and the transferee's marginal income tax brackets.*
- *The Transferor's basis in the assets held by the Transferor.*
- *The value of any other lifetime gifts made by the client before the transfer in question.*

3. <u>The Assumptions</u>

You must also make certain assumptions including the following:

- *The annual rate at which the property interest transferred will appreciate.*
- *The annual rate at which the assets not transferred will appreciate.*
- *The discount rate to be used for determining present and future values.*
- *The life expectancy of the client.*

4. <u>The Steps in the Analysis</u>

Perform the following Calculation first assuming no transfer and then for each of the alternative methods of lifetime transfer considered.

Step One *– Start with a determination of the Fair Market Value of the Assets to be Retained.*

Step Two *– Then determine the Fair Market Value of Assets to be Transferred.*

Step Three *– Determine the Gift Tax on Assets Transferred.*

Step Four *– Subtract the Gift Tax determined in Step Three from the Current Fair Market Value of the Assets Retained.*

Step Five – Determine the Total Future Value of Assets Retained*.*

<u>Determine the Future Value of Assets Retained</u>

Start by determining the Future Value of the Assets Retained by taking the current Fair Market Value of Assets Retained multiplied by the Assumed Rate of Appreciation compounded over the transferor's life expectancy.

For example if the Fair Market Value of the Assets Retained is $5,000,000, the transferor's life expectancy is 15 years, and the Assumed Rate of Appreciation is 3% per annum – the calculation of the Future Value of Assets Retained = $\$5{,}000{,}000 \times 1.03^{15}$

<u>Determine the Future Value of the Net After Tax Income Earned by the Assets Retained</u>

You must add to this figure the Future Value of the Net After Tax Income Earned by the Assets Retained. Determine the Net After Tax Income earned by the Assets Retained by estimating the annual income earned on those assets and reducing it by the estimated income tax on that income using the assumed marginal tax rate of the Transferor. Compound that figure over the Transferor's assumed life expectancy.

For example if the estimated income earned on the Assets Retained is $500,000, the transferor's life expectancy is 15 years, the assumed marginal tax rate is thirty-five (35%) percent, and the Assumed Rate of Appreciation is 3% per annum – the calculation of the Future Value of the Net After Tax Income Earned by the Assets Retained = ($500,000 – ($500,000 x.35)) x 1.03^{15}

Determine the Future Value of the Add Backs

You must now add to this figure the Future Value of the Add Backs. The "Add Backs" are the distributions rights which are retained by the Transferor by reason of the nature of the transfer, e.g., if the transfer is made by using a GRAT, the Add Back would be the Future Value of the qualified income interest, and in the case of the sale to the Intentionally Defective Grantor Trust, the Add Back is the value of the private annuity which must be paid to the Transferor or the interest on the SCIN.

For example if the qualified income interest is $200,000, the specified period over which the qualified income interest is 15 years, and the Assumed Rate of Appreciation is 3% per annum – the calculation of the Future Value of the Add Backs. = ($200,000) x $1.03^{15.}$

The total of the three figures equals the Total Future Value of Value Retained.

Step Six – Determine Estate Tax on Assets Retained

Determine the Federal Estate Tax on the Total Future Value of Value Retained, determined under Step Five, above.

Step Seven – Determine the Net Value of the Assets Retained

Subtract the amount determined under Step Six from the amount determined in Step Five.

Step Eight – Determine Total Future Value of Assets Transferred

Determine the Future Value of Assets Transferred

Determining the Future Value of the Assets Transferred by taking the current Fair Market Value of Assets Transferred multiplied by the Assumed Rate of Appreciation compounded over the transferor's life expectancy in the same manner as you determined the Total Future Value of the Assets Retained, in Step Five, above.

Determine the Future Value of the Net After Tax Income Earned by the Assets Retained

You must add to this figure the Future Value of the Net After Tax Income Earned by the Assets Transferred in the same manner as you determined the Net After Tax Income earned by the Assets Retained in Step Five, but of course substituting the assumed marginal tax rate of the Transferee.

Determine the Future Value of the Add Backs

You must <u>*subtract*</u> *the Future Value of the Add Backs. The "Add Backs" are same Add Backs determined in Step Five*

Step Nine – Determine Value of Basis Step Up

Determine the value of the Value of the Basis Step Up by determining the difference between the Future Value of the Total Future Value of Assets Retained and the basis of those assets in hands of the Transferor

Step Ten – Add the total of Steps Seven, Eight and Nine.

This is the Total Net Value to be Transferred. Perform this calculation for each Alternative Method of Transfer considered, including retaining all of his assets within the Estate.

C. Second – Should you make gifts in 2012?

1. <u>Impact of the Tax Relief Act – How it Alters the Equation.</u>

After a one year repeal, the Tax Relief Act of 2010 reinstated the federal estate tax for at least 2011 and 2012, and if elected by the estate of someone dying in that year, for 2010, as well. During those years, the highest marginal estate tax rate will be 35%, and the exemption amount (termed the "Basic Exclusion Amount") is increased to $5 million per individual for 2011, and will be indexed for inflation thereafter. Starting in 2011, the gift tax exemption is unified with the estate tax exemption. This means that a $5 million Basic Exclusion Amount will also be available for gifts. Prior to 2010, an individual was entitled to a $3.5 million exemption for their estate, but only $1 million for gifts. Because gifts in excess of that amount required payment of gift tax out of pocket, many potential donors were hesitant to make those gifts. Now, an additional $4,000,000 can be transferred gift tax free. Barring any further action by Congress, the Basic Exclusion Amount will reset at $1,000,000, after 2012.

2. <u>The "Clawback"</u>

Another factor to consider is the so-called *"clawback issue*." Because of the way the gift tax is calculated, some commentators are concerned that if the Basic Exclusion Amount drops to a lower level after 2012, and a person dies after that point, the gift tax savings can be recaptured in the form of additional estate taxes. This recapture is sometimes termed a *"clawback."* The recapture potential exists because the estate tax is imposed upon the decedent's taxable estate as increased by the decedent's lifetime adjusted taxable gifts, which is offset by the applicable exclusion amount at the time of the donor's death. As a result because the donor's taxable gifts were sheltered from a gift tax exclusion that is larger than the applicable exclusion amount at the time of the donor's death, such gifts will create additional estate tax for the donor's estate.

Example - Waldo has a $15 million estate. He makes a $5 million gift in 2011, paying no gift tax because he has his full unified credit (equivalent to a $5 million exclusion amount) available. Two years later, Waldo dies, leaving a $10 million taxable estate. The 2010 Tax Relief Act and EGTRRA sunset on December 31, 2012, leaving Waldo with a $220,550 unified credit, equivalent to a $1 million applicable exclusion amount, and a 55-percent top estate tax rate. Waldo's estate will owe $7,795,000 in estate taxes on a $10 million taxable estate, determined as follows:

Taxable estate	$ 10,000,000
Adjusted taxable gifts	$ 5,000,000
Tentative tax base	$ 15,000,000

Tentative tax	$	8,140,800
Gift taxes payable	$	-0-

Example - Assume the same facts as in the preceding Example, except that Waldo made only $1 million of lifetime taxable gifts. Waldo dies in 2013, leaving a $14 million taxable estate. Waldo's estate tax liability will still be $7,795,000, determined as follows:

Taxable estate	*$*	*14,000,000*
Adjusted taxable gifts	*$*	*1,000,000*
Tentative tax base	*$*	*15,000,000*
Tentative tax	*$*	*8,140,800*
Gift taxes payable	*$*	*-0-*
Unified credit on date of death	*$*	*345,800*
Estate tax due	*$*	*7,795,000*

This can create a serious problem if the deceased has made lifetime taxable gifts significantly disproportionate to the decedent's remaining taxable estate. In such cases, the estate tax due could exceed the entire taxable estate.

Example - Waldo has a $6 million estate. Waldo lives largely on the income he receives from a trust created by his great-grandfather, and which is exempt from estate taxes. Waldo makes a $5 million gift in 2011, paying no gift tax because he has his full unified credit (equivalent to a $5million exclusion amount) available. Two years later, Waldo dies, leaving a $1 million taxable estate. The 2010 Tax Relief Act and EGTRRA sunset on December 31, 2012, leaving Waldo with a $345,800 unified credit, equivalent to a $1 million applicable exclusion amount, and a 55-percent top estate tax rate. Waldo's estate will owe $2,595,000 in estate taxes on a $1 million taxable estate, determined as follows:

Taxable estate	$	1,000,000
Adjusted taxable gifts	$	5,000,000
Tentative tax base	$	6,000,000
Tentative tax	$	2,940,800
Gift taxes payable	$	-0-
Unified credit on date of death	$	345,800
Estate tax due	$	2,595,000

Although a $2,595,000 tax on a $1 million taxable estate sounds unreasonable, it reflects that Waldo took advantage of a $4 million gift tax exclusion that did not exist on the date of her death.

3. Techniques for the Reluctant Donor

Here are two techniques which could be utilized by a reluctant donor:

a. Discretionary trust

In states that afford creditor protection to self settled trusts, property can be removed from the transferor's estate by transfers to such trusts. In states where creditors of the transferor can access property transferred to a self-settled trust, the IRS has taken the position that the gift is incomplete.[11] However in a number of states property transferred to an irrevocable self settled trust is protected from creditor attachment and the transfer will constitute a completed gift removing the property from the

[11] See Rev. Rul., 76 -103, 1976- CB 293.

transferor's estate.[12] This is true even if the transferor can receive distributions from the trust distributions made in the discretion of a third party trustee. The negative of such planning is that the transferor must rely on the discretion of the third party trustee to access property transferred to the trust.[13]

b. Reciprocal spousal trusts

*S*pouses could also transfer property to trusts for the benefit of each other which do not qualify for the marital gift tax deduction. Care should be taken to avoid the application of the reciprocal trust doctrine by varying the terms of each trust, and perhaps the amount transferred as well.

4. <u>Should You Make Gifts in 2012?</u>

The question of whether or not to make gifts in 2012 is a difficult one to answer. The enticement of the $5,120,000 gift tax exclusion and the 35% tax rate is difficult to resist. If one could predict with certainty that the Basic Exclusion Amount would revert to $1,000,000, and a 55% marginal tax rate, the answer would be easier to answer. However that is only one of several possibilities. Others include complete estate tax repeal – the Obama proposal of a $3,500,000 exclusion for estates, and a $1,000,000 exclusion for gifts, coupled with a top tax rate of 35%, or something in between.

To what extent do old principles apply? Gifting assets with a low basis relative to fair market value is generally not tax advantageous in the context of gifting strategy since a low basis will increase the value of the loss of basis step up. If one assumes high basis the value of the loss of step up goes down. If the value of the basis step up is eliminated or relatively low – it may be worth it to risk losing the step up in order to obtain potentially greater estate tax savings. Lower net worth individuals will gain less if anything and may lose value by making gifts. One must also factor in that the estate tax is based on entire fair market value of property on the date of death, while the value of basis step up is based only on the difference between the fair market value at the date of death and the adjusted basis of the property in the hands of the decedent.

Generally one is on safe ground gifting high basis assets even in this uncertain environment. As a general rule estates within the application exclusion amounts – twice that for a married couple- should not consider gifts. It is generally true that because the estate tax rates are higher than at least capital gains the value of estate tax savings should be worth more than step up in basis. However, when one factors in the effect of the Basic Exclusion Amount that conclusion may change. For instance the effective estate tax rate under President Obama's budget proposal does not exceed the 2013 capital gains rate of 18.8% until the taxable estate exceed $6,000,000 - $3,000,000 over the $3,500,000 exemption. If one assumes a $1,000,000 exemption, and a 55% rate on estates over $3,000,000, the effective estate tax rate exceeds the capital gains rate at about $1,870,000 - $870,000, over the exemption. This also means that higher net worth individuals will gain more by making gifts because the highest marginal estate tax bracket will generally also be the effective tax rate which applies to the gifted property.

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[12] See Rothschild, Blattmachr, Gans, and Blattmachr, "IRS Rules Sel-Settled Alaska Trust Will Not Be in the Grantor's Estate," 37 Est. Plan. 3 (Jan. 2010).

[13] See *Estate of Levy v. Commissioner*, TC Memo, 1983-453, also Private Letter Ruling 9643013 (Oct.25, 1996).

The question in every case is still the same, *"Will the gift result in more after tax value passing ultimately to the transferor's heirs?"* In answering this question under the Method of Analysis, recited above you are asked as the planner to make certain assumption is making your calculations to determine the answer in a particular case. These included the following:

- *The level of income produced by the property interest transferred.*
- *The fair market value of the owner's assets other than the property transferred, and their potential to appreciate.*
- *The Transferor's and the transferee's marginal income tax brackets.*
- *The Transferor's basis in the assets held by the Transferor.*
- *The value of any other lifetime gifts made by the client before the transfer in question.*
- *The annual rate at which the property interest transferred will appreciate.*
- *The annual rate at which the assets not transferred will appreciate.*
- *The discount rate to be used for determining present and future values.*
- *The life expectancy of the client.*

In the unified transfer tax system the fundamental objective is to make it a tax neutral decision as to whether one makes a lifetime gift or transfers his or her property at death. Generally, the federal estate tax and the federal gift tax work in tandem toward this objective. As a result an individual who owns assets worth $10,000,000, for example, disregarding appreciation will pay basically the same transfer tax whether he retains the assets until death, or gives them away during lifetime, or gives them away in part and retain them in part[14] That been said there are that are differences in the may make a lifetime transfer more or less advantageous than one made at death. These differences were highlighted above in section III.

That being said because of the way the estate and gift tax are calculated the estate tax savings is really normally based on the appreciation in the property removed from the tax base between the date of transfer and the date of death. In a more settled environment, the question could be stated more simply as *"Is the estate savings realized by lifetime gift worth more than the loss of basis step up incurred by retaining the asset in the estate?"* Even in ideal circumstances many of the assumptions are no better than educated guesses. In order to determine the potential estate tax savings you have to know or at least assume the estate tax rate and the Basic Exclusion Amount, applicable at the time of the transferor's death; and in order to calculate the value of the loss in basis step up in have make assumptions as to the marginal tax rate applicable at that time. Because of the scheduled end to the Bush Tax Cut in 2013 – that marginal income tax rate also comes into question. In the current tax environment we can therefore add to the list of unknowns:

- The estate tax exemption
- The gift tax exemption
- The estate and gift tax rate
- The tax rate on capital gains
- The highest marginal income tax rate
- The existence of the unified transfer tax system

[14] Under current law the estate tax on $10,000,000 would be $1,708,000; a gift of $$5,128,000, would result in no gift tax but and a estate tax of $1,708,000, and a gift of $10,000,000 would be $1,708,000.

Where does that leave us? All of this uncertainty makes intelligent planning almost impossible. It is probably a better strategy to wait until more definition of the estate and also the nature of the income tax comes into focus. That will probably not occur until after the Presidential election at the earliest. At that point the Method of Analysis described above can be applied with more certainty to aid in the decisions making process.

V. If a Client died in 2012 – What should you do?

A. Must file 706 to Guarantee Portability

In order to claim the Unused Exclusion Amount, the executor of the estate of the deceased spouse must have filed an estate tax return which computes the Unused Exclusion Amount and make an election that such amount shall be taken into account. The amount of the exclusion considered "unused" will be dependent upon the values stated on that return. The statute requires that this return be timely filed and the statute of limitations to audit the return is suspended. This raises the question of whether all estates no matter what their size should file a federal estate tax return or risk not having the Unused Exclusion Amount of the first spouse to die being available to the surviving spouse's estate. Suppose for example at the time of Bill's death the combined estate was only $4,000,000, and no estate tax return was filed when Bill died. By the time Ruth dies the estate is now worth $6,000,000. Can her estate still claim Bill's Unused Exclusion Amount to shelter estate tax? The answer seems to be no – since as stated by the statute a timely filed estate tax return is required.

The IRS recently issued Notice 2012-21, which grants to qualifying estates (see below), for the purpose of making a portability election, a six-month extension of time for filing Form 706. The extension applies when the executor of a qualifying estate did not file a Form 4768 within nine months after the decedent's date of death, and therefore the estate did not receive the benefit of the automatic six-month extension. An executor of a qualifying estate that wants to obtain the extension must file Form 4768 no later than 15 months after the decedent's date of death. With the extension granted by Notice 2012-21, the Form 706 of a qualifying estate will be due 15 months after the decedent's date of death. (Notice 2012-21,Sec.1).

B. Utilization of Unused Basic Exclusion Amount

Since there is no guarantee that portability will allow a surviving spouse or their estate to take advantage of the Unused Exclusion Amount of the first of a married couple to die – steps should be taken to insure that it will be utilized this year. This can be done either by possibly increasing the size of the deceased spouse's taxable estate – perhaps through disclaimers, or having the surviving spouse making taxable gifts in 2012.

VI. Conclusions

1. The Credit Shelter Trust is still recommended in 2012 even for estates with value as low as $1,000,000.

2. Adopt Credit Shelter Trusts but build in flexibility to the Trust.

3. Wait until year end to make gifts after the future of the estate tax is more definite.

4. Then apply the Method of Analysis to determine if gift should be made.