BLUM
THE BLUM FIRM, P.C.

ATTORNEYS AT LAW
Marvin E. Blum*▪ Gary V. Post* John R. Hunter°▪ Daniel H. McCarthy*°▪
Steven W. Novak* Len Woodard▪ Amanda L. Holliday*▪ Catherine R. Moon*▪
Laurel Stephenson* Laura L. Haley* Amy E. Ott▪ Rachel W. Saltsman
Christine S. Wakeman Kandice R. Killion▪ Kerri G. Nipp Julie A. Plemons
Kent H. McMahan,* Senior Counsel

2012 ESTATE PLANNING UPDATE: PLANNING IN A PERFECT STORM

Fort Worth Chapter
Texas Society of Certified Public Accountants
Tax Institute
August 9, 2012

by Marvin E. Blum

2012 PLANNING CHECKLIST:
PLANNING IN A PERFECT STORM

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 Trusts (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.

6. *Bush Income Tax Cuts Set to Expire*. The Bush-era tax cuts were extended for two additional years in 2010. A further extension is not likely because the Congressional Budget Office has estimated that such an extension would cost $2.84 trillion over 10 years. Therefore, the income tax rates are scheduled to increase in January, making a Roth conversion very attractive in 2012.

With this "Perfect Storm," the goal is to create an estate plan that, given sufficient time, eliminates the estate tax by moving assets outside of the estate (to the right side of the "Tax Fence" as illustrated in the attached Exhibit A). Regardless the size of the estate, it is realistic to reach a point where the estate tax is zero. 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. Thus, a married couple can give $10,240,000 in 2012 without paying gift tax. If dealing with separate property, a married couple can still utilize the full $10,240,000 by electing to split gifts on their gift tax return. Consider these ideas to capture the benefits of the exemption.

1. Outright Gifts to Heirs
2. Gifts to Trusts for the Benefit of Heirs
3. Estate Freeze Sale to DGT*
4. Estate Freeze Sale to "678 Trust"*
5. Gift to Spousal Access Trust
6. Gift of an Undivided Interest in Real Estate or Real Estate Partnership
7. Qualified Personal Residence Trust (QPRT)
8. Irrevocable Life Insurance Trust (ILIT)
9. Gift to Domestic Asset Protection Trust (DAPT)
10. Step-Down Planning

1. <u>Outright Gifts to Heirs</u>

Some clients may wish to utilize the $5.12 million exemption by simply gifting assets outright to their children. Another simple way to make an outright gift is to forgive outstanding loans. However, if parents make outright gifts, they will no longer control the assets, the assets will be subject to their children's creditors, and their estate and GST tax exemptions will not be preserved for future generations. Furthermore, outright gifts of cash fail to take advantage of leveraging and the use of discounts.

Keep in mind that $13,000 (the "annual exclusion amount") may be gifted to any person each year without owing any taxes or utilizing any lifetime gift tax exemption. Further, direct payments to institutions for education and medical care are not considered gifts at all and do not count toward the annual exclusion or the lifetime exemption.

2. <u>Gifts to Trusts for the Benefit of Heirs</u>

A good alternative to making gifts outright to children is to make those gifts to a trust established for the children. There are several advantages to leaving property in a trust for descendants that will last from generation to generation, or a "dynastic" trust. While property remains in trust, it cannot be reached by the descendants' creditors. In addition, property in trust is also segregated from descendants' marital assets, so it is not eligible for division by a family law judge upon a child's divorce. The grantor, a third party, or even the descendants can be the trustee or co-trustee of the trust. Finally,

* These two techniques, when utilized unaccompanied by another technique in the list, will not use any of the lifetime gift tax exemption. They are best taken advantage of in tandem with a gifting technique.

leaving property in trust allows the grantor to preserve his GST tax exemption amount which may prevent applicability of the estate tax or the GST tax at the death of the children. There are two possible types of trusts to gift to:

a. <u>Traditional Trust</u>

A traditional trust, or non-grantor trust, will be responsible for taxes on the income it generates.

b. <u>"Defective" Grantor Trust (DGT)</u>

A grantor can "supercharge" a gift to a trust by making it a "grantor" trust. In a grantor trust structure, the grantor will continue to personally pay the income taxes on the income generated by the trust's assets, which allows the trust to grow without being depleted by income taxes. The grantor's payment of these taxes is not treated as a gift to the trust. Studies have shown that, in many cases, this single aspect of a grantor trust has an even greater impact on the grantor's ability to shift wealth to future generations than discounts. Therefore, as discounts are limited or even eliminated, structuring irrevocable trusts as grantor trusts continues to be an extremely effective way of shifting significant wealth to future generations with minimal gift and estate tax cost.

3. <u>Estate Freeze Sale to DGT</u>

In the sale to a grantor trust technique, the grantor creates a Trust and sells assets to it in exchange for a promissory note. The Trust generally has a longer time over which to pay off the promissory note (typically up to 9 years). This technique freezes the client's estate at the value of the promissory note; all post-sale appreciation is in the trust. The steps involved in creating and implementing a grantor trust are as follows:

1. Grantor creates a GST exempt Grantor Trust for the benefit of the grantor's children and grandchildren as described in technique number 2 above.

2. Grantor makes a seed gift to the Trust as described in 2.b. above (or arranges for guarantees from the children or other trusts), typically in an amount equal to 10% or more of the entire transaction. A $5,000,000 seed gift can support a sale of $25-40,000,000.

3. Assign LP units to the Trust (units of a limited partnership funded with some of the grantor's investments).

4. Trust signs a promissory note payable to the grantor in an amount equal to the value of the assets sold to the Trust. The interest rate on the note would be equal to the mid-term AFR (which is 1.07% for June 2012) for a 9-year note.

5. Obtain an appraisal of the LP units.

6. File a gift tax return reporting the sale to the Trust and allocate GST exemption to the seed gift. This will begin the running of the 3-year statute of limitations within which the IRS must audit the transaction.

7. As the Trust has liquidity, it makes note payments.

Some risks associated with this technique include the risk of IRS challenge and whether the sale will be respected. In order to bolster the sale, it is important to ensure that the trust has adequate creditworthiness to support the sale. The grantor can do this by making a sufficient seed gift to the trust in order to provide equity to support the sale. In addition, the trust beneficiaries or other trusts can serve as guarantors on the note owing back to the grantor and should receive a nominal guarantee fee for doing so (typically 3% of the amount guaranteed).

While the typical structure of the promissory note owing to the grantor is a 9-year term requiring annual payments of interest, if the grantor has a shortened life expectancy, the promissory note could be structured as a self-cancelling installment note ("SCIN"). In addition, the grantor should consider hedging against a revaluation of the LP units by using defined value clauses, which are discussed in more detail later in this outline.

This kind of planning helps prefund the children's inheritance. By setting aside assets for future generations now, the children and grandchildren do not have to wait until their parent or grandparent dies to enjoy the assets. The amount set aside in this way is further compounded through the use of grantor trusts because the grantor pays the income tax liability for the trust out of his or her own assets, as discussed above. As long as the grantor is amenable to paying the trust's income taxes, the trust will get a free ride on the income taxes and can grow without being depleted by them.

If a client has previously made a sale to a DGT, is still carrying the note, and has remaining gift tax exemption that will not be utilized in any other planning, the client may consider forgiving the note (or a portion of it). In addition to utilizing the client's gift tax exemption, this note forgiveness transaction also mitigates an income tax concern that arises when the client dies before the note is fully paid by the DGT.

4. Estate Freeze Sale to "678 Trust"

Typically, when a client is considering options to help reduce estate taxes, the client must consider techniques that require the client to part with at least a portion of the assets he or she has accumulated over the years, as well as part with future appreciation. For example, many estate planning techniques involve gifting and/or selling the client's assets to trusts that benefit the client's children. As a result, the client permanently parts with all of the future appreciation, as well as the income stream from the assets. In these situations, it can be difficult to balance the client's desire to reduce estate taxes with the client's need to retain sufficient assets to maintain his or her standard of living.

One vehicle that allows the client to combine asset protection, estate tax savings associated with "estate freeze" techniques, and the continued ability to benefit from assets he or she has accumulated over the years is the "678 Trust." The 678 Trust is named after the Internal Revenue Code Section upon which it is based, which states that a beneficiary who has a withdrawal right under a Crummey trust will be treated as the owner, for income tax purposes, of the portion of the trust over which the withdrawal power lapsed.

A 678 Trust can be a useful tool under two fact patterns. The first is when the client is contemplating purchasing an asset or starting a new business venture that has high appreciation or income-generating potential. The second is when the client has significant assets that are already material in value, which the client wants to transfer to the 678 Trust. Structuring the transfer of the assets to the 678 Trust in both fact patterns are discussed in more detail below.

a. Structure of a 678 Trust

The 678 Trust is established by the client's parents, sibling, or close friend with a gift of $5,000. **This is the only gift that should ever be made to the Trust**. It is important that the $5,000 contribution to the Trust be a true gift and that the creator of the Trust receive no quid pro quo payments or benefits as a result of making the gift.

The Trust is structured as a "Crummey" Trust, so the beneficiary has a period of time to withdraw the $5,000 gift. If the beneficiary does not demand the gift, his withdrawal right lapses after a certain period of time (e.g., thirty days). In order for the 678 Trust technique to work as intended, it is crucial that the beneficiary not be given a withdrawal right exercisable with regard to any other trust at any earlier point in the year of the gift.

The client is the primary beneficiary of the 678 Trust and can receive distributions for health, education, maintenance, and support purposes. The client can also be named as the trustee. The Trust is structured initially as a "non-grantor" or "complex" trust for income tax purposes. Therefore, at inception, the 678 Trust is a separate taxpayer for income tax purposes. However, the 678 Trust also includes a "Crummey" withdrawal right for the client. When the client allows the withdrawal right over the initial $5,000 contribution to lapse, the 678 Trust becomes a grantor trust as to the client (under the authority of Section 678 of the Code). Thus, all income tax effects of the 678 Trust from that point forward should become the responsibility of the client.

While he is treated as the owner of the Trust for income tax purposes, the client will be responsible for paying the income tax on the income generated by the Trust's assets. Assets outside of the Trust can be used to pay the income taxes, allowing the Trust assets to grow without being depleted by income taxes. This also allows the client to "spend down" assets that would otherwise be includable in his or her estate and subject to estate taxes at death. If the time came that the client were unable to pay the income taxes out of his or her own assets, the 678 Trust could make a distribution to the client in the amount of the income taxes under the health, education, maintenance, and support standard.

b. <u>Benefits of the 678 Trust</u>

As discussed above, the assets owned by the 678 Trust will not be subject to estate taxes at the client's death. While the client is living, he or she will continue to have access to the funds for health, education, maintenance, and support purposes and can serve as trustee of the 678 Trust.

In addition, the assets owned by the 678 Trust will not be subject to the claims of the client's creditors. Texas law provides that a Trust that contains "spendthrift" language that is created by a third party will not be subject to the creditors of the Trust beneficiary. This is true even if the Trust is structured as a Crummey Trust and the beneficiary is given a right of withdrawal over the Trust assets. Section 112.035 of the Texas Trust Code specifically states that a Trust beneficiary is not treated as a settlor of a Trust merely because of a lapse of withdrawal rights, provided that the withdrawal right does not exceed the greater of the amount specified in Section 2041(b)(2) or 2514(e) of the Code or Section 2503(b) of the Code (the 5 and 5 rule). As a result, the lapse of a withdrawal right will not cause the Trust assets to be subject to the reach of the beneficiary's creditors. This very clear legislation makes Texas particularly well suited for 678 Trust planning.

Section 112.035 of the Texas Trust Code also provides that a Trust beneficiary is not treated as a settlor of a Trust merely because the beneficiary has the power to consume or distribute Trust property to or for the benefit of himself or herself as long as the power is limited by an ascertainable standard (such as health, education, maintenance, and support). Therefore, a beneficiary's creditors will not be able to reach the Trust's assets if the beneficiary is also named as the trustee, so long as the trustee-beneficiary's distribution standard is limited to health, education, maintenance, and support.

The 678 Trust technique helps reduce estate taxes, provides creditor protection, and gives the client the ability to continue to benefit from the assets during his or her life. When compared to other estate planning techniques, such as GRATs, the 678 Trust is superior because, among other things, (i) the client does not have to survive the transaction with the 678 Trust by any period of time in order for the assets to be outside of the client's estate, and (ii) the estate tax inclusion period rules do not apply, so that GST exemption can be allocated to the Trust on its creation. The 678 Trust can be structured and customized to fit many different situations.

To see how to leverage $10 million (from two exemptions) to transfer $100 million out of the estate using a 678 Trust, see attached Exhibit B.

c. Building Value in the 678 Trust

The 678 Trust can be utilized by almost any type of client. The most obvious use of a 678 Trust is for clients who are expecting to purchase an asset that has high appreciation potential, are starting a business, or are expanding an existing business (but as discussed below, it can also be used for existing assets with appreciation potential or that are subject to valuation discounts). Some examples include buying a new business opportunity, engaging in additional drilling operations, or investing in restaurant franchises.

In those cases, the client can make a loan to the 678 Trust to enable it to buy the asset, start the new business, or expand the existing business. In order for the loan to be respected by the IRS, it must carry an interest rate equal to, at a minimum, the applicable federal rate for the type and length of the loan. As the asset or business grows in value, the loan can be repaid. The asset will continue to be owned by the 678 Trust, where it will not be subject to estate tax at the client's death. Once the 678 Trust has built up significant assets, it can simply purchase new assets using its own credit.

The 678 Trust can also be useful for clients who have existing assets that have appreciation potential or that are valued at a discount. Furthermore, with many corporations accumulating significant cash, some predict a surge in merger and acquisition activity. A closely-held business owner who might be presented with an opportunity to sell the business at some point in the future would be an ideal candidate to sell his or her ownership interest to the 678 Trust prior to such a liquidity event (the earlier, the better).

In these cases, it would be desirable for the client to sell the asset to the 678 Trust in exchange for a promissory note. For the reasons discussed below, it is important that the sale be structured so that it will be respected by the IRS as a bona fide sale under Section 2036 of the Code. The 678 Trust needs to have sufficient substance to support the sale, which can be problematic if the Trust is new and has not yet built up significant value.

To remedy this situation, the 678 Trust can have other trusts or individuals (other than the client) guarantee the note owing to the client. The assets pledged should equal at least 10% to 20% of the size of the note (the higher, the better). If no other trusts or individuals are available to guarantee the note, the client can create a separate trust for his or her children and make a gift to it. With a $5 million lifetime exemption, the client can make a gift of up to $5 million (or $10 million if the client is married) and pay no gift tax. The new trust can then provide a guarantee to the 678 Trust in exchange for a guarantee fee. To supercharge the new trust, it can be structured as a grantor trust with respect to the client for income tax purposes and as a GST exempt dynasty trust.

It is important when the client transacts with the 678 Trust that the transaction be structured at fair market value, and that **no gifts be made to the 678 Trust beyond the initial $5,000 gift contributed by a third party**. Any additional gifts could alter the income tax and estate tax characteristics of the 678 Trust. Furthermore, if the client is treated as having made a gift to the 678 Trust, then the Trust's assets will be subject to estate taxes when the client dies.

In order to guard against the client being treated as having made a gift to the 678 Trust when he or she loans money to the Trust, the interest rate on the loan should be at least equal to the applicable federal rate in effect at the time the loan is made. When assets are sold to the Trust, the sales price must be equal to the fair market value of the asset.

Sale documents can also include adjustment clauses, where the 678 Trust and the client agree that, if the fair market value of the asset sold to the Trust is ever determined to be different than that agreed upon by the Trust and the client, the sales price will be adjusted to reflect the differently determined fair market value. This adjustment clause could help avoid the argument that the client made a gift to the 678 Trust if the sales price were determined to be lower than the asset's fair market value.

In addition, it is advisable to have the asset sold to the 678 Trust professionally appraised. The appraiser should be advised that the value sought should be on the mid-range of the scale of reasonableness. If the appraisal is too aggressive, and results in a value lower than that reasonably determined by the IRS, it is possible that the client will be treated as having made a gift to the Trust equal to the difference between the appraised value and the IRS-determined value. As a result, the appraisal should not be overly aggressive.

The 678 Trust can also allow the client to exercise a special power of appointment ("SPOA") over the Trust assets during life or at death. An inter-vivos SPOA can give the client-beneficiary the power to provide for Trust property to pass to individuals or charitable organizations during the client's life. As a result, if the client is treated as having made a gift to the 678 Trust, the gift will be incomplete from a gift tax perspective and no gift tax will be due at that time. [Note that although the gift will be incomplete for gift tax purposes, the gift will still cause all of the Trust assets to be included in the client's estate at death because the client will have made a gift to a trust of which he or she is a beneficiary. As a result, the tax will not be avoided by virtue of the gift being treated as incomplete; it will merely be postponed until the client's death.]

A testamentary SPOA can give the client-beneficiary the power to control how the property will be distributed at his or her death and also can give the client-beneficiary flexibility to modify the terms of the Trust on his or her death to account for changed circumstances. The SPOA can be so broad as to allow the client to exercise it in favor of anyone (including other individuals, trusts, and charitable organizations) other than the client, the client's estate, the client's creditors, or the creditors of the client's estate.

d. **Results of 678 Trust Planning**

The 678 Trust should be structured as a GST exempt dynasty trust. When the initial gift is made to the 678 Trust, the client's parents (or other third party who makes the gift) should allocate GST exemption to the Trust, which will allow it to pass to future generations free of transfer taxes. As a result, the assets owned by the Trust should not be subject to estate tax at the death of the client or the client's children. In addition, the 678 Trust should contain a spendthrift provision, in which case the Trust assets should be protected from the client's creditors. Furthermore, assets in the 678 Trust do not constitute marital property, protecting the assets if a beneficiary of the Trust gets a divorce.

With regard to assets sold to the 678 Trust, the value of the assets owned by the client is frozen at the value of the note the client received in the sale (see the left side of the Tax Fence attached as Exhibit A). The client can spend down these assets by paying the income tax liability generated by the Trust's assets and allow the assets owned by the 678 Trust to grow without being depleted by income taxes.

The Trustee of the 678 Trust has the ability to distribute Trust assets to the client and his or her issue for health, education, maintenance, and support needs, and the client may be given a limited inter-vivos or testamentary power of appointment over the assets of the 678 Trust to account for changes in family circumstances or the law. Upon the client's death, the 678 Trust can be drafted to divide into separate trusts for his or her children, and those trusts will be considered "complex" trusts (rather than "grantor" trusts) for income tax purposes.

e. **Reporting Requirements**

The creator of the 678 Trust should file a gift tax return reporting the $5,000 gift to the Trust and allocating GST exemption to the gift. The gift tax return will be due on April 15 of the year following the year in which the $5,000 gift is made.

When the client transacts with the 678 Trust, he or she should file a gift tax return disclosing the sale or loan in order to start the running of the 3-year statute of limitations. Assuming that the disclosure is adequate, if the IRS does not audit the gift tax return within the 3-year period, it will be prohibited from challenging the transaction later. The gift tax return will be due on April 15 of the year following the year in which the transaction takes place.

f. **Examples**

<u>Example #1</u>: The example below illustrates how the 678 Trust would be structured when the Trust will be investing in a new business, expanding an existing business, or purchasing a new asset from a third party.

<u>Step 1</u>: Client decides to buy a new business, and the purchase price is $100,000.

Step 2: Parents of client ("Mom and Dad") create a non-grantor trust (the "Trust") for the benefit of the client ("Son") and his descendants. Mom and Dad initially fund the Trust with $5,000, and the Trust provides that Son has a Crummey withdrawal right over contributions to the Trust.

Step 3: Son receives notice of withdrawal right and allows the withdrawal right to lapse.

Step 4: Trust creates a limited liability company ("LLC") to purchase the new business. Trust is the sole member of the LLC. [Note: If expanding an existing business (such as acquiring more product lines or franchises, additional oil and gas drilling, etc.), the new activity will be owned by the new LLC rather than the existing business.]

Step 5: Trust borrows $100,000 from a bank or a third party. Son, Son's existing business, or another trust guarantees the Trust's debt to the bank/third party for a small fee. Alternatively, the Trust can borrow $100,000 from Son directly, with interest on the loan charged at the applicable federal rate.

Step 6: Trust contributes $100,000 to LLC. LLC purchases new business opportunity for $100,000.

Step 7: Mom and Dad file Form 709 Gift Tax Return, reporting a $5,000 gift to the 678 Trust and allocating $5,000 of GST exemption to the 678 Trust, making the Trust fully exempt from GST tax.

Step 8: Son manages and grows new business. All of the income from the Trust assets is taxed to Son. If necessary, Son (or his descendants) may receive distributions of Trust income or principal.

Step 9: The 678 Trust continues to own and operate business, and has sufficient capital to acquire new business opportunities or other assets. Son and his children can benefit from Trust income or principal. The assets are protected from creditors. At Son's death, if Trust assets are worth $5 million, then Son has saved approximately $2.5 million in estate tax.

Example #2: The example below illustrates how a 678 Trust transaction would be structured when the 678 Trust plans to purchase an existing business or other asset from the client. This use of the 678 Trust may be a fit for more clients' situations.

Step 1: Client owns a package of investment assets that have high appreciation potential. The package of investment assets is currently worth approximately $15 million.

Step 2: Client contributes the investment assets to a limited partnership (the "LP"). Assuming a 35% valuation discount, the LP interests would be worth approximately $10 million.

Step 3: Client creates a grantor trust for the benefit of Client's children (the "Grantor Trust") and makes a gift of up to $5 million worth of LP interests to it. If Client is married, Client's spouse can also make a gift of up to $5 million worth of LP interests to the Grantor Trust. For a transaction this size, a gift of $2 million should suffice. (Note: This step is not necessary if Client has already created trusts for his children that have substantial value.)

Step 4: Parents of Client ("Mom and Dad") create a non-grantor trust (the "678 Trust") for the benefit of Client and his descendants. Mom and Dad initially fund the Trust with $5,000, and the Trust provides that Client has a Crummey withdrawal right over contributions to the Trust.

Step 5: Client receives notice of withdrawal right and allows the withdrawal right to lapse.

Step 6: 678 Trust purchases Client's LP interests in exchange for a promissory note. The note is structured as a 9-year note, with interest at the mid-term applicable federal rate. New Grantor Trust (or previously existing trust, if such exists) guarantees at least 10% to 20% of the note amount in exchange for a small fee. [The size of the guaranty dictates the amount of LP interests the Client can sell, as the guaranty should be at least 10% to 20% of the note amount (the higher, the better).]

Step 7: An appraisal of the LP interests is obtained for the purpose of determining the exact percentage transferred to the Grantor Trust and determining the principal amount of the promissory note owing by the 678 Trust.

Step 8: Mom and Dad file Form 709 Gift Tax Return, reporting a $5,000 gift to Trust and allocating $5,000 of GST exemption to the Trust, making the Trust fully exempt from GST tax.

Step 9: Client files a Form 709 Gift Tax Return, reporting the $2 million gift to the Grantor Trust and disclosing the sale to the 678 Trust. A copy of the appraisal should be attached to the Return.

Step 10: All of the income from the Grantor Trust assets and the 678 Trust assets should be taxed to Client. If necessary, Client (or his descendants) may receive distributions of income or principal from the 678 Trust. Client's descendants may also receive distributions of income or principal from the Grantor Trust. The assets owned by the 678 Trust and the Grantor Trust are protected from creditors.

Step 11: Trust continues to own the LP, which owns and manages the investment assets. Over time, the investment assets appreciate. At Client's death, if Trust assets are worth $25 million and the estate tax rate is 55%, then Client has saved approximately $8.25 million in estate tax. [Calculated as follows: (i) $25 million less $10 million (the $2 million gifted, which used up lifetime gift tax exemption, plus the $8 million sold, in exchange for which Client received a promissory note that was repaid over time), multiplied by (ii) 55% tax rate.] Note that the estate tax savings calculation ignores the benefit received from Client paying the Trust's income out of his non-Trust assets from the "taxable" (left) side of the Tax Fence (attached as Exhibit A).

g. <u>Discussion of Statutory Authority</u>

Although the beneficiary may be deemed to be the grantor of the trust for income tax purposes, he is not considered the grantor for estate and gift tax purposes. Under Section 2041 and Section 2514 of the Code, a lapse of a withdrawal right is not deemed to be a gift to the Trust from the beneficiary so long as the lapse does not exceed the greater of $5,000 or 5% of the Trust assets (the "5 and 5 power"). As a result, allowing the withdrawal right to lapse will not cause the assets of the 678 Trust to be subject to estate taxes at the client's death. (Note that an affirmative <u>release</u> of a withdrawal right may have the opposite effect. If a holder of a withdrawal right releases the right, he or she could be treated as having made a gift to the Trust, causing the Trust assets to be subject to estate taxes at the holder's death. Therefore, in order to clearly qualify for the statutory "5 and 5" exception, the plan is for the beneficiary to allow the withdrawal right to <u>lapse</u>, rather than <u>release</u> it.)

Under Section 678(a)(1), a person who "has a power exercisable solely by himself to vest the corpus or the income" of the Trust in himself will be treated as the owner of the portion of the Trust over which the power is held. A withdrawal right gives the beneficiary the right to vest the corpus or the income of the Trust in himself and, as a result, is a power that will cause the Trust to be owned by the beneficiary for income tax purposes under Section 678(a)(1) so long as the power remains outstanding. If the withdrawal right applies to all of the assets owned by the 678 Trust (as in the case of the initial $5,000 gift), then the entire Trust will be treated as owned by the beneficiary for income tax purposes. Once the withdrawal right lapses, however, the income tax treatment of the Trust is not as clear.

Under Section 678(a)(2), a person who "has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof" will be treated as the owner of the portion of the Trust over which the power was partially released or modified. The question, therefore, is whether the client would be treated as the owner of the Trust under Sections 671 to 677 of the Code if he had been the initial grantor of the Trust.

Under Section 677, the grantor of a trust will be treated as the owner of the trust for income tax purposes if the income of the trust may be distributed to the grantor or held and accumulated for future distribution to the grantor. The client is the beneficiary of the 678 Trust, and as such, income and principal may be distributed to him.

Accordingly, if the client releases or otherwise modifies his withdrawal right, then he will be treated as the owner of the Trust for income tax purposes. Based on the plain language of the statute, it appears that this would apply to the entire Trust (both the income and the principal) since the withdrawal right exists over the $5,000 gift, which would comprise the entire Trust at the time the right was granted.

Note that Section 678(a)(2) refers to a "partial release" (as opposed to a "lapse") of a withdrawal right as the triggering event. Although this terminology does not mirror that contained in Sections 2041 and 2514, the IRS has issued a recent private letter ruling interpreting a lapse under Sections 2041 and 2514 to be a partial release under Section 678. PLR 200949012. In addition, the IRS has implied in prior private letter rulings that a lapse under Sections 2041 and 2514 would have the same effect of a partial release under Section 678. *See, e.g.*, PLRs 200747002, 200104005, 200147044, 200022035, 9809005, 8342088.

If the IRS changes its policy expressed in the private letter rulings and argues that a **lapse** is not treated as a **release** under Section 678, it is possible that the client will not be treated as the owner of the Trust for income tax purposes after the withdrawal right lapses. To help mitigate that result, we propose including additional provisions in the 678 Trust.

First, the withdrawal right granted over the initial $5,000 gift to the Trust could extend until at least December 31 of the year in which the gift is made (i.e., the withdrawal right does not lapse until after December 31). Any sales to the 678 Trust should occur before the withdrawal right lapses. During the time that the withdrawal right remains outstanding, the client should clearly be treated as the owner of the Trust for income tax purposes and should be able to transact tax-free with the Trust.

Second, in December of each year, the client could be given a withdrawal right over all of the Trust income earned during that year, to the extent that the income does not exceed the greater of $5,000 or 5% of the Trust assets. (Note that, if the client dies while the withdrawal right is outstanding, the amount of assets over which the withdrawal right exists will be included in the client's taxable estate.) To the extent that the income is less than or equal to this amount, the client should be treated as the owner of the Trust income for income tax purposes. It is not clear whether this withdrawal right would cause the client to be treated as the owner of the Trust's principal for income tax purposes.

If the client is not treated as the owner of the Trust's principal, then the Trust may be required to pay any capital gains taxes out of its own assets. As a result, the tax amount would deplete the assets that will be protected from estate taxes, as opposed to the client's assets, which will be subject to estate taxes. In addition, if the client is not treated as the owner of the Trust's principal, capital gains taxes could be triggered when the Trust makes principal payments on the note owing to the client.

The client and the Trust should also consider entering into an agreement that, if the client pays income taxes and it is later determined that the taxes should have been paid by the Trust, the client will be treated as having loaned the amount paid to the Trust with interest at the applicable federal rate. This should help prevent the client being treated as having made a gift to the Trust by virtue of paying income taxes on the Trust's behalf.

In any case, the client should, at a minimum, be able to sell assets to the 678 Trust while the withdrawal right is outstanding without being required to recognize gain on the sale. In addition, if the client sells assets to the 678 Trust in exchange for a promissory note or loans money to the 678 Trust, the client should not be required to recognize the interest payments as income. This characteristic may also cause the 678 Trust to be a permissible owner of S corporation stock, without requiring the Trust to elect to become a qualified subchapter S trust ("QSST") or an electing small business trust ("ESBT"). The IRS has issued a recent private letter ruling stating that a 678 Trust is a permitted S corporation shareholder under Code Section 1361(c)(2)(A)(i). PLR 201039010. However, it may be advisable to make a protective QSST or ESBT election in the event that the IRS argues that 678(a)(2) does not apply to the Trust assets.

h. <u>Too Good to be True?</u>

Some have expressed concern that the 678 Trust technique is "too good to be true." However, it is important to note that, while it can be a particularly effective technique in the right situation, the technique has real economic substance, as it may not always achieve the goal of reducing a client's taxable estate. When assets are sold to a new 678 Trust in exchange for a promissory note, another person or entity must guarantee a portion of the note. In many cases, the guarantor of the note will be an irrevocable trust created by the client and funded with a gift that uses some or all of the client's lifetime gift tax exemption.

If the asset sold to the 678 Trust decreases in value and the Trust is unable to repay the note to the client, the guarantee must be called. In that event, the irrevocable trust must satisfy the guarantee using the assets it received as a gift from the client. As a result, it is possible to do "negative estate planning" if the irrevocable trust is required to use assets it received as a gift to repay the note owing by the 678 Trust to the client. Note that the negative planning would be particularly painful if, as is typical, GST exemption has previously been allocated to the irrevocable trust. As a result, there is a risk of loss associated with this technique, which must be carefully considered when structuring a 678 Trust.

5. <u>Gift to Spousal Access Trust</u>

a. <u>Create One Spousal Access Trust</u>

Husband and Wife enter into a marital property agreement, partitioning some of their community property into Husband's separate property. Husband creates a Trust for the benefit of Wife and transfers $5,120,000 of his separate property to the Trust, utilizing his lifetime gift exemption. The Trust is similar to a "Bypass Trust" normally created at first spouse's death but is created while both spouses are living. Wife has access to the Trust assets during her life, and the assets can stay in trust for the benefit of the children and later generations, free of estate and GST taxes. Husband will be the Grantor of this Trust and thus responsible for paying the Trust's income taxes. If desired, the Trust may give Wife a "special power of appointment" to direct how assets pass at death.

Key Facts About Spousal Access Trusts:

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

b) 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.)

c) 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.

d) 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.

To mitigate aspect "d)" above, consider drafting the trust so that it qualifies as a QTIP trust. If by April 2013, the exemption is still $5.12 million or there are other circumstances making this utilization of a spouse's gift tax exemption imprudent, the client can elect to make the trust a QTIP trust instead, preserving the client's gift tax exemption.

b. <u>Create Two "Mutual" Spousal Access Trusts</u>

Each spouse may create a trust for the other so that both spouses utilize their exemptions and each spouse can benefit from the Trust created for his/her benefit. 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 Spousal Trusts included in their taxable estates.

In order to avoid the Reciprocal Trust Doctrine, the Spousal Trusts 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 Spousal Trusts need to be sufficiently different from one another, and there are several ways to accomplish this:

1. <u>Do not execute the Trust Agreements at the same time</u>. 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 Spousal Trust is not required to set up a Spousal Trust for the other spouse.

2. <u>Contribute different assets to the Spousal Trusts</u>. For example, one trust could hold real estate while the other holds investment accounts.

3. <u>Contribute different amounts to the Spousal Trusts</u>. If the Spousal Trusts are still found to be reciprocal, the value that will be included in either spouse's estate cannot exceed the value of the smallest trust.

4. <u>Appoint independent people as Trustee</u>. Corporate Trustees are most preferable, but at the very least, you should consider not having Husband as Trustee of one Spousal Trust and Wife as Trustee of the other Spousal Trust.

5. <u>Use differing powers of appointment</u>. 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.

6. <u>Use differing distribution standards</u>. 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.

7. <u>Grant one spouse withdrawal rights and not the other spouse</u>. 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.

8. 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.

6. Gift of an Undivided Interest in Real Estate or Real Estate Partnership

Gifts of undivided interests in real estate may be particularly useful when a client wishes to utilize his or her lifetime gift tax exemption but cannot afford to part with liquid or income-producing assets. Popular examples of non-residential property to gift are ranches (surface interest) or undivided interests in vacation homes. For example, Client owns a $480,000 vacation home. She deeds an undivided 1/16 in the property to her son and daughter (each acquires an undivided 1/32 interest). The value of each gift is $15,000 minus a 20% discount, which is $12,000 and covered by the annual exclusion. When Client dies and the vacation home is still worth $480,000, her 15/16 interest is reduced by a 20% fractional interest discount ($450,000 minus 20% equals $360,000). That single deed of an undivided 1/16 interest removed $120,000 from Client's estate.

Furthermore, if the client gifts an undivided interest in a primary residence, the client may still be able to live in the residence without paying rent and without the entire residence being includible in the client's estate. In *Estate of Margot Stewart v. Commissioner*, the Donor transferred a 49% interest in her residence to her son claiming a 42.5% discount for lack of control and marketability. Co-tenants are each entitled to nonexclusive possession rights, and they both continued to live in the residence. The Second Circuit court provided that if there is both "continued exclusive possession by the donor and the withholding of possession from the donee," § 2036(a)(1) will cause the entire residence to be includible in the donor's estate. The court suggested that this would not be the case if there is continued occupancy by both owners. Therefore, clients may be able to gift undivided interests in primary residences at a discount and exclude the gifted portion from their estate.

If a client has a partnership that owns both income-producing real estate and non-income-producing real estate and it is easier for the client to part with the asset that does not produce income, consider having the general partner of the partnership create a new subsidiary limited partnership. Move the non-income-producing assets into the new partnership and transfer new partnership units to the original partners. The client is the owner of both partnerships and can then make gifts of the new partnership interests. The client continues to benefit from the income-producing assets in the original partnership in the form of distributions. Furthermore, the general partner of the new limited partnership can be a non-equity partner, enabling the general partner to create the limited partnership with ease and without having to contribute anything for startup. As always, consider the income tax consequences before making any partnership distributions.

7. Qualified Personal Residence Trust (QPRT)

The qualified personal residence trust (QPRT) is a tax-advantaged technique recognized by the IRS that allows a client to transfer either a principal residence or a vacation home to the client's children (or to a trust for them). As a result of transferring a residence to a QPRT, it will be protected from the client's creditors because the client will no longer own it. However, the client will still be able to enjoy the residence, as described below.

The first step of the technique is to transfer (by gift) the residence to the QPRT. For valuation purposes, the law allows the residence to be transferred at a reduced value to take into account the time value of money until the beneficiaries actually receive the house, which will be after the "term." Typically, the term is between 7 and 15 years, with the current value of the gift to the QPRT being lower with a longer term. 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%.

During the term, the client is able to use and enjoy the residence as well as pay the expenses and taxes. At the end of the QPRT term, the residence would pass to a trust for the benefit of the client's children. The client may be the trustee of the trust, ensuring the retention of control. If the client wishes to continue to use the residence after the QPRT term, the client must pay rent. However, the payment of rent has some significant advantages. First, the client would be paying rent to a trust for the client's children, reducing the size of the client's estate by the amount of the rent payments while benefitting the client's children. Second, the payment of rent to the trust is not considered a gift, so the client would be transferring assets to the trust gift-tax free. Finally, the trust can be structured as a grantor trust, meaning that the client would be responsible for the income tax of the trust, allowing the trust to grow without the burden of income tax.

As an economic example, if a client transferred a house worth about $3 million today to a QPRT with a 15 year term, the client would make a gift of approximately $1,956,600 (which could be tax free because of the gift tax exemption). Assuming a 2% growth rate in the property, in 15 years when it is transferred to a trust for children it would be worth approximately $4,037,605. There would be no gift tax at that time on the residence transfer and none at death, saving approximately $728,352 in estate tax, using today's rates. If estate tax rates are increased to 55% as they are currently scheduled to do so in 2013, estate tax savings could be closer to $1,144,553. In addition, the client would transfer any rental payments out of the client's estate without use of further gift tax exemption.

If the QPRT were to sell the residence prior to the end of the QPRT's term, the proceeds from the sale of the residence would be converted into a Grantor Retained Annuity Trust (GRAT). Like the DGT described above, the GRAT is another example of an "estate freeze" technique. If the QPRT were converted to a GRAT, the GRAT would pay an annuity to the client in lieu of usage of the residence. The value of the annuity would be determined using the value of the interest in the residence and an annuity factor determined by the mandated federal rate at the time the residence is transferred. If the assets in the GRAT appreciate at a rate higher than the mandated federal rate, then all of the excess assets would pass to a trust for children at the end of the term without further gift tax or use of additional gift tax exemption. Like the DGT, GRATs work very well with assets that are expected to rise significantly in value or those that produce a large amount of income. If the GRAT under-performs, the client will have only lost the cost of establishing the GRAT, as the annuity payments back to the client would return the assets contributed.

8. Irrevocable Life Insurance Trust (ILIT)

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.

Until the client's death, the trust would only hold an insurance policy, and then it would hold the proceeds upon the client's death. The client's spouse will have access to the money, and there will be no estate or income tax due on the proceeds. Upon the death of the client's spouse, the money can be used to pay the estate tax liability or provide estate liquidity. If an estate is not liquid enough at death to cover estate tax liability, the executor could sell estate assets to the ILIT in exchange for some or all of the insurance proceeds, providing the estate with cash to pay the IRS while preserving illiquid family assets in the ILIT. As long as the assets or proceeds remain in trust, they will be protected from children's creditors and divorcing spouses. An ILIT can save approximately $350,000 in estate tax for every $1 million of face value of insurance (assuming 2012 estate tax rates)(or approximately $550,000 assuming 2013 estate tax rates) by removing the policy from the client's estate.

9. Gift to Domestic Asset Protection Trust (DAPT)

A gift could be made to a self-settled asset protection trust. A self-settled trust is a trust in which the client transfers money into trust and receives distributions from the trust, all while the assets are protected from personal creditors. Very few states recognize self-settled trusts. However, some states do, including Delaware, Alaska, and Nevada (among a few others). (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." Therefore, some commentators suggest that clients not create a DAPT in Delaware if the goal is to remove assets from the settlor's estate, as the Delaware "carveouts" may cause assets to be used to satisfy the settlor's legal obligations, exposing the assets to tax in the settlor's estate.)

10. Step-Down Planning

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 child is the beneficiary of a non-exempt trust, consider a distribution to the child so that the child can make such a gift.

It may be difficult for the trustee to make a distribution to the client depending upon the distribution terms in the trust agreement. For example, if the trustee is limited to making distributions for the beneficiary's health, education, maintenance, and support needs, a trustee may not feel able to justify distributing a large sum of money for the beneficiary's "needs" when the beneficiary is going to turn around and gift it to children. However, there are a few ways around narrow distribution standards, including:

- *Judicial Action Pursuant to Texas Trust Code § 112.054*. Section 112.054 of the Texas Trust Code was amended in 2005 to allow the judicial modification or termination of a trust if such action is appropriate to achieve the settlor's tax objectives and/or to take advantage of circumstances not anticipated by the settlor (e.g., our current gift tax and generation-skipping transfer tax exemption levels). Thus, upon the filing of a petition, a judge may: (a) allow the trustee of a trust to make partial distributions to beneficiaries in excess of the distribution standards in the trust agreement; or (b) terminate the trust to enable the beneficiaries to achieve the settlor's tax objectives through the utilization of current tax exemptions.
- *Distributions Pursuant to Special Trustee Provisions*. Many trust agreements provide for the appointment of Special Trustees for flexibility to take advantage of planning opportunities such as those discussed above. If the trust agreement provides for a Special Trustee, the Special Trustee may be able to make large distributions from the trust to enable the beneficiaries to achieve tax objectives.
- *Release and Indemnify the Trustee*. Prepare a tax comparison for the Trustee demonstrating the amount of taxes the family as a unit will save if the Trustee enables the family to utilize in this planning technique. Convince the Trustee that he or she has the authority to make such distributions for the ultimate benefit of the entire family under the maintenance or support prong of the distribution

provisions. This may require an agreement whereby all beneficiaries agree to release and indemnify the Trustee for these actions.

III. Roth Conversions

Another important planning opportunity that needs to be utilized in 2012 (although it does not involve the use of the lifetime gift tax exemption as the techniques described above do) is the conversion of a traditional IRA into a Roth IRA. Before 2010, clients who made over $100,000 a year were not eligible to convert a traditional IRA into a Roth IRA. Congress repealed that income limitation, enabling many more clients to take advantage of a Roth conversion. 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. Clients can convert their traditional IRAs into Roth IRAs and pay taxes based on their income tax rate for 2012. Once the assets are in a Roth IRA, the growth will not be subject to tax.

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*. Once an owner of a Traditional IRA reaches age 70½, required minimum distributions must be taken from the account and are taxed at the higher tax rate. 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.

Clients can reverse a Roth conversion as late as October 15 of the following year. If a client does a Roth conversion in 2012 and the account incurs a substantial drop in value, the client may undo the Roth conversion as late as October 15, 2013.

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. If a client is still concerned about the possibility of a "clawback," consider shifting the risk to an insurance company by purchasing a life insurance policy to cover the extra estate tax liability. Once the question of whether there will be a "clawback" is resolved, the client can decide whether to keep the policy at that time.

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 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 $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. *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 $5.12 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.

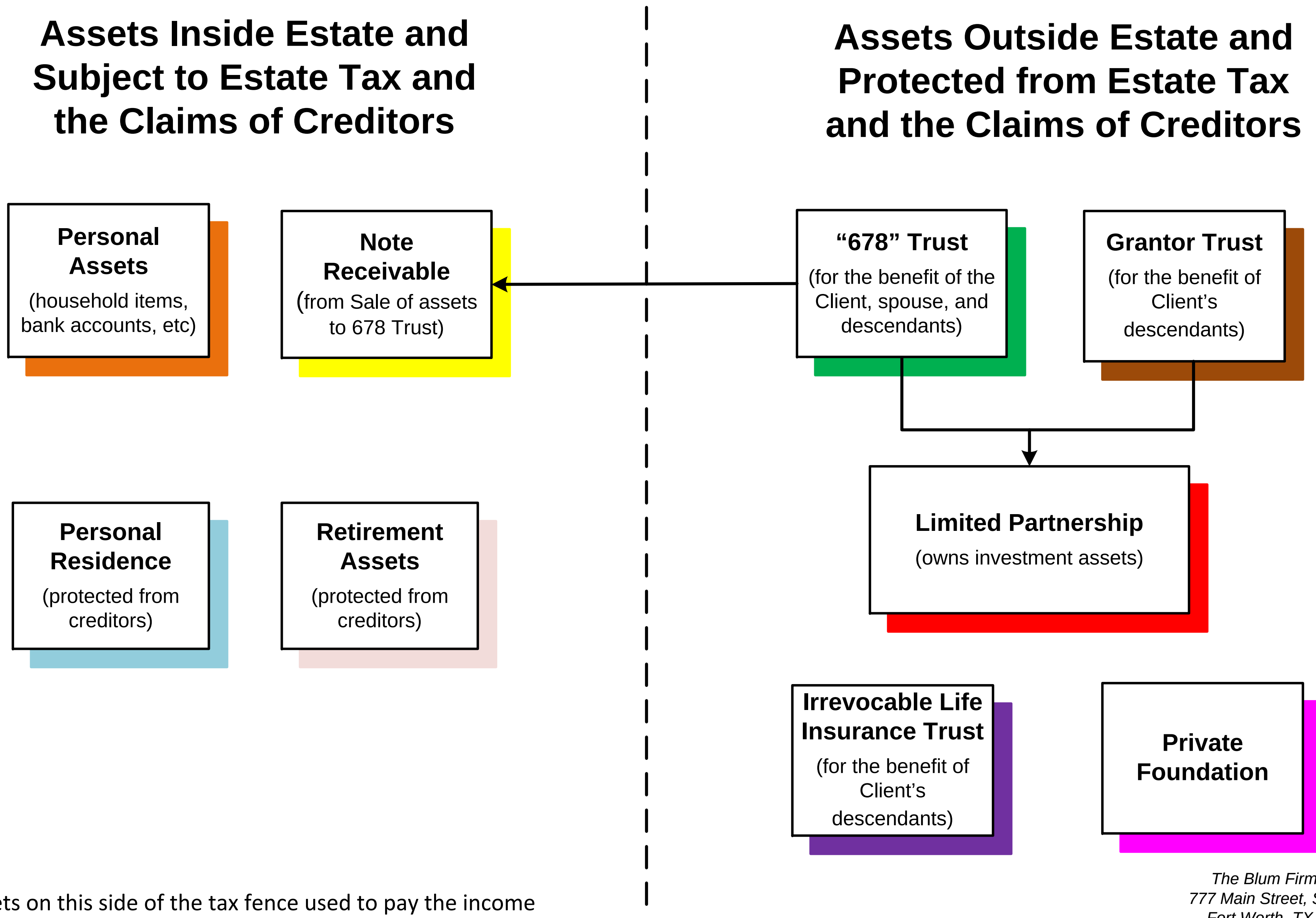
c. *Report the Gift Adequately on a Gift Tax Return*. If a client fails to adequately report the gift on his or her 709, the three-year statute of limitations will not begin to run, and the IRS will be able to contest the value of the gift past the three-year mark.

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.

The Blum Firm, P.C.
777 Main Street, Suite 700
Fort Worth, TX 76102
(817) 334-0066
Our Dallas Office:
300 Crescent Court, Suite 1350
Dallas, Texas 75201

Exhibit B

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	<u>- $40 mil</u> $60 mil
3.	Client makes gift of $10 million to Grantor Trusts for kids	<u>- $10 mil</u> $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.*	<u>- $50 mil</u> - 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.