2012 PLANNING CHECKLIST: PLANNING IN A "PERFECT STORM"

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2012 is the best year for estate planning. The estate tax and gift tax exemptions are at historical highs of **$5,120,000**, but they fall to **$1,000,000** on January 1, 2013. The estate and gift tax rate of **35%** is the lowest rate in almost a century, but the rate reverts to **55%** on January 1, 2013. Other factors contribute to creating a "Perfect Storm" for estate planning in 2012, but this limited opportunity expires soon. Now is the time to take advantage of this historic gifting opportunity.

I. The "Perfect Storm"

1. *$5,120,000 Gift Tax Exemption*. The exemption goes to $1,000,000 on January 1, 2013.

2. *Low Asset Values*. Current asset values offer great upside potential as values recover.

3. *Historically Low Interest Rates*. Low interest rates make "estate freeze" techniques even more attractive.

4. *Valuation Discounts*. Currently, intrafamily transfers can qualify for valuation discounts for lack of marketability and lack of control, but the government is targeting these discounts for elimination.

5. *"Defective" Grantor Trust (DGT) Rules*. DGT rules are still available but also on the government's hit list. (The Obama budget proposal would require all grantor trusts to be taxed in grantor's estate; existing grantor trusts are expected to be grandfathered.)

   Benefits of a DGT:

   a) It allows the grantor to sell assets to a DGT without owing income tax.

   b) It allows the grantor to "supercharge" gifts by having the grantor (instead of the trust) pay income tax on DGT income.

With this "Perfect Storm," the goal is to create an estate plan that, given sufficient time, eliminates the estate tax. Regardless the size of the estate, it is realistic to reach a point where the estate tax is zero. However, the planning window is closing. We recommend taking advantage of the “Perfect Storm” now, before it is too late. Here is a checklist of planning ideas for 2012.

II. 2012 Checklist: 10 Planning Ideas to Harvest the $5,120,000 Exemption

Each spouse has a $5,120,000 exemption that goes to $1,000,000 on January 1, 2013. Consider these ideas to capture the benefits of the exemption. Note that a married couple can give $10,240,000 in 2012 without paying gift tax.

1. <u>Gifts to Traditional Trust for Heirs</u>.
   Trust benefits heirs only. Trust pays the income tax on Trust income.

2. <u>Supercharged Gift to “Defective” Grantor Trust (DGT)</u>.
   DGT benefits heirs only. Grantors (parents) pay the income tax on Trust income, so Trust assets can grow faster.

3. <u>Estate Freeze Sale to DGT</u>.
   Supported by item 2 as a seed gift. Client <u>sells</u> assets to DGT and carries note at low AFR (applicable federal rate) interest rate. A $5,000,000 seed gift in item 2 can support a sale of $25-40,000,000. Freezes the client’s estate at current (discounted) value of assets; all post-sale appreciation goes to the Trust. Trust benefits heirs only.

4. <u>Estate Freeze Sale to “678 Trust.</u>”
   Supported by item 2 as guarantor. Third party creates 678 Trust for benefit of client and client’s family, funded with a $5,000 gift (the only gift ever made to the Trust). Client <u>sells</u> assets to the 678 Trust and carries note at low AFR interest rate. The note is guaranteed by the DGT (item 2). A $5,000,000 seed gift in item 2 can support a sale of $25-40,000,000 to the 678 Trust.

   Benefits of a 678 Trust:
   a) Trust benefits the <u>client</u> as well as the client’s family.
   b) No estate tax on Trust assets at client’s death.
   c) Client can be trustee.
   d) Trust assets are protected from creditors.
   e) Trust assets are protected from beneficiary’s divorce.
   f) Client retains a special power of appointment to direct where assets pass at client’s death.
   g) No estate tax when future generations die, for as long as 678 Trust lasts.

   **NOTE: ARGUABLY, THE GREATEST OPPORTUNITY THE $5,120,000 EXEMPTION OFFERS IS TO EXPAND THE SIZE OF ASSETS YOU CAN SELL TO A 678 TRUST.

5. Spousal Access Trust.

A. Create One Spousal Access Trust.

One spouse creates a Trust for the benefit of the other spouse and makes a $5,120,000 gift to it. The Trust is similar to a “Bypass Trust” normally created at first spouse’s death but is created while both spouses are living. If desired, Trust may give the spouse beneficiary a “special power of appointment” to direct how assets pass at death.

Benefits of a Spousal Access Trust:

i) Harvests one of the spouses’ $5,120,000 exemptions, but in a way that allows one spouse to continue to benefit.

ii) Works only if the gift is over the new 2013 exemption amount. For example, if the gift is $2,000,000, and the exemption is reduced to $3,500,000, there is no tax savings as the gift just eats up $2,000,000 of the $3,500,000 exemption. The gift salvages exemption only to the extent it exceeds the new 2013 exemption level.

iii) May result in grantor trust status for life, even if the spouses later divorce. (This aspect can be mitigated by giving a special trustee the right to reimburse the grantor for income tax purposes and/or the right to distribute assets outright to the spouse beneficiary in the event of later divorce. However, distributing assets outright will eliminate the benefits of the Trust and waste the exemption that was used to create it.)

iv) One example where this technique may apply is if there is a large wealth disparity between the two spouses, and the “monied” spouse makes a gift to a Trust for the non-monied spouse.

B. Create Two “Mutual” Spousal Access Trusts.

Each spouse creates a Trust for the other spouse, and each makes a gift of $5,120,000 to the Trust he or she creates.

Benefits of Mutual Access Trusts:

i) Same benefits as described in items 5.A.i, ii, and iii above.

ii) Can avoid reciprocal trust doctrine if the Trusts are sufficiently different.

iii) Easier to defend if there is separation in time between the creation of the two Trusts. Better to start now.

6. <u>Gift of an Undivided Interest in Real Estate or Real Estate Partnership</u>.
   Particularly useful if the gifted asset is not expected to generate income. Popular examples are gifts of ranches (surface interest) or undivided interests in vacation homes.

7. <u>Qualified Personal Residence Trust "QPRT</u>."
   Clients can gift undivided interests in their homestead to a QPRT, with reversion to donor's estate if donor dies before QPRT term ends. For example, a 65 year old married client might gift an undivided 50% interest in his homestead to a 7 year QPRT, qualifying for a 35% undivided interest discount. The retained right to live in the house would yield an additional discount of over 22%. Therefore, the combined discount would be over 49%. This technique is available for a principal residence plus one additional residence.

8. <u>Irrevocable Life Insurance Trust (ILIT)</u>.
   The client could make a one-time large gift to an ILIT. This could be used either to purchase a single-premium life insurance policy or allow the trustee to invest the gifted proceeds and pay the policy premiums in a more conventional way. A single-premium life insurance policy is categorized as a Modified Endowment Contract (MEC). The only negative consequence of a MEC is the income tax treatment of funds borrowed against the policy. There is no downside to the policy being a MEC if you never borrow against the policy.

9. <u>Gift to Domestic Asset Protection Trust (DAPT)</u>.
   The gift could be made to a self-settled asset protection trust in Alaska or Nevada. (Note that an Alaska or Nevada self-settled trust may not be reached to satisfy the donor's legal obligations, but Delaware has certain spousal "carve outs.")

10. <u>Step-Down Planning</u>.
    If a client is a beneficiary of a nonexempt trust (i.e., a trust that is not exempt from generation-skipping transfer taxes), the trust assets will be subject to tax at the client's death. In order to avoid part of that tax, the trustee should consider making a significant distribution from the trust to the client. The client might gift the distributed assets to a new trust benefitting future generations using the client's gift tax exemption. If the client has sufficient generation-skipping tax exemption, it can be allocated to the trust so that the assets will be protected from estate taxes not only at the client's death, but also at the deaths of future generations. Note that if the client's <u>child</u> is the beneficiary of a non-exempt trust, consider a distribution to the child so that the child can make such a gift.

III. Roth Conversions

Converting a traditional IRA to a Roth IRA has three key benefits:

1. *Converting Locks in Today's Marginal Income Tax Rate*. The highest marginal income tax rates are scheduled to increase in January both because of the

expiration of the Bush tax cuts and because of Obamacare. Also, Obama has targeted the "rich" for income tax increases.

2. *Converting Reduces the Gross Estate for Federal Estate Tax Purposes*. The estate tax is imposed on the Gross Estate, which is not reduced by the income tax on IRD (Income in Respect of a Decedent) items, such as an IRA. The corresponding income tax deduction (a deduction for estate tax paid on the IRA) that the client will receive because of estate tax related to IRD is unsatisfactory. First, it is received over a period of years, as the client recognizes the IRD. Second, the deduction is a miscellaneous itemized deduction that is subject to a 2% annual floor. Therefore, it saves tax to pay the income tax on an IRA before death, eliminating the estate tax on the dollars used to pay the income tax.

3. *Converting Eliminates the Required Minimum Distributions Imposed on Traditional IRAs*. Roth IRAs are not subject to the minimum distribution rules, so the tax-free build up in a Roth IRA continues until the death of the owner.

IV. Gift Planning Considerations

The following items should be considered when making gifts:

1. *Consider Clawback*. Clients should be aware of the possibility of a "clawback." Anecdotal evidence seems to suggest that it may not be an issue, but clients should be informed of the possibility. Because lifetime exemptions are decreasing from $5,120,000 to $1,000,000, there is concern that, upon the client's death, the gifts made in excess of the reduced exemption will generate an attempt to assess extra estate tax through a "clawback." Even if that were to happen, the future appreciation on the gift would escape estate tax, as well as any income earned on the gifted assets. Furthermore, gifts to a DGT would still remove the income tax paid by the grantor from the grantor's estate.

2. *Consider the Loss of the Basis Step Up when Gifting Low Basis Assets*. If client has a $1,000,000 asset with a basis of zero, he would have more tax advantage holding on to asset until death if he knew that asset would grow to be worth $1,500,000 before he died. If he died holding the asset, he would have to pay $175,000 in additional estate tax on the $500,000 growth, but income tax would be zero on a subsequent sale. On the other hand if he gifts the asset, he avoids the step-up and must pay $225,000 ($1,500,000 x 15%) in long-term capital gains, which far exceeds his $175,000 in estate tax savings. Obviously, if the growth is greater, $2,000,000 for example, the estate tax savings exceeds the additional income tax. Also, take into consideration whether the asset is likely to be sold or retained by heirs.

3. *Consider All Ways to Qualify for Discounts*. Undivided interests, non-controlling interests, entities that rely on key persons, entities that are in the middle of lawsuits, and long-term notes bearing low interest may all have discounts

associated with them. If these assets are gifted or sold, the amount of wealth shifted is increased and the risk of wasting exemption is decreased.

4. *Consider Benefits of Trusts over Outright Gifts*. By making gifts to trusts, as opposed to outright, the assets can be protected from a beneficiary's creditors and from a beneficiary's spouse in case of divorce. To the extent of the GST exemption, the assets can also avoid estate tax when children and future generations die. Finally, by structuring as a grantor trust, the gift is "supercharged" by allowing the donor to continue to pay income tax on income generated by gifted assets.

5. *Consider Formula Clauses to Eliminate Audit Risk.* The Wandry case (Wandry v. Commissioner, T.C. Memo 2012-88) is one of a series of recent Federal tax cases that make it clear that formula transfer clauses are going to be respected by the courts. These clauses should always be used to eliminate the possibility of an unexpected gift tax when doing gifts and sales of assets that are difficult to value.