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2013 ESTATE PLANNING UPDATE:
POST-FISCAL CLIFF PLANNING

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The Blum Firm, P.C., established by Marvin Blum over 30-years ago, has law offices in both Fort Worth and Dallas, and specializes in the areas of estate planning and probate, asset protection planning, planning for closely-held businesses, tax planning, tax controversy, and charitable planning. The company has grown to be the largest group of estate planning attorneys in the State of Texas.

Mr. Blum is known for creating customized, cutting-edge estate plans, now serving hundreds of high net worth families, several with a net worth exceeding $1 billion. Mr. Blum was chosen as one of the "Nation's Top 100 Attorneys" by New York's *Worth* magazine, and was also named one of the Top 100 *Super Lawyers* in Texas by *Texas Monthly Magazine*. He is a highly sought-after speaker and lecturer among his peers, having made numerous presentations to legal and tax professionals, and has recently been named to the Editorial Advisory Committee for *Trusts & Estates Magazine*.

Mr. Blum is highly dedicated to his community and currently serves as Secretary/Treasurer and one of three Board members (along with Emmitt and Pat Smith) of the Pat & Emmitt Smith Charities, a public charity devoted to creating opportunities for disadvantaged children. Mr. Blum is in his 34th year as Treasurer of the Fort Worth Symphony, and served as Presiding Chair for numerous terms of The Multicultural Alliance, formerly The National Conference of Christians and Jews, a service organization fighting bias, bigotry and racism. Mr. Blum has recently joined the Texas Cultural Trust Board of Directors to help raise public and legislative awareness of the importance of the arts in Texas.

Mr. Blum, an attorney and Certified Public Accountant, is Board Certified in Estate Planning & Probate Law and is a Fellow of the American College of Trust and Estate Counsel. He earned his BBA (Highest Honors) in Accounting from the University of Texas in 1974, where he graduated first in his class and was named Ernst & Ernst Outstanding Student in Accounting. Mr. Blum received his law degree (High Honors) from the University of Texas School of Law in 1978, where he graduated second in his class and was named the Prentice-Hall Outstanding Student in Taxation. Mr. Blum and his wife, Laurie, reside in Fort Worth, Texas.

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Most estate planners agree that 2012 was the busiest time for planning in the history of their practices. The impending fiscal cliff created a sense of urgency that pushed people to focus on planning that they had been putting on the back burner. With the passage of the American Taxpayer Relief Act of 2012 ("ATRA") on January 1, 2013, which made the $5 million estate tax, gift tax, and GST (generation skipping tax) exemptions (indexed for inflation) permanent, you may wonder whether all of the planning was for nothing. In fact, the planning accomplished in 2012 has been and will be extremely beneficial. We do not believe that anyone will regret the planning that they did.

Those who gifted assets to trusts achieved many benefits, including obtaining asset protection for the assets held in trust and shifting appreciation on the assets held in trust out of the grantor's estate. This planning can often save taxes for generations and laid the groundwork for future planning opportunities. Most of our clients' planning consisted of making large gifts, which is just step 1 in the estate planning process and can be used as a foundation for more advanced planning.

I. What Next?

Now that ATRA has done away with some of the urgency associated with the lowering of the estate tax, gift tax, and GST exemptions (although there are other reasons to engage in planning sooner rather than later, as discussed later in this outline), the focus turns to steps that should be taken in 2013.

1. Review Basic Estate Planning Documents. Many planners (us included) were inundated with planning to take advantage of the $5 million gift tax exemption at the end of 2012. As a result, the focus was completing the projects that had year-end time deadlines and putting aside projects that could wait until 2013, including preparing foundational estate planning documents (i.e., Wills, Living Trusts, and ancillary documents). If a client does not have a set of foundational estate planning documents in place, doing so should be high on the priority list. In addition, existing estate planning documents should be reviewed to be sure that they correspond to the 2012 planning.

2. Determine if Estate Plan Needs to be Revised. In light of ATRA, many people are wondering whether estate plans for clients owning less than $5 million in assets should be simplified to leave all of the assets outright to the surviving spouse. The answer is usually no. We almost always recommend leaving assets

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in trust for the benefit of the surviving spouse. Trusts have many benefits, including the following:

- Appreciation on assets transferred to the bypass trust escape estate tax at the surviving spouse's death.
- Assets left in trust remain protected from the surviving spouse's creditors and from claims of future spouses.
- The spouse who died first can control how his or her portion of the assets are distributed at the surviving spouse's death, insuring that his or her assets ultimately pass to the children when the surviving spouse dies.
- Assets held in trust are more easily managed in the event of the incapacity of the surviving spouse.

3. Determine Whether the Bypass Trust Should be Eliminated. The purpose of the bypass trust is to capture the estate tax exemption of the first spouse to die, while allowing the surviving spouse to maintain access to the assets during his or her life, as a beneficiary of the bypass trust. In addition to making the $5 million exemption permanent, ATRA also made the concept of portability permanent.

   Portability allows the surviving spouse to use any portion of the estate tax exemption not utilized by the spouse who died first. For example, if the spouse who died first leaves all of his or her assets outright to the surviving spouse, using none of his or her exemption, then the surviving spouse will have $10 million of estate tax exemption available at the surviving spouse's death (assuming a $5 million exemption per person).

   In most cases, we do not recommend that our clients rely on portability, and instead we advise them to continue to utilize the bypass trust in their estate plan. One reason is that the surviving spouse's later remarriage could result in a loss of the ported exemption amount since the amount available is based on the unused exemption of the most recent deceased spouse. In addition to the benefits of trusts discussed above, the deceased spouse's remaining GST (generation skipping tax) exemption amount can be allocated to the bypass trust to allow assets to pass to future generations free of tax. This feature is not available with portability.

4. Finalize Appraisals Related to 2012 Gifting. A quality appraisal to support the values used in gift and estate planning is important. The appraisal will serve as the basis to determine the amount of exemption used in a gift transaction or the amount of assets transferred under a formula gift. When the gift tax return is filed, the appraisal should be attached to the return and it should include the necessary detail to begin the running of the 3-year statute of limitations (discussed below).

5. File Gift Tax Returns. A gift tax return should be filed to report gifts made during the year and to disclose certain sales to trusts or family members. The gift tax return (Form 709) for 2012 gifts is due on April 15, 2013, unless extended to

October 15, 2013. If the gift tax return contains the proper disclosures, the IRS will have three years to audit the return or will be barred from later challenging the return or the gifts reported on the return.

It is estimated that over 500,000 gift tax returns will be filed in 2013 reporting gifts made in 2012. This is an increase of more than 200% over the number of gift tax returns estimated to have been filed in 2012 reporting gifts in 2011. The IRS has not increased its workforce to accommodate reviewing the additional returns, so the audit rate will likely be significantly lower than it was last year.

6. Review Life Insurance. Life insurance policies (whether owned outright or in trust) should be reviewed to ensure that they are continuing to perform as expected. This is also a good time to explore whether better products are available.

7. Explore Using the Power of Substitution in DGTs. Many trusts are written so that the creator (also called the grantor) has the power to substitute trust assets with other assets of equivalent value without any income tax consequences. This type of trust is often referred to as a DGT ("defective grantor trust," discussed in more detail below). If the DGT owns assets that do not have good appreciation potential, consider substituting them with assets that have significant appreciation potential or that are subject to discounts (such as closely-held stock or limited partnership interests).

8. Explore Ways to Use the Additional $130,000 of Gift Tax Exemption. The $5 million estate tax, gift tax, and GST exemptions are adjusted for inflation. In 2012, the exemption was $5,120,000 per person, and in 2013, the exemption has risen to $5,250,000 per person. As a result, each individual has an additional $130,000 in exemption available beginning January 1, 2013.

9. Consider "Simple Gifting." Each individual may make an annual exclusion gift to anyone without using any lifetime gift tax exemption. In 2013, the annual exclusion limit rose from $13,000 to $14,000. Utilizing the annual exclusion amount is an easy way to transfer assets out of the taxable estate. Another simple way to make gifts is to forgive intra-family loans.

10. Consider Sophisticated Planning Techniques. There are many techniques available to shift assets to trusts where they will not be subject to estate tax. In the past, some postponed planning in the hope that the estate tax would be repealed, however the estate tax repeal argument seems to have run its course. Since ATRA enacted a permanent $5 million exemption and a 40% tax rate, the appetite for estate tax repeal has virtually disappeared.

II. The "Perfect Storm"

Current conditions set the perfect stage for estate planning:

1. *$5,250,000 Gift Tax Exemption*.

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. The IRS interest rate for February 2013 mid-term loans (3 to 9 years) is only 1.01%.

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. *Grantor Trust Techniques Continue to be Available*. President Obama's Administration 2012 revenue proposals (popularly referred to as the "Greenbook"), which is essentially a "wish list" of fiscal policies that the President and the IRS would like to implement in the upcoming year, included several sweeping proposals which would limit the viability of grantor trusts. These proposals would impact DGTs, 678 Trusts, and other trusts classified as grantor trusts for income tax purposes.

   Under the 2012 Greenbook Proposals, (1) the assets of the grantor trust would be included in the gross estate of the creator for estate tax purposes, (2) distributions from the grantor trust during the life of the creator would be subject to gift tax, and (3) termination of the trust's status as a grantor trust during the creator's life would result in the entire value of the trust being subject to gift tax. For grantor trusts created under Section 678 of the Internal Revenue Code, the beneficiary is deemed the grantor of the trust, and the assets in the trust will be included in the beneficiary's estate upon his or her death. These changes should only apply to trusts created on or after the date that new laws are implemented, so that trusts existing on that date would be grandfathered.

6. *Perpetual Dynasty Trusts*. In States like Delaware and Alaska, it is possible to create a trust that will last in perpetuity, permanently removing the assets from the estate tax system. There have been proposals to limit the terms of trusts to 90 years, but no such legislation has been passed and these types of trusts continue to be available.

7. *More Impending Fiscal Cliffs*. Although the first fiscal cliff was avoided with the passage of ATRA, more fiscal cliffs are in our future. The sequester deadline is at the beginning of March and the debt ceiling deadline is in the middle of May. As these two deadlines approach, it is possible that even more tax reform will be discussed and many techniques that are available today will be legislated away.

With this "Perfect Storm," the goal is to create an estate plan that, given sufficient time, eliminates the estate tax by moving assets outside the estate (to the right side of the "Tax Fence" as illustrated in Exhibit A). Regardless of the size of the estate, it is realistic to reach a point

where the estate tax is zero. When assets on the right side of the "Tax Fence" are sufficient to provide for the children's inheritance, parents are in a position to create the "Optimal Estate Plan" (See Exhibit B). Under the "Optimal Estate Plan," assets that were retained on the left side of the "Tax Fence" pass to a Family Foundation when the parents are deceased, completely eliminating the estate tax.

III. 2013 Checklist: 10 Planning Ideas to Harvest the $5,250,000 Exemption

Each spouse has a $5.25 million exemption available for 2013. Consider these ideas to capture the benefits of the exemption. Note that a married couple can give $10.5 million in 2013 without paying gift tax. Through creative planning, there are ways to substantially <u>leverage</u> the exemption to remove more from the estate. There are even techniques which <u>allow the donor to continue to benefit</u> from the assets (See Exhibit C for an example for using $10 million in exemptions to remove $100 million from the estate, allowing the donor to continue to benefit from the assets).

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>Spousal Lifetime Access Trust (SLAT)</u>.
   The Spousal Lifetime Access Trust is basically a <u>bypass trust</u> or Credit Shelter Trust created by one spouse for the benefit of the other, but it is created inter vivos, while both spouses are alive, instead of waiting until the first spouse dies.

   A. <u>Create One SLAT</u>.
      One spouse creates a Trust for the benefit of the other spouse and makes a $5.25 million 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 SLAT:

      i) Harvests one of the spouses' $5.25 million exemptions, but in a way that allows one spouse to continue to benefit.

      ii) May result in grantor trust status for life. (Note: This is true 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.)

iii) 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" SLATs.

Each spouse creates a Trust for the other spouse, and each makes a gift of $5.25 million to the Trust he or she creates. Creating two Trusts may also allow the spouses to be more comfortable parting with their property. However, there is a "catch" when each spouse creates a Trust for the benefit of the other spouse: the Reciprocal Trust Doctrine. The Reciprocal Trust Doctrine is a judicially-created doctrine that applies to situations where Husband creates a trust for the benefit of Wife, and Wife creates a trust for the benefit of Husband. If a court finds that the trusts are reciprocal, Husband will be treated as the trustor of the trust that Wife created for his benefit; and Wife will be treated as the trustor of the trust Husband created for her benefit. This treatment results in the assets in the SLATs included in their taxable estates.

In order to avoid the Reciprocal Trust Doctrine, the SLATs should not be interrelated, and they should not leave the trustors in approximately the same economic position as they would have been in had they created the trusts for themselves. Thus, the SLATs need to be sufficiently different from one another, and there are several ways to accomplish this:

i) Do not execute the Trust Agreements at the same time. The more time that passes between execution of the Trust Agreements, the better. One Trust should be focused on at a time, and each spouse should acknowledge that they understand that the beneficiary spouse of the first SLAT is not required to set up a SLAT for the other spouse.

ii) Contribute different assets to the SLATs. For example, one trust could hold real estate while the other holds investment accounts.

iii) Contribute different amounts to the SLATs. If the SLATs are still found to be reciprocal, the value that will be included in either spouse's estate cannot exceed the value of the smaller trust.

iv) Appoint independent people as Trustee. Corporate Trustees are most preferable, but at the very least, you should consider not having Husband as Trustee of one SLAT and Wife as Trustee of the other SLAT.

v) Use differing powers of appointment. For example, one spouse may be given an inter vivos power of appointment while the other spouse is only given a testamentary power of appointment or no power of appointment at all. Or one spouse may be allowed to appoint trust property to anyone while the other spouse is only allowed to appoint trust property to charities.

vi) Use differing distribution standards. For example, one trust may allow the Trustee to make discretionary distributions while the other trust has mandatory distribution provisions. Or one trust may require the Trustee to take into account the beneficiary's other sources of income while the other trust does not. Distribution standards may also be different for different beneficiaries.

vii) Grant one spouse withdrawal rights and not the other spouse. The maximum amount a spouse of a grantor can withdraw from the Trust without the Trust assets being includible in the spouse's estate is the lesser of (i) the annual exclusion amount or (ii) the greater of $5,000 or 5% of trust assets. One spouse could be given this withdrawal right while the other spouse has none.

viii) Use differing termination provisions. For example, one trust might continue until the legal limit (approximately 90-100 years) while the other trust might terminate at the spousal beneficiary's death, leaving assets to descendants, subject to lifetime trusts for the children of the husband and wife.

4. Estate Freeze Sale to DGT and/or SLAT.
Client sells assets to DGT or SLAT and carries note at low AFR (applicable federal rate) interest rate. A $5,000,000 seed gift to a DGT or SLAT can support a sale of $25,000,000 to $40,000,000. Freezes the client's estate at current (discounted) value of assets; all post-sale appreciation goes to the Trust.

5. "678 Trust" (also known as a "Dream Trust").
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 sells assets to the 678 Trust and carries note at low AFR interest rate. The note is guaranteed by the DGT or SLAT. A $5,000,000 seed gift to a DGT or SLAT can support a sale of $25,000,000 to $40,000,000 to the 678 Trust.

Benefits of a 678 Trust:

a) Trust benefits the client 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 (often avoiding the need for children to enter into prenuptial agreements).

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.

<u>You no longer should own assets in your name</u>. With the availability of techniques such as this, you can structure your plan so that almost no assets are held in your name (with certain exceptions, such as retirement accounts). Most assets owned by you are subject to estate tax and the claims of creditors. Through thoughtful and advance planning, virtually all of your assets can be transferred to vehicles that are protected from estate tax and from the claims of creditors.

**NOTE: ARGUABLY, THE GREATEST OPPORTUNITY THE $5,250,000 EXEMPTION OFFERS IS TO EXPAND THE SIZE OF ASSETS YOU CAN SELL TO A 678 TRUST, REMOVING SIGNIFICANTLY MORE ASSETS FROM THE ESTATE.

6. <u>Gift of an Undivided Interest in Real Estate or Real Estate Partnership</u>.
Particularly appealing to some clients 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. Gift to Domestic Asset Protection Trust (DAPT).

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. Grantor Retained Annuity Trust (GRAT).

A grantor retained annuity trust ("GRAT") is a trust designed to comply with the requirements of Section 2702 of the Code. Section 2702 provides that for purposes of determining whether or not a transfer in trust for the benefit of one or more members of the grantor's family is a gift, the value of the interest retained by the grantor will be valued at zero unless the interest is a qualified interest. Because it is a statutorily created technique, it has essentially been "blessed" by Congress. The requirements of a GRAT are as follows:

- Payments to the grantor must be made annually. Section 2702(b)(1).
- The payments must be either a fixed amount (annuity) or a fixed percentage of the fair market value of the assets transferred to the GRAT at the date of transfer (unitrust). Treas. Reg. Section 25.2702-3(b)(1)(ii).
- Payments from one year to the next may not increase by more than 20%. Treas. Reg. Section 25.2702-3(e), Example 2.
- The trust agreement must prohibit additional contributions from being made to the trust. Treas. Reg. Section 25.2702-3(b)(4).
- The trust agreement must prohibit commutation of the interest of the grantor, meaning that the GRAT cannot be prematurely terminated and pay the grantor a lump sum payment that represents the net present value of future payments.

Gift Tax Implications. Assuming that the Section 2702 requirements are satisfied, then the annuity or unitrust interest retained by the grantor will be a qualified income interest. The value of the remainder interests will be treated as a taxable gift from the grantor to the remainder beneficiaries of the GRAT. The amount of the taxable gift is affected by the following factors:

- Term of the GRAT. The longer the term of the GRAT, the lower the value of the remainder interest.
- Section 7520 Rate. The higher the Section 7520 rate, the higher the value of the remainder interest. Therefore, lower Section 7520 rates generate lower gift tax costs.
- Annuity or Unitrust Amount. The higher the annuity or unitrust amount paid to the grantor each year, the lower the value of the remainder interest.

Zeroed Out GRAT. The Tax Court decision in *Walton v. Commissioner*, 115 TC 589 (2000), now effectively allows a taxpayer to "zero-out" a GRAT – meaning that the remainder interest would be valued at zero or slightly in excess of zero depending upon the manipulation of the factors discussed above. Obviously, the grantor cannot adjust the Section 7520 rate, so the grantor will have to manipulate the term of the GRAT and the payout amount in order to effectively zero out the GRAT.

Ideal Assets. The ideal assets to be used for a GRAT are those with significant appreciation potential.

- <u>Single Stock</u>. Particularly effective is the creation of a GRAT with a single stock, since a diversified portfolio will likely not have the significant appreciation potential of a single stock. Since a GRAT can be designed to zero out the value of the remainder interest, the grantor will not "waste" lifetime gift tax exemption by allocating to a transfer in which the assets decline in value or fail to grow at a rate in excess of the Section 7520 rate. Thus, a grantor could create a series of zeroed out GRATs that are each funded with a single stock. The GRATs in which the stock appreciates in excess of the Section 7520 rate will have achieved the goal of transferring value from the grantor's estate with little or no transfer tax cost. From a transfer tax perspective, the grantor will not suffer because of the GRATs that have stock that decline in value or fail to grow in excess of the Section 7520 rate. The grantor's only loss will be the professional fees associated with the creation of the GRAT.

- <u>Grant of Option to Acquire Stock</u>. One idea is for the grantor to transfer an option to acquire stock which the grantor owns to a GRAT. The option should be written so that there can be a cash settlement upon exercise of the option. If the underlying stock increases in value, then the trustee of the GRAT will choose to exercise the option.

- <u>Substitution of Low Basis Assets</u>. If a grantor has established a GRAT with low basis assets, the grantor can retain the right in the GRAT to substitute assets of equal value. Thus, a grantor can transfer cash or other high basis assets to a GRAT before the expiration of the term so that the low basis assets might be included in the grantor's taxable estate which will provide for a basis step up at the grantor's death.

Risk of GRAT: Death of Grantor During Term of GRAT. If the Grantor dies during the term of the GRAT, then either the fair market value of the assets in the trust will be included in the Grantor's taxable estate under Section 2036, or possibly the value of the assets in the GRAT necessary to produce sufficient income under Section 2039.

IV. Benefits of Planning During Life

Planning during life, as opposed to waiting until death to transfer assets to future generations, has many benefits.

1. Shift Future Appreciation Out of the Estate. Transferring an asset to a trust that is outside of the client's estate also shifts all of the appreciation on the asset to a vehicle that will be protected from estate tax.

2. Start the Running of the Statute of Limitations. When a gift is made, it should be reported on a gift tax return, which is due April 15 of the year after the gift is made (or October 15 if extended). So long as the proper disclosures are made on the gift tax return, if the IRS fails to challenge the value reported on the gift tax return within three years of its filing, the IRS will be barred from doing so in the future.

3. Lower Incidence of Gift Tax Return Audits. Every estate tax return is reviewed by an IRS agent, whether or not it is ultimately chosen for audit. As the estate tax exemption increases and the number of estate tax returns filed correspondingly dwindles, it is likely that estate tax returns will be subject to even more scrutiny. Conversely, due to the large volume of gift tax returns filed each year, the IRS is unable to physically review each one and, as a result, a much smaller percentage of gift tax returns are audited.

4. Techniques are Available to Reduce the IRS's Incentive to Audit the Gift Tax Return. Many techniques (such as planning with *McCord* and *Wandry* clauses, discussed at the end of this outline) are structured so that, if the IRS is successful in arguing that the value reported on a gift tax return is too low, the increased value will not trigger additional gift taxes. As a result, the IRS has much less incentive to audit these gifts since they will not result in increased revenue for the IRS.

5. Lifetime Gifts are Not Subject to Section 2036 Arguments. One of the IRS's most successful arguments for bringing assets back into a person's taxable estate is that the decedent retained certain rights with respect to the assets, which is prohibited by Section 2036 of the Internal Revenue Code. The Section 2036 argument does not apply to lifetime transfers.

6. Paying Gift Tax is Cheaper than Paying Estate Tax. Assume an individual has $100 million in assets. Based on a 40% tax rate, the estate tax on those assets would be $40 million, and $60 million would pass to the heirs. Because of the way gift taxes are calculated, for the same $100 million, the individual could give almost $71.5 million to his heirs during life and pay only $28.5 million in gift taxes. Engaging in lifetime planning results in almost $11.5 million additional passing to the heirs. In order to achieve these savings, the donor has to live for at least three years after making the gift.

V. Incorporate Charitable Component to Zero Out Estate Tax

As shown in Exhibit B, the Optimal Estate Plan includes charitable components to help avoid the estate tax altogether. Along with creating Family Foundations, some particularly useful charitable planning techniques are discussed later in this outline.

VI. Planning to Avoid Higher Income Tax Rates

The effective income tax rate for virtually everyone is higher than it was last year, and this trend is expected to continue as Congress addresses the nation's fiscal issues. As the amount of income tax paid increases, planning to reduce income tax exposure is going to become more popular. A few techniques are discussed below.

1. IRA Charitable Rollover. The Pension Protection Act added the flexibility (originally through the end of 2007) to donate directly from an IRA to charity, within certain limitations. The American Taxpayer Relief Act of 2012 (ATRA) extended this option until December 31, 2013. Under prior law, there was no provision allowing the tax-free distribution from an IRA where the distribution was donated to a charitable organization.

   A person over age 70 ½ (at the time of charitable gift) may make charitable gifts up to $100,000 per year directly from an IRA without having to report the distributions as taxable income (through the end of 2013). However, no charitable income tax deduction can be claimed.

   Things to Look Out For.

   Applies Only to IRAs. The exclusion applies only to traditional IRAs and Roth IRAs, not other types of retirement plans like SEP IRAs or Simple IRAs.

   Only Applicable Until the End of 2013 (unless further extended).

   Participant Must be Age 70 ½. The individual must be at least age 70 ½ *at the time of the contribution*. (This is different from the rule requiring minimum distributions *in the same year* the individual reaches 70 ½.)

   No Carryover. As mentioned above, only $100,000 of charitable gifts of IRAs per year may qualify for the income exclusion. There is no carryover to future years.

   Public Charities. The charitable organization must be a public charity or a "conduit private foundation." Contributions to donor advised funds, supporting organizations and most private foundations do not qualify.

   Favorable Treatment of Nontaxable Portion. Charitable distributions from IRAs are deemed to come first from the taxable portion. This is

favorable, because distributions from the nontaxable portion (attributable to nondeductible contributions to the IRA) are normally tax-free in any event. §408(d)(8)(D). Under normal rules, distributions are made pursuant to a ratio between taxable and nontaxable portions – this changes that rule for distributions going directly to charity.

Pass Directly to Charity. The distribution must pass directly from the IRA to the charity. §408(d)(8)(B)(i).

No Requirement for Administrators to Participate. The new law permits distributions directly to charities, but does not require administrators to make such distributions. Many current plans do not have specific provisions in them that allow distributions to charities. While the law allows such distributions, it will be up to the administrators whether or not to change their plans accordingly.

<u>Advantages of Tax Free Distributions to Charity</u>.

Satisfies Minimum Distribution Requirements. Charitable gifts from IRAs can also satisfy the annual minimum distribution requirement (in whole or in part). For example, if the minimum required distribution is 4% in a year, that requirement could be satisfied by a 3% contribution to charity and a distribution of 1%. In effect, the individual can make charitable gifts desired by the individual and also reduce the amount of distributions that would otherwise have to be made from the IRA.

If Donor Does Not Itemize. Without the rollover opportunity, when a person takes a distribution from an IRA, he reports it as income. If he uses it to make a charitable contribution, he can deduct the contribution as an itemized deduction. However, if he takes the standard deduction and does not itemize, he gets no tax benefit from the charitable contribution. With the new rollover, the IRA distribution that goes to charity is excluded from income, so no charitable deduction is needed to offset the income.

Social Security Recipients. Social security recipients will be benefitted if excluding the IRA income keeps their income below thresholds that cause social security benefits to be subject to income tax.

No Percentage Limitation. Donors who make such large gifts that they are subject to the 50% charitable deduction limitation are benefitted. It is better for them to have income exclusion than to have a charitable deduction that cannot be fully utilized.

2. <u>Charitable Remainder Trusts</u>. When an individual creates and funds a charitable remainder trust ("CRT"), income from the trust is distributed back to the donor (either a fixed amount (a "CRAT") or a variable amount (a "CRUT")), and at the

death of the donor, the remaining principal passes to the named charity. Alternatively, the CRT can be structured to continue after the donor's death for the benefit of the donor's family members (for either their lives or a fixed period of time), and at the death of the named family members, the remaining principal passes to the named charity.

Tax Advantages of a CRT. When a CRT is established, the grantor receives an income tax deduction for the value of the remainder interest (with special rules applying to property with a basis that is lower than the property's fair market value). If appreciated assets are contributed to a CRT, the CRT can sell them with no tax due at the time of the sale. This provides an excellent opportunity to convert low income-producing assets to cash without a capital gains tax. In many plans, taxpayers use the savings to purchase life insurance (to be owned by an irrevocable trust for the benefit of family members) to "replace" the assets going to charity at the grantor's death.

When CRTs are Beneficial. The best time to create a CRT is when interest rates are high and the donor owns an asset that is highly appreciated. When interest rates are high, it is easier to meet the requirement that the CRT have a charitable remainder with an actuarial value of at least 10% of the value of the property transferred to the CRT. Because a CRT can sell property without income tax consequences (as noted below), a CRT provides the most benefit when a donor contributes property with a high fair market value but with a low income tax basis. Additionally, as tax rates increase, CRTs are even more effective for donors with highly appreciated assets.

Income Tax Consequences. As noted above, the donor receives an up-front charitable contribution deduction equal to the value of the remainder interest when the CRT is created. The CRT is exempt from tax, so it does not pay capital gains tax or income tax as a result of its transactions. When the donor (or other family members) receive annual distributions from the CRT, the distributions may be subject to income tax based on a tiering system. The tiering system carries out trust income to the beneficiaries, with the tax treatment determined by the original character of the income when it was generated inside the trust. For example, if the CRT distributed income to the donor that was generated when the CRT sold stock, the donor would pay tax on the income at long-term capital gain rates.

3. Charitable Lead Trusts. An individual who is predisposed to give a certain amount of assets to a charity each year may be an ideal candidate for the charitable lead trust technique. A charitable lead trust ("CLT") is a trust that makes an annual payout (either a fixed amount (a "CLAT") or a variable amount (a "CLUT")) to a charity for a fixed term of years (such as 10, 15, or 20), and at the end of the term, the trust assets pass to the donor's family (typically to the donor's children). CLTs are one of the most underutilized estate and charitable planning vehicles. Because both asset values and interest rates are at historically low rates, now may be the perfect opportunity to utilize the CLT.

Tax Advantages of a CLT. The CLT removes assets from the donor's estate so that the donor avoids the estate tax on the assets, but when the term ends, the assets pass to the donor's children. With careful planning, a CLT can be structured so there is no estate or gift tax on the portion of the assets passing to the children at the donor' death.

When CLTs are Beneficial. As noted above, the best time to create a CLT is when interest rates and asset prices are low. Currently, interest rates are at historic lows, which serves to reduce the present value of the remainder interest that passes to the children and makes it easier to avoid paying gift tax on this amount. In addition, when asset values are low, the assets have more potential to appreciate, which also increases the amount that later passes to the children.

Income Tax Consequences of a CLT. The income tax consequences of a CLT depend on whether the CLT is structured as a grantor trust or a non-grantor trust. If the CLT is a *grantor trust*, the donor receives an income tax charitable contribution deduction when the CLT is created, but pays income tax each year on the trust's entire taxable income (with no deduction for the amount passing to charity each year). If the CLT is a *non-grantor trust*, the donor receives no up-front income tax deduction, but the CLT gets a deduction each year for the amount passing to charity.

4. <u>Use S Corporations when you own a Business</u>. In 2013 there is only one entity choice that allows you to avoid both self-employment tax <u>and</u> the new 3.8% NII (net investment income) tax. Taxpayers who actively participate (more than 500 hours per year) in their business will not be subject to the 3.8% NII tax but will remain subject to the self-employment <u>unless</u> they operate in S corporate form. S corporation income is not subject to the self-employment tax. If you own a business, in which you actively participate, consider converting that business to an S corporation.

   > For example, if your business earns $1 million and you draw $250,000 as a salary and $750,000 as an S Corp distribution, you will save $28,500 per year by avoiding 3.8% payroll/NII tax on the S Corp distribution.

5. <u>Private Placement Life Insurance</u>. Life insurance products can be used to grow assets income tax free and avoid income taxes when the assets are paid out as part of a death benefit. Under the Internal Revenue Code, the cash value of a life insurance policy can be invested in almost anything, even illiquid assets. Furthermore, several reputable insurance companies offer "private placement" life insurance contracts that will allow such investments. With higher income tax rates, these products are even more appealing than in the past.

VII. Roth Conversions

In addition to forever avoiding the income tax on IRA earnings, converting a traditional IRA to a Roth IRA has three other key benefits:

1. *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.

2. *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.

3. *Converting May Avoid Subjecting Other Income to the NII Tax.* The 3.8% net investment income (NII) tax is imposed on the net investment income of individuals whose total adjusted gross income (AGI) exceeds $200,000 in the case of single taxpayers and $250,000 in the case of married taxpayers filing a joint return. Distributions from a traditional IRA, while not subject to the NII tax, are included when calculating an individual's AGI. The inclusion of such IRA distributions in the calculation of AGI could cause an individual's AGI to exceed the threshold and subject his or her investment income to the NII tax. Distributions from Roth IRAs are not included in the AGI calculation.

VIII. Gift Planning Considerations

The following items should be considered when making gifts:

1. *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 the 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 $200,000 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 loses the step-up and must pay $300,000 ($1,500,000 x 20%) in long-term capital gains, which far exceeds his $200,000 in estate tax savings. Obviously, if the growth is greater, more than $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.

2. *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.

3. *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.

4. *Use Caution with Hard-to-Value Assets.* When clients gift hard-to-value assets, it is possible that the IRS will contest the value of the gift. If the IRS prevails against a client and the value of a gift is determined to be higher than what the client intended, the client will owe additional gift taxes. Clients face an additional consequence in this situation when the client gifts his or her entire gift tax exemption amount to a trust and allocates GST tax exemption to the gift. If the IRS prevails on a value that is higher than the client's GST tax exemption, the client will have a trust that is partially exempt and partially nonexempt because the client has no more GST tax exemption to allocate to the trust. There are several ways of guarding against the risk of revaluation of hard-to-value assets, including:

    A. *Leave a Cushion*. If a client decides to utilize $3 million of his or her gift tax exemption instead of the full $5.25 million, the IRS is less likely to be tempted to audit the gift transaction because the IRS has nothing to gain even if it succeeds in raising the value of the gift to $4 million. Furthermore, if the IRS prevails and the gift is valued at $4 million, this determination will not ruin the status of a trust as wholly exempt from the GST tax.

    B. *Obtain a Qualified Appraisal.* A well-documented appraisal is a necessity when dealing with hard-to-value assets, and it may enable the client to prevail against the IRS in the event of a valuation challenge.

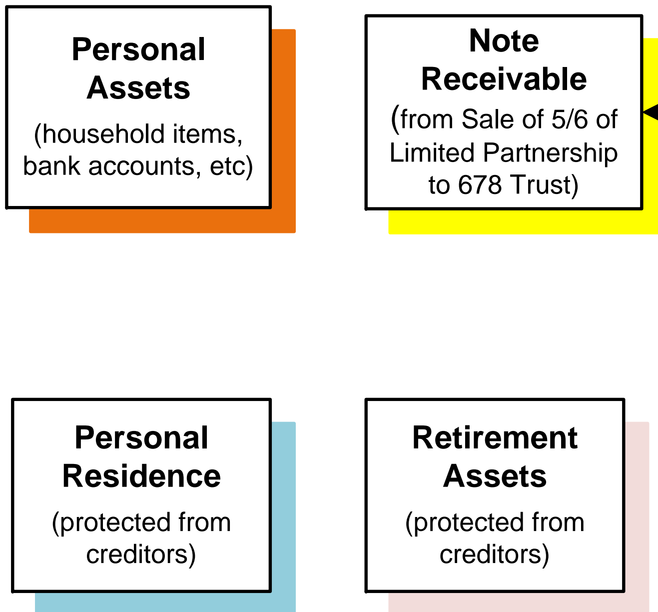
    C. *Report the Gift Adequately on a Gift Tax Return.* If a client fails to adequately report the gift on his or her Form 709, the three-year statute of limitations will not begin to run, and the IRS will be able to contest the value of the gift past the three-year mark.

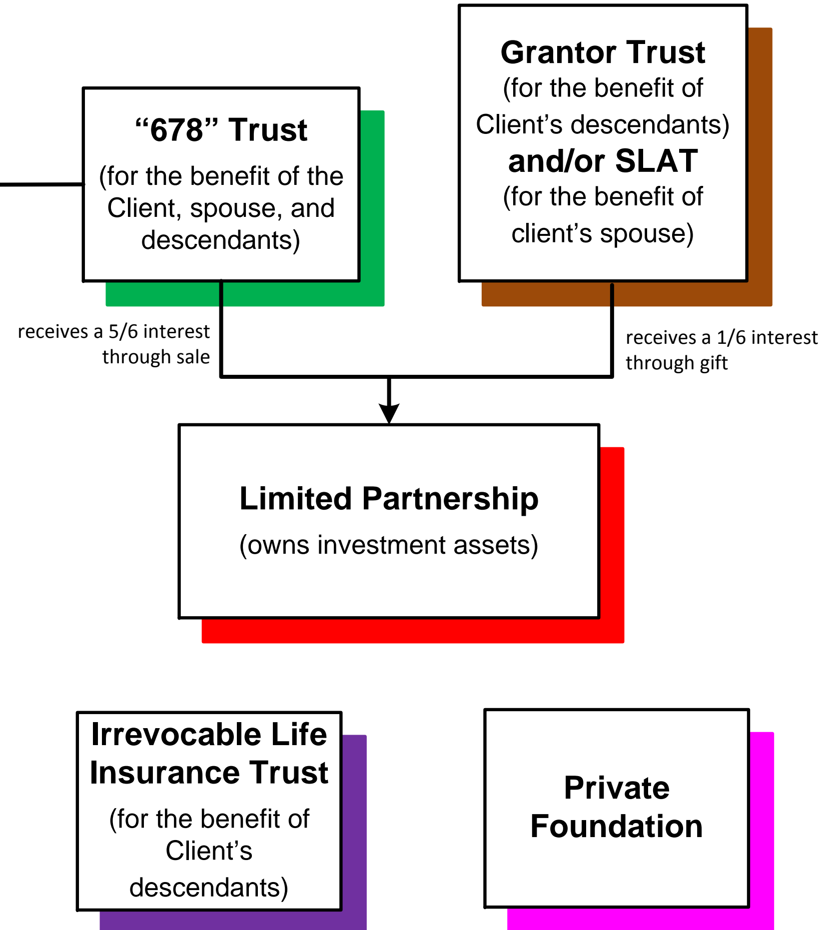
    D. *Use a McCord Defined Value Clause.* A defined value clause states that if the IRS succeeds in raising the value of a gift, the additional value transferred would be treated as a gift to charity. The client would not owe additional gift taxes because this transfer would qualify for the charitable gift tax deduction. Furthermore, such a clause deters the IRS from auditing the value of the gift because it has nothing to gain from the audit.

E. *Use Wandry Adjustment Clauses in Gifting Documents.* The Wandry case (Wandry v. Commissioner, T.C. Memo 2012-88) made it clear that the courts will respect adjustment clauses where the grantor of a gift states that if the value of the gifted assets is ever determined to be more than that assumed by the grantor, the amount of assets will be adjusted downward to reflect the differently determined value. Consider tracking the language approved by the court in Wandry in gifting documents to ensure the adjustment clause will be respected.

EXHIBIT A

"Tax Fence"





*Assets on this side of the tax fence used to pay the income tax generated by assets held outside the estate.

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EXHIBIT B

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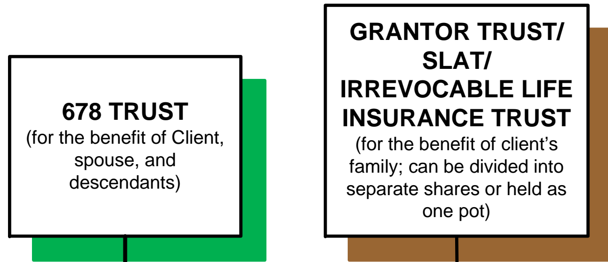
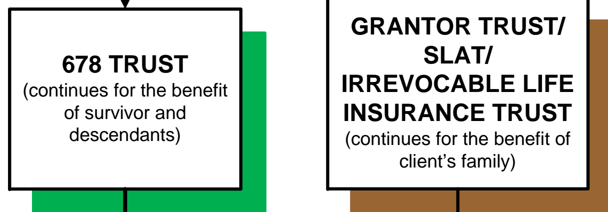
OPTIMAL ESTATE PLAN

DURING JOINT LIVES



AFTER FIRST DEATH



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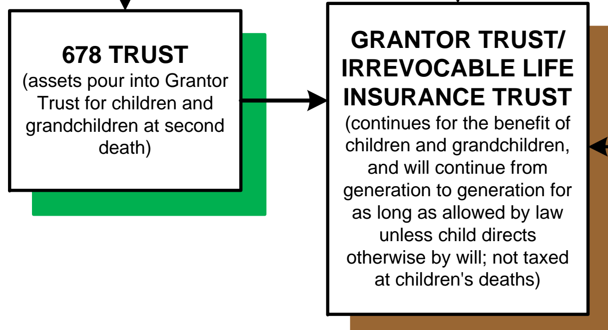

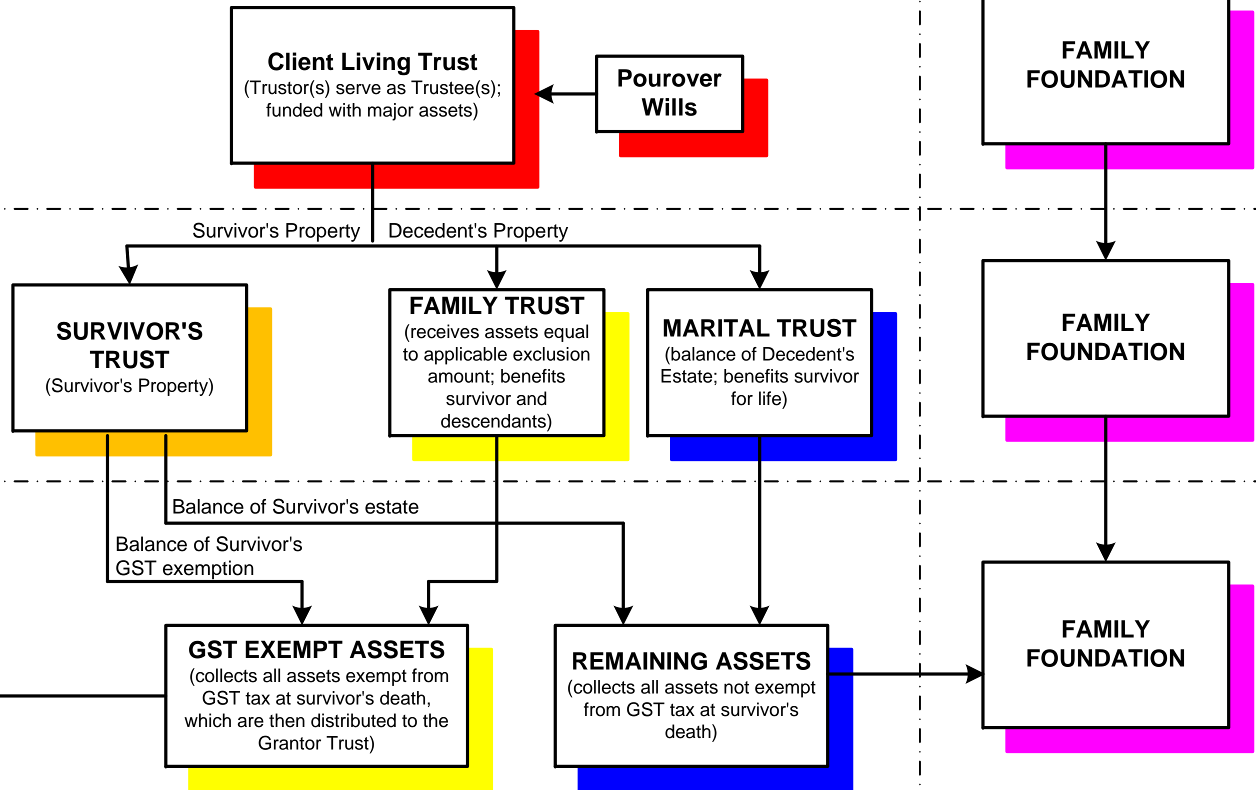

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EXHIBIT C

HOW TO USE $10 MILLION (FROM TWO EXEMPTIONS) TO TRANSFER $100 MILLION OUT OF THE ESTATE

1.	Client starts with $100 million asset (Real Estate, Oil & Gas, Limited Partnership, etc.)	$100 mil
2.	Less 40% Discount	- $40 mil $60 mil
3.	Client makes gift of $10 million to Grantor Trusts for kids	- $10 mil $50 mil
4.	Client sells $50 million to 678 Trust, with Guaranty from Grantor Trust. No income tax on sale to 678 Trust. Income earned by 678 Trust is taxed to client, so 678 Trust grows at accelerated pace (free of income tax). Client carries $50 million note and collects note payments. Client uses note payments to pay living expenses, income taxes, and engage in other planning techniques.*	- $50 mil - 0 -

(*Note: For example, in the future, client could take accumulated unspent note payments and do another sale to 678 Trust.)

With time, the entire $100 million is out of estate, as well as all future appreciation on the $100 million.

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