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# The 2010 Tax Act's Impact on Estate Planning

## Making Sense out of the Confusion

**November 11, 2011**

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# Your Presenters

- **Michael R. Savage, JD, CFP, Senior Vice President, US Trust**
  - Michael is a Senior Vice President and Wealth Strategist for U.S. Trust. Prior to joining U.S. Trust, Michael served as a Senior Manager at Ernst & Young, LLP for ten years. Michael's primary specialties are financial, tax, and estate planning for executives and high net worth individuals, and has extensive experience in investment planning, education planning, equity compensation and charitable giving.

- **John B. O'Grady, JD, Partner, McGuire Woods**
  - John's practice concentrates on estate and gift taxation, generation-skipping transfer taxes, estate planning, estate administration, and chancery litigation. He is a Fellow of The American College of Trust and Estate Counsel, a member of the Legislative Committee for the Trusts and Estates Section of the Virginia Bar Association, and past chair of the Virginia State Bar Trusts and Estates Section.
  - He has served as an adjunct professor at the Marshall-Wythe School of Law at the College of William and Mary where he taught estate planning and wealth transfers. He has also taught estate planning, and estate and gift taxation at Virginia Commonwealth University.

# Agenda

- Introduction
- Overview of 2001 and 2010 Tax Acts
- The 2010 Tax Act - Provisions and planning
- What it means:  Estate Tax Return Metrics
- Planning under the TRA
- Questions

# EGTRRA

- The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") provided for significant transfer tax reductions that were in effect for nearly a decade.
  - By 2009, the maximum estate and gift tax rates had fallen to 45%, the estate exemption had risen to $3.5 million, and the gift exemption remained at $1 million.
  - For 2010, EGTRRA repealed the estate and generation-skipping transfer ("GST") taxes, although the gift tax remained with a 35% maximum rate. In place of the estate tax, there were modified carryover basis rules.
  - For 2011 and after, EGTRRA contained a "sunset" provision which would have eliminated all of the tax changes, effectively reinstating the transfer tax laws that existed in 2001 ($1 million estate exemption, 55% tax rate)

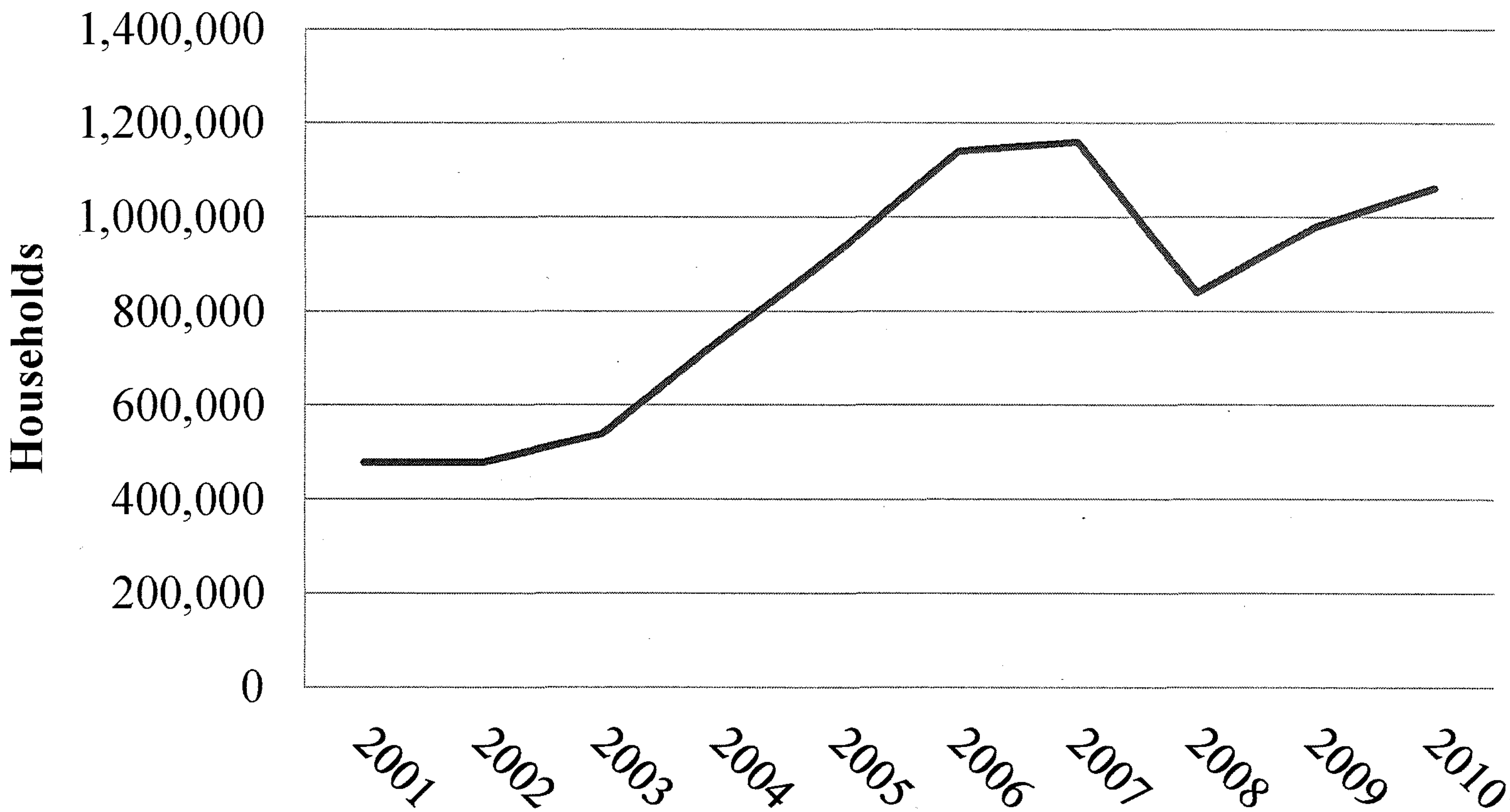
# TRA

- The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("TRA"), signed into law on December 17, 2010, again provides for significant, although temporary, changes to the transfer tax laws.
  - For 2010, TRA retroactively eliminated the repeal of the estate and GST taxes, and provided for a $5 million exemption and 35% top rate. However:
    - An election was allowed to have estate tax repeal and modified carryover basis apply, and
    - The GST tax rate was zero. TRA did not change the gift tax, which remained with an exemption of $1 million and top rate of 35%
  - For 2011 and 2012, TRA provides for the estate, gift and GST taxes with a $5 million exemption (adjusted for inflation in 2012) and 35% top rate.
  - The TRA, similar to EGTRRA, contains a sunset provision which would undo all of the tax changes on December 31, 2012, reinstating the transfer tax laws that existed in 2001 (a 55% top rate and an exemption of $1 million. The GST exemption, indexed for inflation, would be approximately $1.4 million).

# Summary – Estate Tax Chart

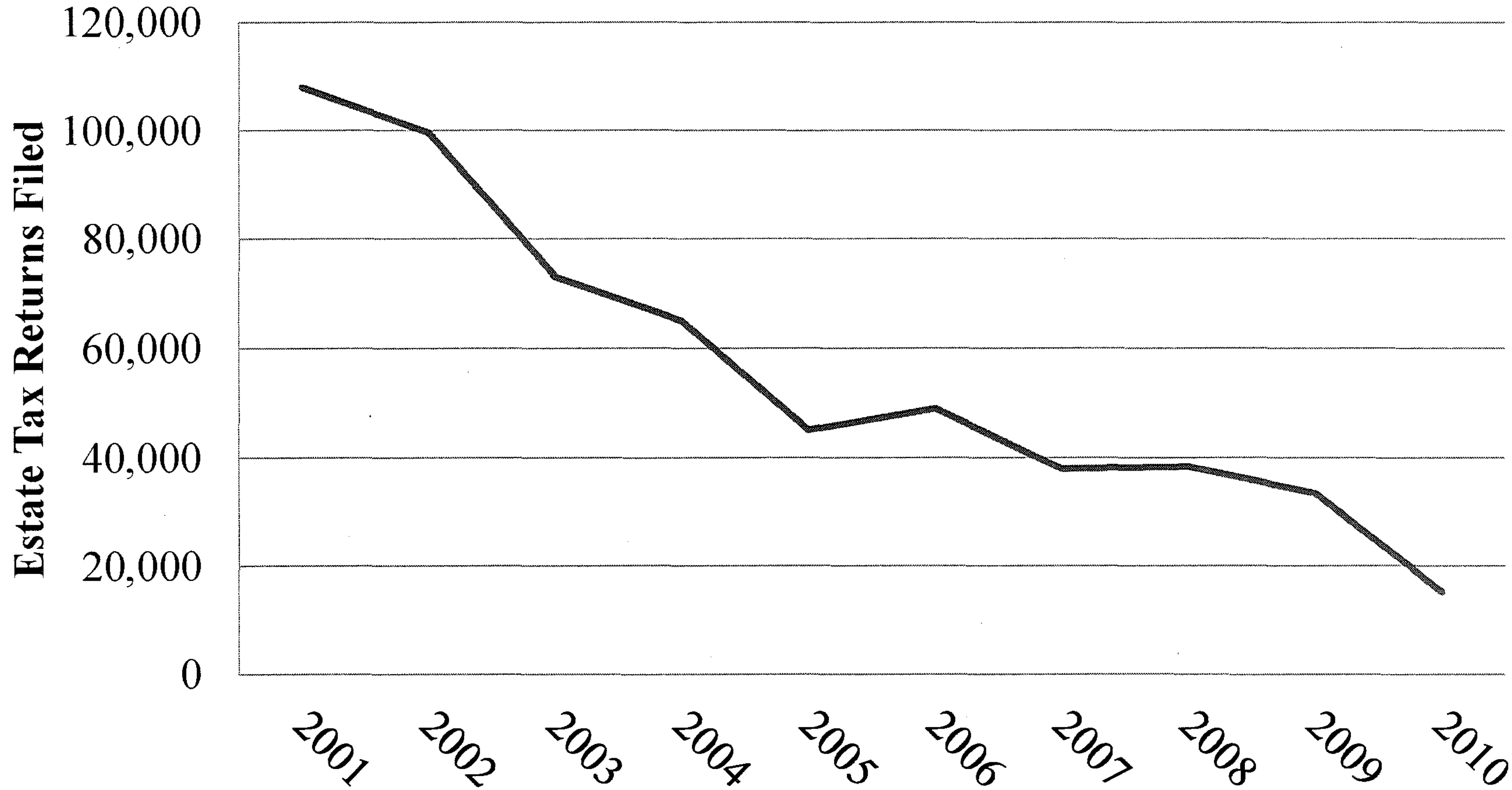
| | 2010 | 2011 | 2012 | 2013 and after |
|---|---|---|---|---|
| Top rate | 35% (or can elect no tax) | 35% | 35% | 55% |
| Exemption | $5 million | $5 million | $5 million (adjusted for inflation) | $1 million |
| Portability | No | Yes | Yes | No |
| Step-up in basis | Yes (unless election for no tax, then modified carryover basis ) | Yes | Yes | Yes |

# Number of Households with $5MM + Investible Assets




Source: *Spectrem Group, Affluent Market Insights 2011*

# Estate Tax Returns Filed




Source: IRS

# Portability – Implications and Planning Opportunities

- TRA provides that the unused exemption of a deceased spouse may be transferred to a surviving spouse. This is commonly referred to as portability.
  - An election by the executor of the deceased spouse must be made on the estate tax return.
    - Planning: For small estates, this may necessitate the filing of a return which would otherwise not be required
  - The estate tax applicable exclusion is:
    - The basic exclusion amount ($5 million) plus
    - the deceased spousal unused exclusion amount (DSUEA).
  - Example 1 from the Joint Committee on Taxation's Technical Explanations:
    - Assume that Husband 1 dies in 2011, having made taxable transfers of $3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's DSUEA. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million DSUEA from Husband 1), which she may use for lifetime gifts or for transfers at death.

# Portability – Special Provisions

- The DSUEA will be available to a surviving spouse only if the personal representative of the predeceased spouse's estate makes an election on the predeceased spouse's estate tax return.
- The IRS may examine the return of a predeceased spouse at any time for purposes of determining the DSUEA available for a surviving spouse.
- Only the most recent deceased spouse's unused exclusion may be used by the surviving spouse
- Portability applies only in 2011 and 2012 for:
  - Gifts made after 2010 and before 2013
  - Estates of decedents dying after 2010 and before 2013 (when the exclusion is portable)

- **IMPORTANT:** Portability does **<u>not</u>** apply for the GST tax exemption

# Watch the Gap: Planning for Federal and State Exemptions

- Currently, there are 22 states and the District of Columbia that impose an estate tax
- Most of these states impose tax ("decoupled, pick-up tax") by using a pre-EGTRRA date to reference the Internal Revenue Code, so they are not affected by the repeal of section 2011.
  - In such states, the taxable estate is the "adjusted taxable estate" in §2011, which is the federal taxable estate minus $60,000. The tax rates are those contained in §2011, which start at 0.80% and goes up to 16%.
  - The variable is how the unified credit, which in effect functions as the state exemption, is computed. In most of these states, the federal exemption of $5 million is greater than the state exemption.
    - $5,000,000: Delaware, North Carolina
    - $3,500,000: Hawaii
    - $2,750,000: Vermont
    - $1,000,000: District of Columbia, Maine, Maryland, Massachusetts, Minnesota, New York, Oregon
    - $859,350: Rhode Island
    - $675,000: New Jersey
  - Other states impose a separate estate or inheritance tax: Connecticut ($3,500,000), Illinois ($2,000,000), Indiana, Iowa, Kentucky, Nebraska, Ohio ($338,333), Pennsylvania, Tennessee, Washington ($2,000,000)

# Gift Tax

- **2010**
  - TRA does not change the gift tax, which remains with an exemption of $1 million and top rate of 35%.

- **2011 and 2012**
  - The gift tax exemption and rates are the same as the estate tax. Accordingly, the exemption is **$5 million** and the top rate is **35%**.
    - In 2012, the exemption is further adjusted for inflation.
    - The gift exemption is also increased for any unused estate exemption of a deceased spouse (**portability**)

- **2013 and after**
  - TRA, similar to EGTRRA, contains a **sunset** provision which would undo all of the tax changes, effectively reinstating the transfer tax laws that existed in 2001. With regard to gift taxes, this would mean a return to a 55% (or 60% in limited instances) top rate, and an exemption of $1 million.

# Gift Tax Chart

| | 2010 | 2011 | 2012 | 2013 and after |
|---|---|---|---|---|
| Top rate | **35%** | **35%** | **35%** | **55%** |
| Exemption | **$1 million** | **$5 million** | **$5 million (adjusted for inflation)** | **$1 million** |

# Gift Exemption: Adjustment for Prior Gifts

- **Adjustment of the gift exemption**
  - TRA modifies/corrects gift tax §2505, regarding the adjustment of the gift credit on account of prior gifts. The modification is made to take account of the fact that different tax rates may have been in effect at the time of prior gifts. The modification adjusts the credit previously used by applying the tax rates currently in effect. In effect, the $5 million gift exemption (adjusted for inflation in 2012) is reduced by any gift exemption previously used.

- **This may be illustrated by the following examples:**
  - If no prior gifts have been made, $5 million may be gifted in 2011 or 2012 free of gift tax.
  - If prior gifts of less than $1 million have been made (using part of the gift exemption), an additional amount of $5 million less the prior gifts may be gifted in 2011 or 2012 free of gift tax.
  - If prior gifts of $1 million have been made (using all of the gift exemption), an additional $4 million may be gifted in 2011 or 2012 free of gift tax.
  - If prior gifts of more than $1 million have been made (using the gift exemption and paying gift tax on the balance), an additional $4 million may be gifted in 2011 or 2012 free of gift tax.

- **Planning:** Depending on the amount of any prior gifts, at least $4 million and up to $5 million may be gifted in 2011 or 2012 free of gift tax.

# Gift Tax: Potential Pitfall: Recapture/Clawback?

- The effect of a lifetime gift of the $5 million exemption is somewhat uncertain due to the possible application of recapture.

- Some practitioners are concerned that if a donor uses the increased exemption of $5M during 2011 and 2012, and, in 2013, that exemption is reduced back to $1M, then, upon the death of the donor, there could be a potential clawback of the gifts made in excess of that reduced exemption when determining the estate tax owned by the donor's estate.

  - There is nothing in the current law to suggest that the government would take this approach

# GST Tax

- **2010**
  - TRA eliminates the 2010 GST tax repeal of EGTRRA, thereby **retroactively reinstating the GST tax.**
  - The GST **exemption** is **$5 million**, and the The **"applicable rate"** is **zero.**
    - Although an argument can be made that since the applicable rate is zero, the inclusion ratio is also zero, that does not appear to be the intended result.

- **2011 and 2012**
  - The GST **exemption** is the same as the estate exemption, **$5 million**, and the GST tax **rate** is the maximum estate tax rate, **35%.**
    - In 2012, the exemption is further adjusted for inflation since 2010.
    - *Planning*
      - *The increased GST exemption will allow for the creation of transfers and trusts which are GST exempt.*
        - *GST exemption may be allocated to new trusts, or to existing trusts.*
        - *Once GST exemption has been allocated to a trust, it appears the trust should retain its inclusion ratio, even if the GST exemption is subsequently decreased due to a change in the law.*
      - *Formula bequests in testamentary documents will need to be carefully reviewed. A typical GST formula will result in $5 million being transferred to the GST trust. In modest sized estates, this may leave the children with much less than was originally intended.*
- **2013**
  - TRA, similar to EGTRRA, contains a **sunset** provision which would undo all of the tax changes, effectively reinstating the transfer tax laws that existed in 2001. With regard to GST taxes, this would mean a return to a **55% rate**. The GST exemption, which is indexed for inflation, should be **approximately $1.4 million.**

# GST Tax Chart

| | 2010 | 2011 | 2012 | 2013 and after |
|---|---|---|---|---|
| Rate | **0%** | **35%** | **35%** | **55%** |
| Exemption | **$5 million** | **$5 million** | **$5 million (adjusted for inflation)** | **Approximately $1.4 million (adjusted for inflation)** |

# Estate – the Road Ahead

- We know that:
  - Since 2001, the filing threshold has gradually increased from $675,000 for 2001 deaths to $3.5 million for 2009 deaths
  - The estate tax was repealed (with affirmative election by the executor) for 2010 deaths
  - It was revived with a $5 million filing threshold for 2011 and 2012 (adjusted for inflation for 2012)
  - The threshold is scheduled to return to $1M in 2013
  - There will be more pressure to do something than to do nothing

- We all don't know what 2013 will bring:
  - President seeks the return of a $3.5 million estate tax exemption
  - Ryan Tax Reform: House Budget repeals the estate tax (under an opt in/out income tax provision)
  - Already legislation has been introduced to fully repeal the estate tax

- Future of trusts and estates legal and accounting professions?

# Planning under the TRA

- Clients should consider using their $5 million exemption to make non-taxable lifetime gifts
- For example, if a client makes a $5 million gift his year, and dies in 25 years, the value of the gifted interest will be:
  - Over $54 million, assuming 10% growth
  - Over $34 million, assuming 8% growth
  - Over $13 million, assuming 4% growth

- How do we best take advantage of this unique opportunity?
- Because of the combination of depressed asset values, low interest rates, and high gift tax exemptions, there are certain techniques that may enable clients to pass considerable wealth to the next generation at very low transfer tax costs. These include:
  - Intra-Family Loans
  - Grantor Retained Annuity Trust
  - Sales to Intentionally Defect Grantor Trust
  - Family Limited Partnership
  - Charitable Lead Trusts

# Intra-Family Loans

- An intra-family loan is a basic estate planning technique with low transaction costs
- Loans may be made to family members at lower rates than those charged by commercial lenders without the difference in rates beeing deemed a gift
- Although the lender must charge interest on the loan to avoid making a gift, these interest rates are currently at an all time low

# Applicable Federal Rates – October 2011

| | Annual | Semiannual | Quarterly | Monthly |
|---|---|---|---|---|
| Short Term (3 years or less) | **.16%** | **.16%** | **.16%** | **.16%** |
| Mid Term (3 to 9 years) | **1.19%** | **1.19%** | **1.19%** | **1.19%** |
| Long Term (more than 9 years) | **2.95%** | **2.93%** | **2.92%** | **2.91%** |
| Section 7520 Rate | **1.4%** | | | |

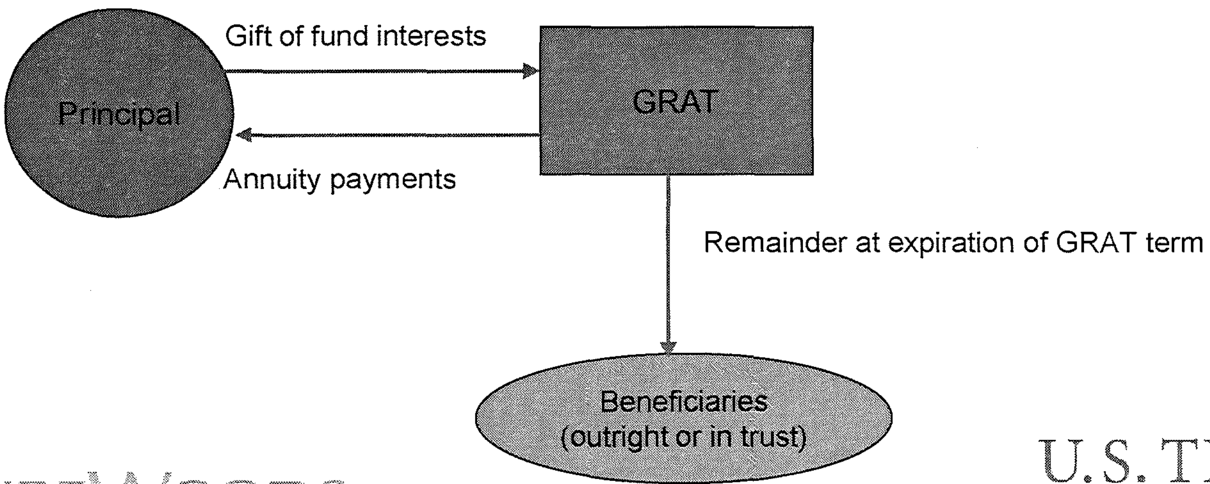
# Grantor Retained Annuity Trust ("GRAT")

**How a GRAT Works**

A GRAT is a strategy that transfers all income and appreciation over a stated period above a set IRS discount rate to beneficiaries. Principal receives an annuity over a specified term of years. At the end of the term, the remainder passes to beneficiaries (or to trusts for their benefit). Works best when funded with assets expected to appreciate significantly.

**Mechanics**

- The Principal makes a gift of fund interests to an irrevocable trust for a fixed term
- Fixed or variable annuity is paid to the principal during the trust term
- At end of trust term, remaining assets pass to beneficiaries or a trust for their benefit



# Preferred Planning Techniques

## Grantor Retained Annuity Trust ("GRAT")

**Tax Benefits:**

- GRAT can be structured to produce a gift valued at, or close to, zero (a "zeroed-out GRAT")
- Transfer of assets to a GRAT does not create an income tax event
- A zeroed-out GRAT virtually eliminates risk of excess gift on audit—an IRS increase in value would require an increase in the annuity but almost no taxable gift would result

**Additional Considerations:**

- GRAT is successful only if income and appreciation outperform the IRS discount rate
- If the manager dies during the term, some or all GRAT assets will be taxable in his estate—GRATs with staggered terms can be used to mitigate risk of death during the term of a single GRAT
- If GRAT assets are illiquid, manager can fund with enough cash to pay the annuity until assets become liquid or GRAT can borrow (but not from the principal) or pay the annuity in kind (may require an appraisal)
- Not possible to allocate generation-skipping transfer ("GST") tax exemption until end of GRAT term—not typically used to plan for grandchildren and more remote descendants

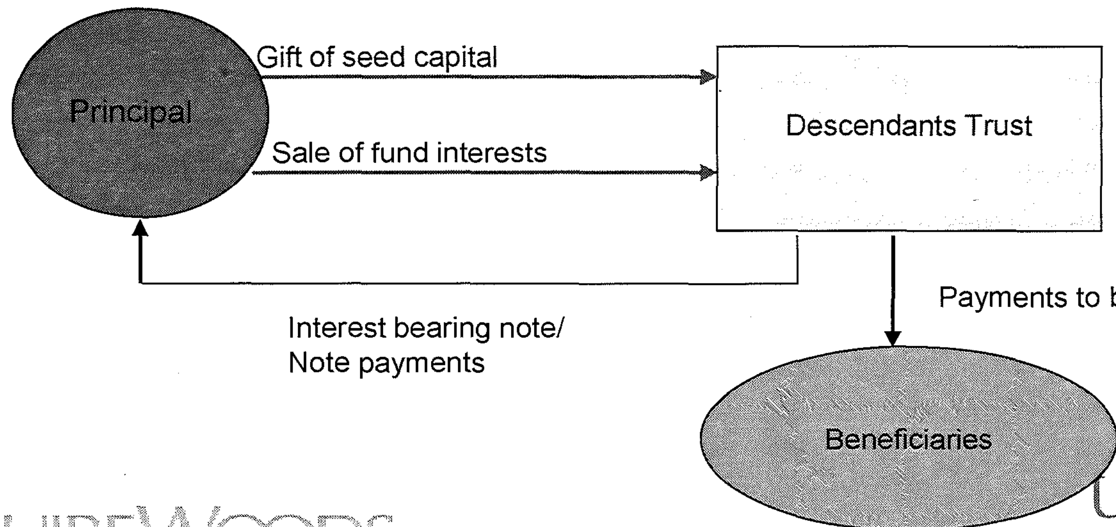
# Sale to a Grantor Trust

**How a Sale to a Grantor Trust Works:**

A sale to a "grantor trust" is a strategy that transfers income and appreciation over a stated period above an IRS determined interest rate (the "AFR") to beneficiaries or to trusts for their benefit.

**Mechanics:**

- The principal establishes a trust; generally seeds the trust with gift of cash or assets
- The Principal sells fund interests to the trust and receives a recourse note for the fair market value of the purchased asset, plus interest at the AFR
- Interest on the note is generally paid on a current basis
- After the note is repaid, all income and appreciation remaining in the trust can be paid to trust beneficiaries with no gift tax due



# Preferred Planning Techniques

## Sale to a Grantor Trust

**Tax Benefits:**

- A "grantor trust" is considered the same "taxpayer" as the principal so sale is a non-taxable event
- The principal is liable for payment of tax on trust income and realized gain, so that payments are, in effect, additional "gift tax free" contributions to the trust
- Freezes value of assets in the principal's estate at time of sale; trust keeps all post-sale income and appreciation above the AFR
- Can allocate GST tax exemption to initial gift—upside can pass to remote descendants free of GST tax

**Additional Considerations:**

- If the principal dies before note is repaid, value of the note's remaining balance is taxable in the principal 's estate— unclear if balance is also capital gain upon the principal's death
- A successful IRS claim that fund interests were undervalued may result in a taxable gift
- If value of fund interests drops below the sale price, fund interests (and possibly seed money) will revert to the principal to satisfy the note payments
  - Wastes any gift tax paid or exemption used in connection with gift of seed money

# GRAT vs. Sale to Defective Grantor Trust

- **GRAT**
  - Statutory authority
  - Minimum upfront gift
  - Mortality risk
  - No GST
  - Little flexibility
  - Clarity of tax implications
  - No insurance
  - Self-adjusts to mitigate gift tax risk

- **Sale to Defective Trust**
  - No statutory authority
  - Upfront gift for "seed"
  - No mortality risk
  - Facilitates GST
  - Great flexibility
  - Uncertain tax implications
  - Can help finance insurance
  - Gift and GST tax risk

# Preferred Planning Techniques

## Interposing a Family Limited Partnership ("FLP") or LLC

**Why Interpose a FLP/LLC?**

- Permits consolidated management and control of family assets
- Enables gifts of fractional interests in a pool of assets to family members
- Facilitates transfer of fund interests (where interests in several entities must be transferred)
- Non-managing LLC/LP interests may give rise to valuation discounts for lack of control and marketability—permits greater leverage of other tax saving strategies (*e.g.,* GRATs, sales to grantor trusts)

**How it Works:** The Principal:

- Transfers fund interests and perhaps cash (for capital calls, *etc.)* to FLP/LLC; retains 100% economic interest and investment discretion but no "control" that would cause estate tax inclusion
- Appoints an independent person to control FLP/LLC distributions and liquidation
- Gifts a fractional LP or non-managing LLC interest to a GRAT or sells it to a grantor trust

**Tax Considerations:**

- Capitalization of FLP/LLC is not a taxable event if the principal holds 100% of the economic interest
- FLP/LLC must be carefully structured to avoid assets being included in the principal's estate