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# Advising Estate Planning Clients After the 2012 Tax Act

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# WILLIAM & MARY TAX CONFERENCE

## Advising Estate Planning Clients After the 2012 Tax Act

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## **I. INTRODUCTION<sup>1</sup>**

### **A. WHAT DOES THIS MEAN FOR PLANNING FOR CLIENTS**

On January 1, 2013, at almost the last possible hour, Congress approved the American Taxpayer Relief Act, which is the first *permanent* set of estate, gift, and generation-skipping transfer (GST) tax rates and exemptions in 12 years. Despite speculation and attempts over several years focused on options ranging from total repeal to a return to pre-2001 law, the law now made permanent by Congress is identical to 2012 law, except that the compromise rate is 40 percent rather than 35 percent.

The Senate approved this legislation in a bipartisan 89-8 vote a couple of hours after 2013 had begun. The House of Representatives approved it an hour before midnight in a much less bipartisan 257-167 vote, with twice as many Democrats as Republicans supporting it.

## **II. 2001, 2010 AND 2012 LEGISLATION**

### **A. THE PHASE-IN (AND OUT) OF THE 2001 TAX ACT**

President George W. Bush's 2000 campaign position paper "Tax Cuts with a Purpose" pledged to "eliminate the death tax," but, significantly, did not say exactly when and for how long. This indefinite pledge ripened in the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act"), which phased in higher exemptions and lower rates through 2009 for the federal estate tax and generation-skipping transfer (GST) taxes and then repealed those taxes for 2010. To comply with rules that prevented tax cuts beyond ten years in the "budget reconciliation" framework that was used to pass the 2001 Tax Act, the repeal applied only for 2010. After 2010, the transfer tax laws would return to pre-2001 law (referred to as the "sunset"). The American Taxpayer Relief Act has now enacted permanent changes.

### **B. THE 2010 TAX ACT**

On Monday, December 6, 2010, President Obama announced on national television that he and certain congressional leaders had agreed on "the framework of a deal" to permit the 2001 and 2003 income tax cuts – the so-called "Bush tax cuts" – to be extended for two years. The President reported that the agreement included an extension of the estate tax for two years with a \$5 million exemption and a 35 percent rate. As signed into law on December 17, 2010, the Tax Relief,

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<sup>1</sup> This outline is based in part upon an update of the McGuireWoods LLP White Paper, "The Door is Closing: Taking Advantage of the 2010 Tax Act" (October 26, 2012) which was written by Ronald D. Aucutt, Michael H. Barker, Dennis I. Belcher, W. Birch Douglass, III, Charles D. Fox IV, Kristen Frances Hager, Michele A. W. McKinnon, and William J. Sanderson. It is also based in part upon the McGuireWoods LLP Alert "Permanent Changes to the Estate Tax and Other Tax Provisions" (January 2, 2013) by Ronald D. Aucutt, Dennis I. Belcher, W. Birch Douglass III, and Charles D. Fox IV and "Estate Planning After the American Taxpayer Relief Act of 2012" (January 25, 2013) by Ronald D. Aucutt.

Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the “2010 Tax Act”) provided:

1. A postponement of the 2001 Tax Act sunset for two years, until December 31, 2012;
2. A reunification of the estate and gift taxes with an estate and gift tax exemption of \$5 million and top tax rate of 35 percent, beginning January 1, 2010;
3. An opportunity for executors of 2010 estates to elect out of the estate tax and into the 2010 carryover basis rules;
4. A GST exemption of \$5 million beginning January 1, 2010;
5. A GST tax rate of zero in 2010 and 35 percent beginning January 1, 2011;
6. Indexing of the \$5 million estate, gift, and GST tax exemptions for inflation, beginning in 2012; and
7. Portability of the exemption from a deceased spouse to the surviving spouse.

The \$5 million exemption and 35 percent rate were a bit of a surprise, even though they had been proposed and even voted for in past bills since 2001. But no one predicted or foresaw the application of that exemption and rate 11½ months retroactively for all of 2010.

Thus, the 2010 Tax Act did little for stability and only postponed by two years the return to pre-2001 law. Meanwhile, the fact that hardly anyone predicted what Congress did in December 2010 makes it hard now to predict with any confidence what Congress will do, if anything, in the balance of 2012, including December.

### **C. THE ADMINISTRATION’S REVENUE PROPOSALS**

Although it is well known, and variously explained, that Congress has not approved an annual budget for many years, that does not stop Presidents from sending budget proposals to Congress every spring. The proposals dealing with tax revenue are generally included in a document like the current “General Explanations of the Administration’s Fiscal Year 2013 Revenue Proposals” which was released on February 13, 2012. Those General Explanations are often called “Greenbooks,” after the color of the cover of the bound versions.

All four Obama Administration Greenbooks have proposed to freeze the estate, gift, and GST taxes at, or return them to, their 2009 levels. That would mean an essentially flat 45 percent estate and GST tax above a \$3.5 million exemption and apparently an almost flat gift tax (starting at 41 percent) for cumulative taxable gifts over an exemption of \$1 million. The current Greenbook views the 2010 Tax Act

as “a substantial tax cut to the most affluent taxpayers that we cannot afford to continue” and concludes that “[w]e need a permanent estate tax law that provides certainty to taxpayers, is fair, and raises an appropriate amount of revenue.”

Some or all of the Obama Administration Greenbooks, including the current Greenbook, include the following proposals:

1. Make the portability provisions enacted by the 2010 Tax Act permanent;
2. Require the income tax basis of property received from a decedent to equal to the estate tax value (not the heir’s after-the-fact opinion of date-of-death value);
3. Strengthen the regulatory authority to disregard certain restrictions in valuing interests in entities (such as family limited partnerships);
4. Require the term of grantor retained annuity trusts (GRATs) to be at least ten years;
5. Require expiration of allocations of GST exemption to long-term trusts to expire after 90 years; and
6. Subject the value of all grantor trusts to estate or gift tax upon the grantor’s death or at such other time as grantor trust status ceases.

#### **D. BILLS INTRODUCED IN CONGRESS**

In every Congress, dozens of bills are introduced dealing with the estate tax, but few if any get serious consideration. The immediate prior 112th Congress (2011-2012) was no exception.

The summer of 2012 saw both the Democratically-controlled Senate and the Republican-controlled House of Representatives approve tax measures dealing with the expiration of the “Bush tax cuts” at the end of 2012, but, in the view of many, these approvals were intended more to make a political statement than to move closer to resolution. In the Senate, an early version of S. 3412, Majority Leader Harry Reid’s “Middle Class Tax Cut Act,” would have returned the estate, gift, and GST tax law generally to 2009 levels, with a \$3.5 million exemption, portable but not indexed, and a top 45 percent rate. But, reportedly to focus more on “middle class tax relief,” that provision was deleted from the final version that passed the Senate by a partisan vote of 51-48 on July 25th. A virtually identical bill, H.R. 15, was introduced in the House on July 30th by the ranking member of the Ways and Means Committee, Rep. Sander Levin (D-MI).

As for the House, the “Job Protection and Recession Prevention Act of 2012,” title I of H.R. 8, would simply extend 2012 law, including indexing and portability, for one year, through 2013. H.R. 8 was introduced by Ways and Means Committee Chairman Dave Camp (R-MI) on July 24th and passed by the House of

Representatives by another largely partisan vote of 256-171 on August 1st. Similar provisions appeared in the “Tax Hike Prevention Act of 2012,” S. 3413, introduced on July 19th by Finance Committee Ranking Member Orrin Hatch (R-UT) and Minority Leader Mitch McConnell (R-KY).

Bills prior to 2012 also addressed the estate tax. The “Sensible Estate Tax Act of 2011,” H.R. 3467, introduced on November 17, 2011, by Congressman Jim McDermott (D-WA), a senior Democrat on the Ways and Means Committee, would reduce the estate and gift tax exemptions to \$1 million, effective in 2012. Quixotically, it would index that amount for inflation *since 2001*, but would appear to begin that indexing in 2013, not 2012, with the result that the 2011 exemption of \$5 million would apparently have dropped to \$1 million in 2012 and then jumped to about \$1.34 million in 2013 (assuming 2011 inflation rates). If indexing began in 2012, which is the likely intent, the 2012 exemption would have been about \$1.31 million. H.R. 3467 would also restore the top 55 percent rate, but for taxable estates over \$10 million, and after 2012 all the rate bracket amounts would also be indexed for inflation, which would make the 55 percent rate effective for taxable estates over about \$13.43 million.

As a significant tax *increase*, H.R. 3467 had no future in the Republican-led House of Representatives. But it is of foremost significance for its attention to a number of subsidiary technical issues and its careful and effective drafting to address those issues. These technical issues include prevention of the widely discussed “clawback” that might operate to recapture some or all of the benefit of today’s large gift tax exemption if the donor dies when the estate tax exemption is lower, correction of a divergence between the statutory “portability” language and the legislative history, and statutory language implementing the Administration proposal to require the estate tax value to be used as the heir’s basis for income tax purposes.

In contrast, on June 24, 2010, a bill dubbed “the liberals’ bill,” the “Responsible Estate Tax Act” (S. 3533), was introduced by Senators Sanders (I-VT), Whitehouse (D-RI), Harkin (D-IA), Brown (D-OH), and Franken (D-MN). A companion bill, H.R. 5764, was introduced in the House by Rep. Linda Sanchez (D-CA) on July 15, 2010. These bills would have restored a \$3.5 million estate and gift tax exemption effective January 1, 2010, with a flat 39 percent rate used to calculate the pre-unified credit tax on the amount of the taxable estate from \$750,000 to \$3.5 million. The tax would then be imposed at rates of 45 percent over \$3.5 million, 50 percent over \$10 million, 55 percent over \$50 million, and 65 percent over \$500 million. Thus, while the label “liberals’ bill” would usually suggest a high estate tax, by this measure the “liberal” estate tax proposed in June 2010 would have been more lenient, except for estates well above a half billion dollars, than the November 2011 proposal of Congressman McDermott, who is also a liberal but, unlike the authors of “the liberals’ bill,” sits on a tax-writing committee. Such are the hazards of using labels and presumptions to predict an estate tax position, much less an estate tax outcome.

Meanwhile, the “Death Tax Repeal Permanency Act of 2011” (H.R. 1259) was introduced March 30, 2011, by Congressman Kevin Brady (R-TX). It has more than 200 co-sponsors. The “Death Tax Repeal Permanency Act of 2012” (S. 2242) was introduced March 28, 2012, by Senator John Thune (R-SD) with 20 Republican co-sponsors. Both would repeal the estate and GST taxes again, effective as of the date of enactment. Both also would leave “stepped-up” basis provisions intact and would not revive carryover basis. These bills would leave the gift tax at its 2011-2012 rate (35 percent) with a \$5 million lifetime exemption (non-indexed and non-portable).

### **III. AMERICAN TAXPAYER RELIEF ACT**

#### **A. THE CHANGES BROUGHT ABOUT BY THE AMERICAN TAXPAYER RELIEF ACT ARE:**

1. **Forty Percent Rate.** The new 40 percent rate is up from the 35 percent rate of 2010 through 2012, but less than the 45 percent rate of 2009 law that had been the position of the Obama Administration. Indeed, 40 percent is the precise midpoint of those two positions, which had marked the boundaries of the debate at the end.
2. **Unified Exemption.**
  - a. The exemption remains at \$5 million, indexed for inflation since 2011, which places it at \$5.25 million for gifts made and the estates of decedents dying in 2013.
  - b. Although the gift tax exemption was lower than the estate tax exemption from 2004 through 2010 and many viewed its “reunification” with the estate tax exemption in 2011 and 2012 as very fragile, Congress has chosen to keep the two exemptions the same, as well as the GST exemption, which is also \$5.25 million for 2013.
  - c. With unified estate and gifts tax exemptions maintained at their 2011 and 2012 levels, we now know that the rush to make large gifts at the end of 2012 may not have been necessary. But there was no way to know that until a few hours after it was too late, when Congress finally acted. And if the timing of some of the gifts was dictated by the January 1 “sunset” that was on the books when 2012 ended, our sense is that those year-end gifts generally reflected serious thinking about estate planning priorities, responsibly provided younger generations with access to family wealth, and removed any future appreciation in transferred assets from the reach of the gift and estate taxes. Besides, it would be naïve to assume that Congress is done making changes to the tax law, even to the estate tax, and while permanence at last is a



welcome relief, we know that it lasts only until Congress chooses to make more changes.

**B. CHANGES NOT MADE – YET**

Among the possible changes that Congress did not make this time are significant Administration proposals for revenue-raising by limiting the benefits of grantor trusts, imposing a minimum ten-year term for grantor retained annuity trusts (GRATs), limiting the duration of the allocation of GST exemption, and reducing the availability of entity-based valuation discounts. Because Congress could embrace any or all of those proposals almost anytime, we still see reasons for significant estate planning in 2013, especially with the increased ability to make tax-free generation-skipping gifts that comes with the sustained and even inflation-indexed exemptions.

**C. PORTABILITY**

The December 2010 legislation introduced the “portability” of the exemption for gift and estate tax purposes, whereby the exemption not used by the first spouse to die would be available for use by the surviving spouse for gift tax purposes and the surviving spouse’s executor for estate tax purposes (but not for GST tax purposes). Treasury Regulations published in June 2012 provided considerable clarity and welcome guidance regarding portability. Congress has now made portability permanent.

**D. OTHER 2001 CHANGES**

The New Year’s Day legislation also makes permanent the relatively non-political technical provisions enacted in 2001, related to the allocation of GST exemption, the GST inclusion ratio, conservation easements, and the extension of time to pay estate tax under section 6166.

**E. OTHER NON-TRANSFER TAX MEASURES**

1. Although estate and gift taxes are the principal focus of our analysis, because of their obvious importance to estate planning, it is well known that the New Year’s Day legislation was a part of a broad if unruly rescue from a “fiscal cliff” by modifying and making permanent the “Bush tax cuts,” extending certain employment benefits for a year, and postponing many of the “sequestration” effects for at least two months.
2. Significant tax measures approved January 1 include
  - a. Under the 2012 Tax Act, the 10 percent income tax bracket is permanently retained.

- b. The top rate is permanently raised from to 39.6 percent, but only for taxable incomes over \$450,000 for joint filers and \$400,000 for single individuals.
- c. With the 3.8 percent Medicare tax on investment income under section 1411, applicable if adjusted gross income, without regard to the foreign earned income exclusion, exceeds \$200,000 (\$250,000 in the case of a joint return and \$125,000 in the case of a married person filing separately), the top federal rate on investment income is essentially 43.4 percent. On earned income, the Medicare tax is 0.9 percent, making the top federal rate 40.5 percent.
- d. Restoration of the IRA charitable rollover for 2012 and 2013 for individuals over 70½, with special rules for IRA distributions made in December 2012 and for charitable rollovers made in January 2013;
- e. The taxable income of a trust or estate is taxed at 39.6 percent above a 2013 level of \$11,950 (43.4 percent in the case of undistributed net investment income). The 35 percent bracket is eliminated for trusts and estates.
- f. The top rate on long-term capital gains is permanently raised from 15 percent to 20 percent (23.8 percent with the 3.8 percent Medicare tax).
- g. The top rate on qualified dividends is also permanently raised from 15 percent to 20 percent (not 39.6 percent) (also 23.8 percent with the 3.8 percent Medicare tax).
- h. Itemized deductions and personal exemptions are again subject to phaseouts, but the itemized deduction threshold is reset to \$300,000. (Under normal indexing it would have been about \$180,000 in 2013.)
- i. The annual individual alternative minimum tax “patch” is made permanent, by indexing the AMT exemption, beginning in 2012.
- j. Most of the business and individual “extenders” are extended for two years, 2012 and 2013.
- k. Some popular credits – the American Opportunity Tax Credit, the Child Tax Credit, and the Earned Income Tax Credit – are extended for five years.
- l. Modest spending cuts were agreed to, but the issue of “sequestration” in general was postponed for two months.

**F. IMPACT OF CHANGE**

1. Forty Percent Rule

- a. Midpoint between 2012 law (35%) and 2009 law (45%)
- b. “Tax-exclusive” gift tax rate = 28.57% (40/140 or 2/7)
  - At 35%, “tax-exclusive” rate was 35/135 or about 25.9%
- c. Produces an overall top marginal rate of:
  - 40% in a state with no estate tax (e.g., Virginia)
  - 48.3% in a state with an estate tax that allows a §2058 deduction
  - 49.6% in a state with no deduction (e.g., Minnesota)

2. Top Marginal Estate Tax Rates

	<b>Federal</b>	<b>State</b>	<b>Total</b>
<b>2009</b>			
No State Tax	45%	0	45%
State Tax with §2058 Deduction	38.8%	13.8%	52.6%
State Tax, No §2058 Deduction	37.8%	16%	53.8%
<b>2010-2012</b>			
No State Tax	35%	0	35%
State Tax with §2058 Deduction	30.2%	13.8%	44%
State Tax, No §2058 Deduction	29.4%	16%	45.4%
<b>2013 and Beyond</b>			
No State Tax	40%	0	40%
State Tax with §2058 Deduction	34.5%	13.8%	48.3%
State Tax, No §2058 Deduction	33.6%	16%	49.6%

3. The Exemption

- a. \$5 million, indexed for inflation since 2011
- b. Apparently \$5.25 million in 2013 (\$5.12 million in 2012)
  - 1. Produces a unified credit of \$2,045,800 (\$1,818,300 at 35%)
- c. Unified (same for gift tax purposes)

- d. Same rate for GST tax
- e. Portable (for estate and gift tax purposes)
  - 1. “Example 3” problem fixed; regulations affirmed
- f. No “clawback”
  - 1. Generally addressed by sections 2001(g) and 2505(a)(2)
  - 2. Essentially moot anyway: Exemption not going down

#### **IV. FOLLOW UP ON 2012 GIFTS**

##### **A. RENOUNCING, REFOCUSING, REVERSING, RESCINDING, REFORMING, REFINANCING**

- 1. Disclaimers.
  - a. Some gifts in 2012, especially at the end of the year, were structured with explicit provisions for a disclaimer, with a redirection in the instrument of the property in the event of a disclaimer. Such disclaimers may now be used within nine months after the gift (thus, in some cases, as late as September 2013) to determine the effect of a gift otherwise completed for gift tax purposes in 2012.
  - b. A disclaimer or renunciation of an unaccepted outright gift probably would cause the property to revert to the would-be donor and be treated as if the gift had never been made.
  - c. A disclaimer by a trustee is more controversial and more doubtful, although broad authority (or even direction) in the instrument creating the trust (and, thus, the instrument creating the office of the trustee) might be helpful.
- 2. QTIP trusts.
  - a. Some trusts created in 2012 were designed to qualify as inter vivos QTIP trusts, with the non-donor spouse entitled to all the trust income for life within the meaning of section 2523(f)(2)(B). In some cases, the expectation was that the donor could wait to see if the 2012 gift tax exemption really was reduced in 2013, by congressional action or inaction, and then, if the exemption was reduced, simply forgo the QTIP election and make use of the donor’s now-lost 2012 exemption. Such donors still have that opportunity, if they are satisfied with the terms of the trust. But if, free from the pressures of 2012, the donor chooses a more

thoroughly planned use of the exemption (or chooses simply to preserve the exemption for such use in the future), the donor may achieve that objective by making the QTIP election. That is especially convenient if features of the QTIP trust, such as a testamentary power of appointment in the donee spouse, can be used to refocus or redirect the trust assets at the spouse's death.

- b. If the donor chooses to use gift tax exemption for the 2012 trust and forgoes the QTIP election, the donor's spouse, and thereby the donor's household, can retain the income for the spouse's life, which might have been one of the objectives of making the spouse a beneficiary. Alternatively, the spouse could disclaim all or part of the income interest and thereby permit the trust to accumulate income and continue more efficiently as a generation-skipping trust for descendants. If the spouse disclaims a mandatory income interest and still retains a right to income or principal in the trustee's discretion, the disclaimer is still a qualified disclaimer under the explicit exception for spouses in section 2518(b)(4)(A).
- c. In any event, a QTIP election for a 2012 gift must be made by April 15, 2013, or, if the due date of the gift tax return is extended, by October 15, 2013.

3. Rescission or judicial construction or reformation.

- a. Much discussion of rescission of gifts that are subsequently regretted revolves around the concepts of "mistakes" of fact or law and the recent, oft-cited case of *Breakiron v. Gudonis*, 106 A.F.T.R. 2d 2010-5999 (D. Mass. 2010). There the taxpayer and his sister were the two beneficiaries of qualified personal residence trusts (QPRTs) created by their parents, following the ten-year QPRT term. The taxpayer sought to disclaim his interest, so the remainder would pass solely to his sister, and was incorrectly advised by his attorney that he could do so within nine months of the expiration of the QPRT term. Once he had made the disclaimer, he learned that it was untimely and therefore was treated as his taxable gift, resulting in a gift tax of about \$2.3 million. The court likened this case to those in which courts had held that "the original transfer was defective *ab initio* because the original instrument contained a mistake." It therefore allowed a rescission of the disclaimer *nunc pro tunc*, stating that "[t]he rescission binds all parties to this action and is conclusive for federal tax purposes." (The suit was originally brought in a Massachusetts state court, naming the United States as a party. The Justice Department appeared and removed the case to the federal court.)

- b. But it would be a stretch to compare Breakiron's attorney's erroneous advice about what the deadline for a qualified disclaimer *was* to the inability of advisors in 2012 to know for sure what the gift tax exemption after 2012 *would be*. And the actual appearance of the Government in the *Breakiron* litigation was perhaps a fluke and in any event could not be assured in any 2013 rescission action.
- 4. Exchange of assets.
  - a. It may be possible to mitigate any remorse over a 2012 gift if the grantor can exchange assets into the trust, such as non-income-producing assets in exchange for assets that produce income the grantor now may wish to have to live on. Such an exchange can be pursuant to a reserved power to substitute assets of equivalent value under section 675(4)(C), or can be a simple exchange with the trustee even in the absence of such a reserved power. If the trust is not a grantor trust, however, the income tax on the capital gain needs to be taken into account.
  - b. In the most serious cases of the donor's insecurity following the gift, the exchange could even be for the grantor's installment note – the reverse of the typical installment sale *to* a grantor trust, but generally subject to the same rules and best practices.

## **B. PERFECTION AND IMPLEMENTATION**

- 1. Recording, obtaining transfer agents' acknowledgments, making book entries, adjusting capital accounts, etc.
- 2. Opening accounts, obtaining taxpayer identification numbers (or using the grantor's Social Security number), etc.
- 3. Establishing a businesslike administration. (Many of these trusts will be the first trusts those clients have created.)
- 4. Communicating, as appropriate, with beneficiaries.
- 5. Assembling professional team: investment advice, property management, accounting, etc.

## **C. SPECIAL ISSUES WITH 2012 GRANTOR TRUSTS**

- 1. The grantor's exchange of assets with 2012 grantor trusts.
  - a. Short-term benefits.

1. Complete the strategic funding of a grantor trust funded in haste with cash or marketable securities.
  2. Regain liquidity.
  3. Mitigate a reluctant 2012 transfer (discussed above).
- b. Long-term benefits.
1. React to changes in value, “harvest” appreciation.
  2. Include appreciated assets in the grantor’s estate, where they will receive a stepped-up basis.
- c. Issues.
1. Documentation.
  2. Verifications by the trustee “that the properties acquired and substituted by the grantor are in fact of equivalent value, and ... that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.” See Rev. Rul. 2008-22, 2008-16 I.R.B. 796.
2. The use of the assets in the grantor trust to further leverage additional installment sales and similar transactions.
  3. The grantor’s termination of grantor trust status by relinquishing the feature that confers grantor trust status.

**D. 2012 GIFT TAX RETURNS**

1. Assigning responsibility early.
2. Obtaining appraisals promptly.
3. Considering gift-splitting.
4. Considering the level of disclosure on the gift tax return. Reg. §301.6501(c)-1(f).
5. Allocating GST exemption (including making elections, in or out).
6. Reviewing previous returns.

## E. SPECIAL ISSUES WITH DEFINED-VALUE GIFTS

1. Although not unique to 2012 planning, the use of “defined value clauses” or “value definition formulas” has received both attention and an arguable boost from this year’s Tax Court decision in *Wandry v. Commissioner*, T.C. Memo 2012-88, *nonacq.*, 2012-46 I.R.B.
2. Background.
  - a. Just as in the days when one could drive into a gas station and ask for “five dollars’ worth of regular,” without specifying the number of gallons, there is an intuitive notion that a donor ought to be able to make a gift of any stated amount expressed in the form of “such interest in X Partnership, an ... limited partnership, as has a fair market value of \$13,000,” which the IRS approved in Technical Advice Memorandum 8611004 (Nov. 15, 1985). (The ellipsis is in the version of the TAM that was made public; the deleted word appears to have been Oklahoma.)
  - b. In *Knight v. Commissioner*, 115 T.C. 506 (2000), the Tax Court disregarded the use of such a technique to transfer “that number of limited partnership units in [a partnership] which is equal in value, on the effective date of this transfer, to \$600,000.” As a result, the court redetermined the value subject to gift tax. It was generally believed, however, that the result in *Knight* could have been avoided if the taxpayers had acted more consistently and carefully. Despite the apparent attempt to make a defined-value gift, the gifts shown on the gift tax return were stated merely as percentage interests in the partnership (two 22.3% interests on each return). Moreover, the taxpayers contended in court that such interests were actually worth *less* than the “defined” value.
  - c. Field Service Advice 200122011 (Feb. 20, 2001) addressed, negatively, the facts generally known to be those at issue in *McCord v. Commissioner*, 120 T.C. 358 (2003), in which the taxpayers had given limited partnership interests in amounts equal to the donors’ remaining GST exemption to GST-exempt trusts for their sons, a fixed dollar amount in excess of those GST exemptions to their sons directly, and any remaining value to two charities. The IRS refused to respect the valuation clauses, citing *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), a case with unusual facts in which the court found a provision in a document of transfer that “the excess property hereby transferred which is deemed by [a] court to be subject to gift tax ... shall automatically be deemed not to be included in the conveyance” to be contrary to public policy because it would discourage the collection of tax, would require the courts to rule on a moot issue, and would seek to



allow what in effect would be an impermissible declaratory judgment. The IRS acknowledged that the approach in question was not identical to the valuation clause in *Procter*, because it used a “formula” clause that defined how much was given to each donee, while *Procter* involved a so-called “savings” clause that required a gift to be “unwound” in the event it was found to be taxable. Nevertheless, the IRS believed the principles of *Procter* were applicable, because both types of clauses would recharacterize the transaction in a manner that would render any adjustment nontaxable.

- d. Technical Advice Memoranda 200245053 (July 31, 2002) and 200337012 (May 6, 2003) took the IRS discomfort with defined-value clauses to the next level.
- e. When *McCord* itself was decided by the Tax Court, the court essentially avoided the formula issue by dwelling on the fact that the assignment document had used only the term “fair market value” not “fair market value as determined for federal gift tax purposes.”
- f. In *Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), the Court of Appeals for the Fifth Circuit reversed the Tax Court totally, scolded the Tax Court majority soundly, and remanded the case to the Tax Court to enter judgment for the taxpayers. The court said that “although the Commissioner relied on several theories before the Tax Court, including ... violation-of-public policy [the *Procter* attack], ... he has not advanced any of those theories on appeal. Accordingly, the Commissioner has waived them.” But, in the view of many, the Fifth Circuit said other things that are hard to understand unless the court was comfortable with the use of defined value clauses in that case.
- g. *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008) (reviewed by the court), addressed the use of value formulas in the different context of a disclaimer of a testamentary transfer. The decedent’s will left her entire estate to her daughter, with the proviso that anything her daughter disclaimed would pass to a charitable lead trust and a charitable foundation. The daughter disclaimed a fractional portion of the estate, with reference to values “finally determined for federal estate tax purposes.” Noting that phrase, the Tax Court, without dissent, rejected the Service’s *Procter* argument and upheld the disclaimer to the extent of the portion that passed to the foundation. (The court found an unrelated technical problem with the disclaimer to the extent of the portion that passed to the charitable lead trust.) In a pithy eight-

page opinion, the Eighth Circuit affirmed. 586 F.3d 1061 (8th Cir. 2009).

- h. In *Estate of Petter v. Commissioner*, T.C. Memo 2009-280, the Tax Court upheld gifts and sales to grantor trusts, both defined by dollar amounts “as finally determined for federal gift tax purposes,” with the excess directed to two charitable community foundations. Elaborating on its *Christiansen* decision, the court stated that “[t]he distinction is between a donor who gives away a fixed set of rights with uncertain value—that’s *Christiansen*—and a donor who tries to take property back—that’s *Procter*. ... A shorthand for this distinction is that savings clauses are void, but formula clauses are fine.” The court also noted that the Code and Regulations explicitly allow valuation formula clauses, for example to define the payout from a charitable remainder annuity trust or a grantor retained annuity trust, to define marital deduction or credit shelter bequests, and to allocate GST exemption. The court expressed disbelief that Congress and Treasury would allow such valuation formulas if there were a well-established public policy against them. On appeal, the Government did not press the “public policy” *Procter* argument, and the Ninth Circuit affirmed the taxpayer-friendly decision. 653 F.3d 1012 (9th Cir. 2011).
  - i. *Hendrix v. Commissioner*, T.C. Memo 2011-133, was the fourth case to approve the use of a defined value clause, with the excess going to charity, although the court emphasized the size and sophistication of the charity, the early participation of the charity and its counsel in crafting the transaction, and the charity’s engagement of its own independent appraiser.
3. In *Wandry v. Commissioner*, T.C. Memo 2012-88, the donors, husband and wife, each defined their gifts as follows:

I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows: [Here each donor listed children and grandchildren with corresponding dollar amounts.]

Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date....

4. The court stressed the now familiar “distinction between a ‘savings clause’, which a taxpayer may not use to avoid the tax imposed by section 2501, and a ‘formula clause’, which is valid. ... A savings clause is void because it creates a donor that tries ‘to take property back’. ... On the other hand, a ‘formula clause’ is valid because it merely transfers a ‘fixed set of rights with uncertain value’.”
5. The Tax Court then compared the Wandry’s gifts with the facts in *Petter* and determined that the Wandry’s gifts complied. Most interesting, the court said (emphasis added):

It is inconsequential that the adjustment clause reallocates membership units among petitioners and the donees rather than a charitable organization because the reallocations do not alter the transfers. On January 1, 2004, each donee was entitled to a predefined Norseman percentage interest expressed through a formula. The gift documents do not allow for petitioners to “take property back”. Rather, the gift documents correct the *allocation* of Norseman membership units among petitioners and the donees because the [appraisal] report understated Norseman’s value. The clauses at issue are valid formula clauses.

6. This is a fascinating comparison, because it equates the rights of the charitable foundations in *Petter* that were the “pourover” recipients of any value in excess of the stated values with the rights of the children and grandchildren in *Wandry* who were the primary recipients of the stated values themselves. In a way, the facts of *Wandry* were the reverse of the facts in *Petter*.
  - a. The effect of the increased value in *Petter* was an *increase* in what the charitable foundations received, whereas the effect of the increased value in *Wandry* was a *decrease* in what the donees received. The analogs in *Wandry* to the charitable foundations in *Petter* were *the donors themselves*, who experienced an *increase* in what they *retained* as a result of the increases in value on audit.
  - b. It is also telling that in the court’s words the effect of the language in the gift documents was to “correct the *allocation* of Norseman membership units among petitioners and the donees because the [appraisal] report understated Norseman’s value.” Until *Wandry*, many observers had believed that the courts had approved not “formula transfers” but “formula allocations” of a clearly fixed transfer. In fact, the *Wandry* court used a variation of the word “allocate” five times to describe the determination of what was transferred and what was retained. But the “allocation” was between the donees and the original donors. “Allocation” to the donors looks a lot like *retention* by the donors, if not a way to

“take property back,” and thus the court might be suggesting that the time-honored distinction between “formula transfers” and “formula allocations” might not be so crucial after all. But it is a cause for concern that the court did not acknowledge that tension, but continued to use “allocation” language to justify what in economic effect defined what was *transferred* by the donors, not merely how the transferred property was allocated among donees. Again, though, the overall context and thrust of the court’s analysis was that the donors had not sought “to take property back,” but had merely defined what was given on the date of the gift.

7. Thus, there is now a taxpayer victory in a case that does not involve a “pourover” to charity of any excess value. The court concluded by again acknowledging the absence of a charity and saying that “[i]n *Estate of Petter* we cited Congress’ overall policy of encouraging gifts to charitable organizations. This factor contributed to our conclusion, but it was not determinative.” Thus, *Wandry* appears to bless a simpler fact pattern that more closely conforms to the common sense “five dollars’ worth of regular” approach that many observers, apparently even the IRS in 1985, have thought should work.
8. The Government appealed *Wandry* to the Court of Appeals for the Tenth Circuit, but dropped the appeal on October 16, 2012. The IRS issued a nonacquiescence in *Wandry* on November 9, 2012. 2012-46 I.R.B. Although that could signal that the IRS is waiting for cases with “better” facts (for the IRS, “bad” facts for taxpayers), *Wandry* itself included some facts that could have been viewed that way, including a 19-month delay for obtaining the appraisal, a description of the gifts on the gift tax returns as straightforward percentage interests without reference to the defined-value formulas, and adjustments to capital accounts rather than percentage interests as the prescribed response to changes in valuation.
9. The fairest summary of *Wandry* is that it is undeniably significant for extending the scope of the decided cases beyond the context of a charitable pourover. Unlike the charitable cases, where the weight of case law has now accumulated behind defined value clauses with a “pourover” to a charity that has actively monitored and participated in the transaction, *Wandry* does not represent a consistent body of Tax Court and appellate court jurisprudence, and, as even the charitable cases show, the IRS does not approve of the defined-value technique. Because it is also fair to speculate that many year-end 2012 gifts followed the pattern of a “*Wandry* formula,” we should not be surprised to see future cases involving *Wandry* types of defined-value gifts.

**F. CALIBRATING THE OVERALL ESTATE PLAN TO THE 2012 GIFTS**

1. Because the 2012 gift-giving was probably the most recent opportunity to fine-tune the donor's estate planning objectives – selection and succession of trustees, standards for distributions, ages of mandatory distributions (if any), and so forth – the decisions made in designing trusts in 2012 might also be incorporated into the donor's will, revocable trust, and other estate planning vehicles. There is nothing like irrevocability to sharpen one's focus.
2. In any event, long-term estate planning documents should be reviewed to make sure that their formulas still produce a desirable result despite the hit the credit-shelter disposition took from the 2012 gift, and that those formulas will work properly in a world of significant annual inflation adjustments – so far \$120,000 in 2012 and \$130,000 in 2013.

**V. FUTURE CHANGES IN THE LAW?**

**A. “FUNDAMENTAL TAX REFORM”?**

1. Heard every presidential election/inauguration year
2. Maybe more serious this year
3. But apparently limited to changes in the income tax
  - a. “Loopholes” (“targeted” provisions)
  - b. Deductions
  - c. Exceptions for family-owned businesses?
4. Estate tax not affected
5. Breaks for farmland, ranchland, and timberland
  - a. Like “Baucus Bill” amendment of December 2010
  - b. Probably less likely now
6. Targeted relief for other family businesses
7. Could parallel or mirror income tax breaks
8. “Revenue raisers”?

**B. TREASURY-IRS PRIORITY GUIDANCE PLAN**

1. Final regulations under section 67

2. Sample CRT forms
3. Guidance concerning private trust companies
4. Regulations regarding uniform basis
5. Final regulations under section 2032(a)
6. Guidance under section 2053: Guarantees, present value
7. Regulations on allocating GST exemption at end of ETIP (new)
8. Final regulations on extensions of time to allocate GST exemption
9. Regulations under section 2704
10. Guidance under section 2801 (gifts from expatriates) (next?)

## **VI. THE CONTINUING ESTATE PLANNING OPPORTUNITY PRESENTED BY LEVERAGING THE TRANSFER TAX EXEMPTIONS**

### **A. PLANNING FOR GIFTS IN 2013**

The 2012 Tax Act, by maintaining the reunification of the estate tax and the gift tax with a \$5.25 million exemption continues the ability of individuals to make large gifts and thereby remove significant amounts of property and post-gift appreciation on that property from their estates.

Reducing estate tax through lifetime gifts is one of the most effective methods of decreasing transfer taxes. An individual can give away substantial amounts of property without incurring gift tax. For wealthy individuals, making large taxable gifts almost always is advantageous from a tax standpoint. The challenges in planning for lifetime giving often are the non-tax ones and include factors such as:

1. The impact of the gift on the beneficiary;
2. Concerns about the sufficiency of the donor's remaining resources after the gift; and
3. Perceptions about the inflexibility of irrevocable transfers, such as the inability to make significant future changes to the terms of the trust based upon changed circumstances when gifts are made in trust.

The sophisticated and well-advised donor will usually follow a particular sequence in making gifts, starting with those that have the least tax impact and are the easiest to implement, and then moving to gifts that have permanent tax consequences or involve more complex planning. That typical gift sequence is:

1. Annual exclusion gifts and payment of tuition and medical expenses;

2. Lifetime exemption gifts;
3. Leveraged and split-interest gifts (such as grantor retained annuity trusts, qualified personal residence trusts, gifts with sales for a promissory note, loans, and charitable remainder and lead trusts); and
4. Gifts that require payment of gift tax.

**B. ANNUAL EXCLUSION GIFTS AND PAYMENT OF TUITION AND MEDICAL EXPENSES**

The federal tax laws currently exclude from gift tax the first \$14,000 in 2013 given to any donee in any year. Thus, an individual currently can make annual gifts of up to \$14,000 in 2013 to any number of people, without any gift tax on the transfers or use of gift tax exemption. A married individual can double the annual exclusion by gift-splitting – using one spouse’s funds and having the non-donor spouse consent to treat the gifts as being made one-half by each of the spouses.

The benefits that can be derived from making annual exclusion gifts should not be underestimated. In substantial estates, simple cash gifts of \$14,000 can generate a federal estate tax savings of at least \$5,600 for every transferee involved, assuming a 40 percent estate tax rate.

Tuition payments made directly to an educational organization on behalf of a person and payments for a person’s medical care made directly to the provider also are not treated as gifts. This can be an important exclusion for planning purposes. For example, grandparents who already take full advantage of the annual exclusion for gifts to grandchildren can make additional tax-free transfers by paying their grandchildren’s tuition for private school or college. The education expense exclusion is limited to tuition. “Tuition” means the amount of money required for enrollment. It includes tuition for part-time students. It does not include payments for books, supplies, room and board, or similar expenses. The medical expense exclusion applies to payments for (1) the diagnosis, cure, mitigation, treatment, or prevention of disease, (2) the purpose of affecting any structure or function of the body, or (3) transportation primarily for and essential to medical care. Payments for medical insurance are also included.

**C. THE ADVANTAGE OF USING THE \$5.25 MILLION GIFT TAX EXEMPTION IN 2013**

The shelter provided by the gift tax exemption does not actually exclude the property transferred from the transfer tax system. Because the unified estate and gift tax system adds adjusted taxable gifts back to an individual’s estate at death, the value of the property transferred by taxable gift at the time of the transfer does not escape tax.

Annual exclusion gifts and the direct payment of education or medical expenses are true excluded transfers. The property given away is never subject to gift tax or

estate tax in the estate of the donor and does not use exemption. Therefore, an individual first should take advantage of these exclusions to the fullest extent possible, on an annual basis. It rarely makes sense to make a taxable gift and use exemption instead of making annual exclusion gifts or paying tuition or medical expenses.

Even with the 2012 estate and gift tax law being made permanent beyond 2012, making large gifts now to take advantage of the \$5.25 million gift tax exemption can be beneficial. The sooner gifts are made, the sooner the appreciation and income from the assets are removed from taxation.

The best assets to use for taxable gifts that use the donor's gift tax exemption are ones with a high return and a high income tax basis. Because the value of the taxable gift itself is usually not excluded from the estate tax calculation, the primary benefit of a taxable gift is removing the future appreciation of and earnings from the gifted property from the donor's estate.

**Example:** Mother transfers \$1 million of stock to an irrevocable trust. Over ten years, the stock provides an average total return of 6 percent annually after tax. When Mother dies in year ten, the trust holds \$1,790,848. A total of \$790,848 escaped inclusion in Mother's estate, saving \$316,339 in estate tax with a 40 percent tax rate.

One thing to consider when making a gift is that any property transferred by gift retains the donor's tax basis. In contrast, appreciated property included in a decedent's estate receives a step-up in basis. These rules lead to the common advice that higher basis assets are generally more suited for lifetime gifts. These concepts and their application in the current tax environment are discussed in more detail in section V below.

#### **D. COMBINING THE GIFT TAX EXEMPTION AND THE GST EXEMPTION**

There is also a very important exemption to the GST tax in 2013. Every individual has a \$5.25 million GST exemption that can be used in 2013 to shield transfers from GST tax. A husband and wife have a combined GST exemption of \$10.5 million. The ability to apply this GST exemption to property and have that property and all future appreciation insulated from transfer tax can provide substantial benefits to future generations.

Individuals with significant wealth should try to take advantage of the GST exemption during life by setting aside property in an irrevocable trust for children and grandchildren. The sooner the GST exemption is used, the greater the amount of property that will be sheltered from transfer tax. An individual who makes a lifetime transfer of \$5.25 million (or spouses who make a \$10.5 million) transfer



can remove substantial amounts of property from his or her estate even if no annual exclusions are available.

**Example:** Husband and Wife give \$10.5 million to an irrevocable trust for the benefit of their descendants and allocate their GST exemptions to the trust. If the trust assets grow on average at a 6 percent after-tax rate (accumulated income plus appreciation) and Husband and Wife live for another 25 years, there will be approximately \$45 million in the trust at their deaths. By creating the trust during life, the couple has transferred an additional \$34.5 million to grandchildren free of any transfer tax.

Another way to maximize the use of the GST exemption is to create a so-called “dynasty trust” that is intended to last for the maximum period permitted by law. Under many states’ laws, a dynasty trust can last for a period of time called the “perpetuities period,” which is up to 21 years after the death of the last surviving family member who was living when the trust was created. Assuming normal life expectancies, such a trust created by an individual today could be expected to last nearly 100 years. By choosing which state’s law will govern the trust, an individual can take advantage of the laws in one of the states that now permit perpetual trust terms. During the existence of the trust, trust property will be available to the grantor’s descendants for such purposes as the grantor designates. There will be no gift, estate, or GST tax assessed on the trust property during the term of the trust.

**Example:** Husband and Wife place \$10.5 million in a dynasty trust for the benefit of their descendants and allocate their GST exemptions to the trust. The trust is to last until the end of the perpetuities period, assumed to occur in 100 years. Assuming the trust assets grow on average at a compounded 6 percent after tax rate and 2 percent is paid out annually to the beneficiaries, the assets will be worth around \$510 million when the trust ends in 100 years. This property will pass to their grandchildren or great-grandchildren free of transfer tax at the termination of the trust.

Assume instead that the assets grow at the same rate but the trust is not exempt from the GST tax because no GST exemption was allocated to it. Assume that a 40 percent GST tax is imposed in 80 years when the grantor’s last child dies. At the child’s death, the assets will have grown in value to approximately \$242 million. However, a GST tax of about \$97 million will be due, leaving about \$145 million after tax. At the end of an additional 20 years, the trust will be worth around \$317 million or \$193 million less than if it was exempt from GST tax because an allocation of GST exemption was made to the trust.

A number of states have no rule against perpetuities and therefore no limit on the duration of trusts. These trusts are commonly referred to as dynasty or perpetuities

trusts. Other states allow an option to have the rule against perpetuities not apply and have passed legislation that encourages the use of their jurisdictions to create perpetuities trusts. Alaska, Idaho, Kentucky, New Jersey, Pennsylvania, Rhode Island, South Dakota, Wisconsin, and Idaho all have eliminated the rule against perpetuities. Delaware also has abolished the rule with respect to interests in personal property. North Carolina has also repealed the rule against perpetuities effective August 9, 2007. In addition, Arizona, Colorado, Illinois, Maine, Maryland, Missouri, Ohio, Nebraska, New Hampshire, Virginia, Wyoming (up to 1,000 years), and the District of Columbia all permit a trust settlor to opt out of the rule in varying degrees. Finally, Nevada (365 years), Tennessee (360 years), Utah (1,000 years), Florida (360 years), and Washington (150 years) have modified the rule to allow trusts potentially to last longer than would be permitted under the common law rule against perpetuities.

It is not necessary to be a resident of one of these states to take advantage of their laws. However, it is necessary to establish some nexus to the state. This is usually done by creating a trust governed by the law of that state, using a trustee domiciled in the state, and having some of the trust administration take place in the state.

#### **E. PRESERVING ACCESS TO TRANSFERRED ASSETS WHILE TAKING ADVANTAGE OF THE EXEMPTION**

Many clients currently believe that they have sufficient assets with which to make gifts of up to \$5.25 million (or \$10.5 million if married and both spouses make the gift or elect to split the gifts) to a dynasty trust that will last for several generations, but they worry about possibly needing access to those funds at some point in the future. Married clients should consider planning in which either one spouse or both spouses create a dynasty trust for the benefit of the other spouse and the descendants. Single clients can consider using a domestic asset protection trust to provide access to funds in the future.

**Trusts for the Benefit of the Spouse and Descendants.** Married couples, as discussed above, have a combined \$10.5 million exemption in 2013. To provide future access to funds that are transferred to a dynasty trust, each of the husband and wife could consider funding a dynasty trust with up to \$5.25 million for the benefit of the other spouse and their descendants. Because the other spouse is a beneficiary of the trust, the other spouse will have direct access to the funds in the trust if needed along with the children, grandchildren, and other descendants or other designated beneficiaries. The spouse who is the beneficiary of the trust can also, with certain restrictions, serve as trustee of the trust.

Each spouse may be able to establish a trust for the benefit of the other spouse and the descendants. If either spouse lacks sufficient funds to make the gift, the other spouse could use the unlimited gift tax marital deduction to make a transfer of sufficient funds to the spouse to permit the spouse to fund the dynasty trust. As discussed below, the trusts should be structured in such a manner as to avoid application of the "reciprocal trust doctrine." If one spouse is a beneficiary of a

trust created by the other spouse, the IRS takes the position that a spouse who is the beneficiary cannot elect to split gifts with the spouse who created the trust and each spouse must file separate gift tax returns.

**Example:** Husband transfers \$5.25 million to a dynasty trust that will last for the maximum period permitted by law. Wife is named as trustee and the beneficiaries are Wife and the descendants. The terms of the trust provide that Wife, as trustee, can distribute the income and principal of the trust to herself or the descendants for their respective health, support, and education. If an independent trustee is appointed, then distributions can be made for broader purposes. The trust could also provide that Wife's needs have first priority. The gift is complete for gift tax purposes and the property in the trust will escape estate taxation at Husband's death, Wife's death, and for as long as the trust continues even though the trust can benefit Wife and the descendants for their lives.

Wife could also transfer \$5.25 million to a dynasty trust for the benefit of Husband and the descendants of which Husband could be trustee. In this way, a total of \$10.5 million could be transferred with each of Husband and Wife being permissible beneficiaries of trusts funded with \$5.25 million.

If both spouses create dynasty trusts of which the other is a beneficiary, the IRS may recharacterize the trusts and treat them as if each party created a trust for himself or herself under the "reciprocal trust doctrine." This would cause inclusion of the trust in the grantor's estate.

Because the reciprocal trust doctrine is subjective in nature, there is no clear line demarking when husband and wife each can create irrevocable trusts for the other without causing recharacterization. The standard guidance is that husband and wife should not create the trusts at the same time, or as part of one plan, or with identical provisions for each other. To be in the best position to avoid application of the doctrine, one of the trusts should not benefit the other spouse at all.

If the clients do not want to leave one spouse out as a beneficiary of the other's trust, then one spouse's trust should give the other beneficial interests that are meaningfully different and ideally separated by time in the creation of the two trusts. For example, assume wife is a discretionary beneficiary of income and principal in husband's trust, pursuant to a standard providing for the discretionary distribution of income and principal for health, support, and education. The wife's trust could do one or more of the following:

1. Make the husband a discretionary beneficiary of income only;
2. Allow distributions to the husband only in the discretion of an independent trustee;

3. Allow distributions to the husband only if his income or net worth falls below a certain level; or
4. Limit the husband's interest to a five and five withdrawal power.

**Gift Splitting.** In creating trusts for the benefit of the spouse and descendants, some may want to take advantage of the rules permitting a husband and wife to split their gifts so that one spouse may use the exemption of the other spouse. One limitation on gift splitting may impact couples who are planning to use some or all of the \$5.25 million exemption amount. Many couples would like to use the exemption while it is available, but they are concerned about retaining sufficient assets for themselves. Their preference is for one spouse to create the trust with the other spouse named as a discretionary beneficiary of the trust and use gift splitting to fund the one trust with more than \$5.25 million. Unless there is a basis for determining a value for the beneficiary spouse's interest in the trust, the gift to the trust cannot be split, and only the donor spouse's exclusion can be used. When spouses split a gift, the consenting spouse is considered for gift tax purposes to have made one-half of the gift. The consenting spouse is not treated as having made the gift for purposes of the estate tax, however, so the consenting spouse is not in danger of being treated as a grantor for estate tax purposes under Internal Revenue Code section 2036, 2037, or 2038. If a consenting spouse is to be named as a trustee, and gift-splitting is contemplated, the trust instrument should subject the consenting spouse's distribution powers to an ascertainable standard to ensure that the property is not included in the spouse's estate.

**Domestic Asset Protection Trusts.** Alaska, Delaware, Missouri, Nevada, Rhode Island, South Dakota, Tennessee, Utah, Wyoming, New Hampshire, Hawaii, and Virginia are some of the states that currently permit an individual to establish a trust of which the individual can be the beneficiary but which, unlike trusts in the other states, protects the assets of the trust from the claims of the creditors of the individual if certain requirements are met. These types of trusts are sometimes referred to as "domestic asset protection trusts."

Several commentators have taken the position that if creditors cannot reach the trust property, as will be the case if the Alaska, Delaware, Missouri, Nevada, Rhode Island, South Dakota, Tennessee, Utah, Wyoming, New Hampshire, Hawaii, and Virginia laws prove effective, the trust property will not be includible in the settlor's gross estate, even though the settlor is a discretionary beneficiary of the trust. Instead, a completed gift will occur upon the transfer of the property to the domestic asset protection trust. The result is a freeze transaction. By using this technique, the creator of the trust removes the appreciation from his or her estate but continues to enjoy the benefits. With the gift tax exemption at \$5.25 million through the end of 2013, one can transfer up to \$5.25 million to one of these trusts. The asset protection trust states also permit trusts that can run forever or for long periods of time and benefit several generations.

**Example:** Father creates a domestic asset protection trust in Delaware in 2013 and funds it with \$5.25 million. This gift escapes gift tax because it is sheltered from gift tax by Father's \$5.25 million gift tax exemption. Father and his children are discretionary beneficiaries of the trust. Because creditors cannot reach the assets in the trust, the gift is complete. Father dies in 2020 when the assets in the trust are worth \$15.25 million. Up until the time of his death, Father has been a discretionary beneficiary and received distributions from the trust. By using a domestic asset protection trust, according to its proponents, the almost \$10 million of appreciation after the funding of the trust will escape estate taxation.

Many commentators also believe that the donor's GST exemption can be allocated to the domestic asset protection trust so that the trust can run for several generations, the same as the dynasty trusts discussed above.

## **F. OTHER TECHNIQUES FOR MAKING GIFTS**

The exemption amount is a limited resource. It pays to use it with techniques that maximize its benefit. For the wealthiest individuals, it is not enough just to transfer \$5.25 million of property and start it growing outside the estate. Instead, these individuals should consider one of the following:

1. Valuation discounts for closely held business interests;
2. Limited partnerships and limited liability companies;
3. Gifts of fractional interests, with fractional interest discounts;
4. Sales to an intentionally "defective" grantor trust;
5. Qualified personal residence trusts; or
6. A gift augmented with a loan bearing interest at the applicable federal rate or a sale in exchange for a promissory note.

**Using Discounts in Valuing Closely Held Business Interests.** The valuation for estate and gift purposes of transfers of interests in a closely held business or partnership offers significant opportunities for transfer tax savings. The courts have held that a majority interest has more value than a proportionate share of a business's total value, while a minority interest has less value than a proportionate share. A business owner, therefore, should look to fractionalization and dispersal of such interests, both as a defensive measure to eliminate the control premium the IRS will try to attribute to a majority holding, and as an offensive measure to obtain a minority interest discount on a transfer of a minority interest.

A discount for lack of control, commonly called a "minority interest discount," is appropriate when the stock being valued does not carry control of the company and

the owner of the stock is unable to dictate the company's management or distribution decisions. A discount is applicable because the buyer is unable to influence his return on investment. A willing buyer would take this lack of control into account in making an offer to purchase a minority block of stock. The "control premium" is the flip side of the minority discount. It is the value added to a block of stock to reflect the fact that the owner controls the company. Market studies and cases indicate that the minority interest discount (or control premium) often is in the range of 15 percent to 40 percent. Thus, the combined effect of marketability and minority interest discounts in valuing closely held stock can be very significant.

The business owner also should be able to take advantage of discounts for lack of marketability, which usually apply to closely held assets regardless of whether the person holds a majority interest or a minority interest. A lack of marketability discount is available for closely held stock because there is no ready market for the stock. It is not traded on an exchange. This illiquidity renders the stock less attractive than publicly traded stock and justifies a reduction in value. The discount for lack of marketability in reported cases and rulings ranges from 15 percent to as high as 50 percent or 60 percent in exceptional situations.

**Limited Partnerships and Limited Liability Companies.** For years, many individuals have been using a family-owned partnership or limited liability company ("LLC") as a vehicle for managing and controlling family assets. A typical family partnership is a limited partnership with one or more general partners and limited partners. Usually, the parents act as general partners of the partnership or own a controlling interest in a corporate general partner. As general partners, the parents manage the partnership and make all investment and business decisions relating to the partnership assets. The general partnership interest usually is given nominal value, with the bulk of the partnership equity held by the limited partners. Initially, the parents receive both general partnership interests and limited partnership interests. Thereafter, the parents can transfer their limited partnership interests to the children.

**Example:** Parent transfers \$10,000 of his \$1 million of real estate, cash, and securities to his children. Parent contributes the remaining \$990,000 to a newly formed limited partnership, to which the children contribute their \$10,000. Parent receives a general partnership (GP) interest worth \$10,000 and limited partnership (LP) interests with a net asset value of \$980,000. The children receive \$10,000 of LP interests. Parent makes gifts of their LP interests to children.

An LLC can be structured in much the same way as a limited partnership. The parents or one of them, often act as manager of the LLC and thereby control the decision-making. Initially, the parents receive the bulk of the LLC membership interests. Over time, they can transfer most or all of those interests to their children. The LLC can provide an attractive alternative to the use of a partnership, especially

where there is a desire to limit the personal liability of all the participants in the entity without creating a separate entity to serve as the general partner.

Family partnerships and LLCs can be used in many cases to obtain additional valuation discounts. It should be possible to discount the value of the limited partnership or LLC membership interests for gift and estate tax purposes below the value of the underlying partnership or LLC assets because the interests lack marketability and control. As with interests in a closely held corporation, there is no ready market for closely held limited partnership or LLC interests. By their very nature, limited partnership interests do not participate in management of the partnership and therefore lack control. A non-manager member of an LLC also does not participate in management of the LLC. These characteristics of a limited partnership or LLC interest make it less valuable than the assets transferred upon formation of the partnership or LLC. In effect, one can transfer assets to a partnership or LLC in order to create a closely held business and take advantage of discounts where they otherwise would not be available. The benefit of these discounts, of course, is that they enable an individual to leverage available exemptions under the transfer tax laws or reduce the tax cost of a transfer.

**Example:** After creating a partnership with \$1 million of real estate, cash, and securities, Parent gifts \$980,000 of LP interests to his children. The appraiser discounts those interests by 35 percent to reflect their lack of marketability and control. This enables Parent to transfer the LP interests for \$637,000 and possibly shelter the entire gift with annual exclusions and gift tax exemption.

A family partnership or LLC can be particularly beneficial with assets such as real estate (held directly or through other partnerships) and business assets because it permits ownership to remain consolidated while economic interests in the assets are given away in the form of partnership or LLC membership interests. The partnership or LLC also can hold other investment assets, such as marketable securities. A family partnership or LLC cannot hold stock in an S corporation because a partnership or LLC is not a permissible S corporation shareholder.

**Fractional Interest Discounts.** A donor also can give away partial interests in property for any type of gift. This may reduce the overall cost of the gift because valuation discounts may be available for these partial interest gifts. These fractional interest discounts are most often applied to gifts of real estate. The IRS has been reluctant to allow fractional interest discounts of any significance for gifts of real estate. The IRS often takes the position with fractional interests of real estate that the only discount that should be allowed is one that reflects the cost of partitioning the real estate. In many situations, this cost represents only a small portion of the value. However, courts generally have recognized that such

discounts should apply and should reflect not only the cost of a partition, but also the risk and delay inherent in the partition process.<sup>2</sup>

**Sales to “Intentionally Defective” Grantor Trusts.** The sale to an “intentionally defective” grantor trust (that is, a trust purposefully set up to be a grantor trust for income tax purposes) combines the long-recognized advantages of a sale in exchange for a promissory note with the benefits of a grantor trust.

An installment sale involves the sale of a business interest or other property by an individual to the business, a family member, or a third party in exchange for an installment obligation (e.g., a promissory note). The sale limits the value of the individual’s retained interest to the amount of any down payment plus the face value of the note (or other evidence of indebtedness) received, reduced by the income tax liability on the payments made to him. A market rate of interest normally must be paid on the installment obligation in order to avoid having the face value of the note discounted for tax purposes and a gift imputed. However, the courts have concluded that interest at the applicable federal rate (“AFR”) will avoid an imputed gift. This is advantageous to the taxpayer because the AFR is usually lower than commercial lending rates. For example, the annual AFRs for February 2013 are:

Short-Term Rate	.21%
Mid-Term Rate	1.01%
Long-Term Rate	2.52%

Any gain from an installment sale of an asset is generally reportable on a proportionate basis over the time period in which the payments are actually received, unless the seller elects otherwise. Thus, income tax resulting from the gain can be deferred and spread over more than one year. Exceptions from installment sale treatment exist if the property is sold within a certain period (generally two years) or the repayment obligation is forgiven. If the seller dies before the obligation is paid in full, any unpaid principal balance is included in the seller’s estate, and the deferred gain is taxed as payments under the note are received by the seller’s beneficiaries. Finally, if the installment obligation is transferred by bequest or inheritance to the obligor or is canceled by the deceased seller’s executor, the seller’s estate will recognize any unreported gain.

An interest charge is imposed on the capital gains tax deferred under such installment obligations to the extent the amount of such obligations held by the taxpayer resulting from sales in a single year have an aggregate face value that exceeds \$5 million. The interest rate is the rate charged by the IRS for underpayment of tax. The income tax treatment of the capital gain and this interest charge are often acceptable costs, and an installment sale directly to children or to a non-grantor trust still makes sense. However, in most estate planning motivated transactions, the installment sale is made to an irrevocable grantor trust. The trust is

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<sup>2</sup> See, e.g., *LaFrak v. Commissioner*, 66 T.C. Memo 1297 (1993); *Estate of Baird v. Commissioner*, T.C. Memo 2001-258; *Estate of Busch v. Commissioner*, T.C. Memo 2000-3; *Ludwick v. Commissioner*, T.C. Memo 2010-40.



not treated as a separate taxpayer for income tax purposes. As a result, the transaction is not treated as a sale for tax purposes and the resulting capital gain from the sale, and the interest charges, are eliminated.

**Example:** A creates an irrevocable trust and funds it with a gift of \$100,000 of stock in his S corporation. The trust is structured as a grantor trust. A then sells \$1.9 million of the stock to the trust for a 13-year installment note, bearing an interest rate of 2.31 percent (the assumed long-term AFR). The company distributes cash to the trust of \$240,000 per year, and the stock and other assets of the trust are appreciating at 5 percent per year. The amortized payments to A under the note are about \$170,000 per year. At the end of 13 years, the trust will own all the stock, debt-free, and the stock and other investments from the accumulated distributions in excess of the note payments will have a value of \$5,011,000.

One variation on the sale to defective grantor trust technique that has received some attention recently is called a Beneficiary Defective Inheritor's Trust ("BDIT"). In this variation, a family member or third party creates the trust rather than the client who will sell assets to the trust and be a beneficiary of the trust. In this way, according to the proponents of the BDIT, the client can continue to have access to the funds in the trust.

**Qualified Personal Residence Trusts.** A qualified personal residence trust ("QPRT") is a form of grantor retained income trust – a type of split interest trust where someone receives an income interest and someone else receives the remainder interest. To create such a trust funded with a personal residence, the trust must be in a form prescribed by IRS regulations. To create a QPRT, the grantor transfers a residence to an irrevocable trust that gives the grantor the right to use the property and receive whatever income it produces for a specified term. At the end of the term, the property will be distributed to the grantor's beneficiaries (spouse, descendants, or others) or held in trusts for their benefit. The grantor has the option of leaving the residence in trust for his or her spouse, which would permit the couple to continue to reside there after the term.

When the trust is established, the grantor makes a gift of the present value of the remainder interest. This gift equals the value of the transferred property less the present value of the retained income interest. The gift tax savings occur because the IRS valuation tables assume a return based on the "treasury bond" model – that is, that a person invests in a treasury bond that pays interest over the life of the bond and pays face value at maturity. Other assets that have a significant appreciation element, such as stocks and real estate, do not fit the model but are subject to the same rules.

If the grantor dies during the income term, all of the property will be included in the grantor's estate. This negates the transfer tax benefit but puts the grantor in no

worse a position than had the grantor not created the trust because the property would have been included in the grantor's estate anyway.

The IRS regulations define a personal residence to include appurtenant structures used for residential purposes and a reasonable amount of adjacent land. The IRS has been quite liberal in its interpretation of "appurtenant structures" and "adjacent land." The key test is whether the property size is unusual for the area. The IRS has permitted QPRTs for large properties where the size was not unusual compared to other local properties.<sup>3</sup> Similarly, the IRS has approved QPRTs with ancillary buildings related to the residence.<sup>4</sup>

**Example:** Assume that Father is 67 when he transfers a vacation home, worth \$1.5 million, to a QPRT for ten years in January 2013. At the end of that ten-year period, the vacation home will pass to his children (or, if Father dies before the end of the ten-year term, will revert to his estate). Under the IRS tables, which assume an interest rate of 1.0 percent, the value of Father's retained income interest is \$485,000, and the amount of the gift of the remainder is \$1,015,000. Thus, this \$1.5 million property is transferred out of Father's estate at a gift tax value of \$1,015,000. Father can use \$1,015,000 of his \$5.25 million gift tax exemption to shelter the gift from gift tax. If the home doubled in value before the end of the ten-year term, the \$1.5 million of appreciation will escape transfer tax as well.

**Taxable Gifts.** The 2013 tax rate on gifts over \$5.25 million is 40 percent. The payment of gift tax has always been "cheaper" than the payment of estate tax. This is because of the difference in the ways that the gift tax and estate tax are computed. As long as the donor lives three years after making the gift (so the gift tax is not brought back into the estate), the gift tax is calculated on a tax-exclusive basis. The estate tax, on the other hand, is calculated on a tax-inclusive basis.

**Example:** Mother is in the top marginal gift and estate tax bracket of 40 percent, has already used up her \$5.25 million gift tax exemption, and wants to transfer \$1 million to Son after tax. If she makes that gift during 2013, she would need \$140 million to complete the gift: \$1 million to give to Son and \$400,000 to pay the resulting gift tax. On the other hand, if Mother waited until her death to give him the \$1 million, she dies in 2016, she would need approximately \$1,667,000 to complete the transfer: \$1 million to give to Son and \$667,000 to pay the estate tax. This result occurs because the money used to pay the estate tax will be part of Mother's estate at death, and estate tax will be due on that money as well as on the \$1 million passing to Son. Thus, transferring the \$1 million to Son during life requires about \$267,000 less than making the same transfer at death.

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<sup>3</sup> See P.L.R. 9639064 (residence on 43 acres); P.L.R. 9544018 (vacation home on 18 acres).

<sup>4</sup> See P.L.R. 9606003 (residence with apartment over garage).

There are of course disadvantages to making large taxable gifts. The primary disadvantage is that the donor no longer has the property transferred or the cash used to pay the gift tax. This is less of a problem for very wealthy individuals. To achieve the maximum advantage, the donor would have to live for three years after making the gift.

Another disadvantage of lifetime gifts is that whenever a decision is made to transfer property during life (as opposed to at death), a potential step-up in income tax basis will be lost. As discussed in more detail in Section V, if a donor transfers property by gift during life, the donee's basis for purposes of computing any gain realized on a subsequent sale is the donor's basis, increased by any gift tax paid that is attributable to the asset's appreciation. If the property is transferred at death, the beneficiary would generally receive a step-up in basis to the property's fair market value at date of death or alternate valuation date. Thus, the decision to transfer property by gift may have a significant income tax cost if the beneficiary subsequently sells the property.

### **Low-Interest or Interest-Free Loans**

A simple way for a client to take advantage of the current low interest rate environment is to lend funds at the AFR to a child, grandchild or trust for the benefit of one or more descendants, to enable the recipient to take advantage of investment opportunities with a potential for high returns.

**Loan to Trust.** One possibility is to make a loan to a trust.

**EXAMPLE:** Clara creates an irrevocable grantor trust in December 2012 for the benefit of her descendants. Clara makes a \$1,000,000 taxable gift to the trust in January 2013, which she splits with her spouse, and which uses a portion of their applicable exclusion amounts. They allocate GST exemption to completely exempt the trust. Thus, after the gift, they have a \$1,000,000 trust that is completely exempt from gift, estate and GST taxes. In January 2013, Clara lends an additional \$2,000,000 to the trust for a 5-year note bearing interest at .87% annually (the mid-term AFR). The principal is due in a balloon payment at the end of the term.

Several benefits may result from this arrangement:

- The trust has obtained \$2,000,000 of investment capital at a rate significantly less than what is available commercially.
- The annual interest cost for the loan is \$17,400 (.87% of \$2,000,000), or \$87,000 in total over five years.

- If the trust invests the \$2,000,000 and earns a return of 5% annually over 5 years, it will earn over \$82,600 per year on the spread. (This is in addition to earnings on the original \$1,000,000 corpus received by gift.)
- After the repayment of principal after 5 years, the trust will have \$413,000 remaining from the loaned funds, plus the \$1,000,000 originally given to the trust plus investment earnings on that \$1,000,000.

If the trust is structured as a grantor trust, the grantor will be responsible for all income taxes on income generated by the trust. In addition, the annual interest payments on the loan will not be taxable income to the grantor. In the foregoing example, the annual \$17,400 of interest payments to Clara will not be taxable income to Clara.

There is no additional gift or generation-skipping transfer to the trust as a result of the loan.

A client should not make a loan to a grantor trust that has no other assets. The same principles apply here as apply in the installment sale context. If the trust has no other assets, there is a risk that the IRS could treat the loan as not bona fide and recharacterize it.

In particular, the IRS could argue that the AFR does not constitute an adequate interest rate for a loan that has a substantial risk of default because of the lack of independent assets with which to repay it. This would enable the IRS to discount the value of the note and treat the loan as a part loan/part gift.

**Outright Loan.** As an alternative, one could simply loan money outright.

**EXAMPLE:** Clark loans his daughter, Zoe, \$ 1,000,000 in January 2013 for three years when the minimum short term interest rate is .21%. The loan is for simple interest with annual payments of interest and payment of the principal at the end of the three year term. Zoe invests the \$1,000,000 in assets earning 5% over the three term. At the end of the three year term, Zoe, after paying \$2,100 in interest each year, clears \$153,105.

## VII. THE SELECTION OF GIFT PROPERTY: TRANSFER TAX VERSUS INCOME TAX<sup>5</sup>

Gifts are not always without tax cost though. A gift of property may be a trade of the transfer tax for the income tax. Because of the interplay of basis for income tax purposes and income taxes payable upon the sale of the gifted property, individuals analyzing the transfer tax savings of a lifetime gift must consider the potential income tax consequences of the gift to evaluate the overall tax effect of the gift.

The following tax-related factors with respect to particular assets favor making a lifetime gift of those assets:

1. The assets have a high basis for income tax purposes;
2. The assets are legacy or family assets not likely to be sold by beneficiaries;
3. The assets have significant potential for appreciation in value during the life of the owner/donor; and
4. Income tax on the sale of assets may be deferred through use of tax-free exchanges under Internal Revenue Code section 1031 or other deferral methods or avoided through the use of capital losses.

The following tax-related factors with respect to particular assets favor holding those assets until death:

1. The assets have a low basis for income tax purposes; and
2. Appreciation in the value of the assets is uncertain or unlikely.

### B. DATE OF DEATH BASIS VERSUS CARRYOVER BASIS

**Date of Death Basis.** The beneficiaries of assets inherited at death receive a new basis in the inherited assets equal to the value of the asset on the decedent's date of death or the alternate valuation date.<sup>6</sup> Because the date of death value generally increases the basis of assets owned by a decedent, inherited assets are said to receive "stepped-up" basis treatment.<sup>7</sup> The fair market value of the property is most often determined by the executor of the decedent's estate and reported on the decedent's estate tax return if a return is filed.

**Example.** John purchased 1,000 shares of common stock of Apple Inc. on September 5, 2003 (at a price of \$11.25 per share). John's

<sup>5</sup> For purposes of this section, references to the capital gains tax rate will refer to the long-term capital gains rate.

<sup>6</sup> The executor may elect to value all assets included in the decedent's estate at the value determined as of the date that is six months following the decedent's death or the value on the date that an asset is liquidated if the election reduces the amount of estate taxes payable.

<sup>7</sup> Internal Revenue Code section 1014(a)(1) provides that "the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall...be the fair market value of the property at the date of the decedent's death..." For exceptions to this rule regarding DISC stock and appreciated property acquired by decedent by gift within one year of death, see Internal Revenue Code section 1014(d) and (e).

basis in those shares is \$11,250. At John's death on January 3, 2012, the fair market value of those shares at date of death was \$412,750.<sup>8</sup> This amount would be included for determining the value of John's gross estate for estate tax purposes, and the beneficiary who received those shares upon his death would have a basis in the shares of \$412,750.

**Carryover Basis.** Assets given by an individual to a beneficiary do not get stepped-up basis treatment. Rather, the donor's basis is carried over to the beneficiary of the gift.<sup>9</sup> The beneficiary will use the donor's basis in the property – not the value of the property at the time of the gift – as the basis of the property in most circumstances.<sup>10</sup>

**Example.** John purchased 1,000 shares of Apple Inc. at a price of \$11.25 per share on September 5, 2003. He immediately gave those shares to his son, Jack. Jack's basis would be \$11,250, the same as John's basis. At John's death, the assets would not be included in his gross estate and Jack's basis would remain the same as John's basis in the shares at the time of the gift.

### C. ESTATE TAX VERSUS INCOME TAX

Because of the carryover basis rules, beneficiaries may be better off inheriting property (at the death of an individual) rather than receiving property as a gift. Stated otherwise, an individual may not be saving taxes by making lifetime gifts of property because the income taxes paid as a result of the carryover basis may be greater than the estate tax saved by transferring the property during life. But there are reasons why an individual may want to trade the estate tax for the income tax.

**Timing.** With the estate tax, the taxpayer (the executor of an individual's estate) cannot choose when the estate tax is paid. Any estate tax must be paid within nine months of the decedent's death. With the capital gains tax, however, the individual taxpayer controls when the capital gains tax is paid. Assets are only subject to income tax when the taxpayer sells the assets. So long as the taxpayer holds the assets, the gain remains untaxed. A taxpayer can sell the property and trigger the tax at a time when the asset values, liquidity for paying the tax, or capital gains rates are favorable. In addition, a taxpayer may be able to take advantage of the tax provisions that allow the deferral of capital gain, such as the ability to make tax-free exchanges under Internal Revenue Code section 1031 or may time the sale so that it is offset by capital losses attributable to the sale of other assets.

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<sup>8</sup> Based on a \$412.75 per share price, which is the average of the high and low price of the shares as of January 3, 2012.

<sup>9</sup> Internal Revenue Code section 1015(a) provides that when assets are gifted, "the basis [in the hands of the donee] shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift..." If the fair market value of the property at the time of the gift is less than the donor's basis, the basis will be the fair market value rather than the donor's basis. For this reason, a donor will rarely make a gift of property if the donor's basis exceeds the fair market value of the property at the time of the gift.

<sup>10</sup> If the donor's basis in property given away exceeds the fair market value of the property at the time of the gift, the donee's basis is the fair market value of the property at the time of the gift.

**Rates.** The rate of tax may be the most important factor in evaluating the two taxes. The capital gains tax rate is at an all-time low. For those individuals in the highest income tax bracket, long-term capital gains are taxed for federal purposes at 15 percent. Under current law, the total value of a decedent's estate that exceeds the exemption amount will be taxed at an estate tax rate of 40 percent.

Making lifetime gifts of property is an opportunity to trade the avoidance of the estate tax for potentially incurring a capital gains tax. The following examples illustrate potential tax consequences of retaining assets until death or making gifts of assets during life.

**Example – Retaining Assets.** If, in the example described above, John retains the Apple Inc. stock until death, Jack's basis in the stock when received would be the date of death value of the stock, or \$412,750. If John's estate – or the amount passing to non-charitable beneficiaries – is less than or equal to John's remaining available estate tax exclusion amount, there is little incentive for John to make a lifetime gift. No estate tax will be paid, and Jack will receive the stock with a stepped-up basis (Example 1 in the chart below). If the value of John's estate exceeds the available estate tax exclusion amount, the assets in the estate will be subject to estate tax. The estate tax liability attributable to the Apple Inc. stock in 2012 would equal \$144,463 (at a 35 percent rate). If Jack sold the stock on September 5, 2012, at a per share price of \$678.29, he would report the gain on the shares in excess of his basis. In this example, Jack would report gain of \$265,540 and would pay income tax on the gain equal to \$39,831 (Example 2 in the chart below). If Jack holds the stock and does not sell it, no capital gains tax will be paid (Example 3 in the chart below).

**Example – Gifting Assets.** If, in the example described above, John makes a lifetime gift of the Apple Inc. stock to Jack, the stock will not be taxable in John's gross estate. Jack would have a basis in the stock for income tax purposes of \$11,250. If Jack sold the shares on September 5, 2012, when the stock was trading at an average price of \$678.29 per share, Jack would report taxable gain of equal to the difference between his basis and the proceeds of the sale (\$667,040) and would pay income tax on the gain equal to \$100,056 (Example 4 in the chart below). If Jack sells the stock at some future time, when the stock is trading at a per share price of \$1,000, Jack may pay income tax on the gain of \$148,313, assuming a 15 percent long-term capital gains tax rate (Example 5 in the chart below).

	<b>Example 1</b>	<b>Example 2</b>	<b>Example 3</b>	<b>Example 4</b>	<b>Example 5</b>
<b>Shares of Apple</b>	1,000	1,000	1,000	1,000	1,000
<b>Donor's Basis</b>	\$11,250	\$11,250	\$11,250	\$11,250	\$11,250
<b>Amount Includable in the Gross Estate</b>	\$412,750	\$412,750	\$412,750	\$0	\$0
<b>Estate Tax Rate</b>	35%	35%	35%	35%	35%
<b>Estate Tax Payable</b>	\$0	\$144,463	\$144,463	\$0	\$0
<b>Beneficiary's Basis</b>	\$412,750	\$412,750	\$412,750	\$11,250	\$11,250
<b>Proceeds from Sale</b>	\$678,290	\$0	\$678,290	\$678,290	\$1,000,000
<b>Gain on Sale</b>	\$265,540	\$0	\$265,540	\$667,040	\$988,750
<b>Capital Gains Tax Rate</b>	15%	15%	15%	15%	15%
<b>Capital Gains Tax</b>	\$39,831	\$0	\$39,831	\$100,056	\$148,313
<b>Total Tax – Estate Tax and Capital Gains Tax</b>	\$39,831	\$144,463	\$184,294	\$100,056	\$148,313

#### **D. DETERMINING WHEN TO GIVE**

Individuals considering a significant gift in 2012 will want to know whether they should give property in 2012 to avoid estate tax or retain the property to benefit from stepped-up basis treatment. The analysis must take into consideration the fair market value of the assets to be gifted, the individual's tax basis in those assets, the potential appreciation in the value of the assets during the individual's lifetime, and the relevant income and estate tax rates.

The potential for appreciation in the value of the assets of an individual's estate is one of the most important factors in deciding whether to make a lifetime gift. If an individual considering a gift can determine the basis and fair market value of the assets of his or her estate and make assumptions about the tax rates, the individual can solve for the important variable: How much appreciation in value must occur between now and the time the assets would be subject to tax in the individual's estate for the gift to have been tax efficient. The following formula addresses that question and can be used as a tool to estimate and analyze the tax costs of a gift.

$$P = \frac{\text{Capital Gains Rate} \times (1 - \text{Basis}/\text{FMV}) + \text{Gift Tax Rate} - \text{Estate Tax Rate}}{\text{Estate Tax Rate} - \text{Capital Gains Rate}}$$



*P*, simply put, is the percentage appreciation of an asset at which there is no tax difference between making a gift during lifetime or transferring at death. If real appreciation is expected to be higher than *P*, it is more tax efficient to make a lifetime gift. If real appreciation is expected to be lower than *P*, it is more tax efficient to transfer property at death.

The following examples illustrate the formula described above in certain familiar rate structures. To illustrate the differences in rates and the importance of the spread between the rates, the following examples assume an asset with a zero basis and significant current fair market value.

	<b>Low Capital Gains, Gift, and Estate Tax Rates</b>	<b>High Capital Gains Rate; Low Gift and Estate Tax Rates</b>	<b>High Capital Gains, Gift, and Estate Tax Rates</b>
<b>Capital Gains Tax Rate</b>	15%	28%	28%
<b>Gift Tax Rate</b>	35%	35%	45%
<b>Estate Tax Rate</b>	35%	35%	45%
<b>Basis in Assets</b>	\$0	\$0	\$0
<b>Fair Market Value of Assets</b>	\$1,000,000	\$1,000,000	\$1,000,000
<b><i>P</i></b>	<b>75%</b>	<b>400%</b>	<b>165%</b>
<b>Years until Death</b>	10	10	10
<b>If estimated annual appreciation exceeds this amount, lifetime gift is tax efficient:</b>	<b>7.5%</b>	<b>40%</b>	<b>16.5%</b>

If the capital gains tax rate is low and the estate and gift tax rates are low, relatively little appreciation is required to make a lifetime gift tax efficient. If the capital gains tax rate increases and the estate and gift tax rates remain unchanged – meaning the spread between the two rates narrows – significant appreciation must occur during an individual’s lifetime for a gift to be considered tax efficient. If the capital gains tax rate is higher, inherited property with a stepped-up basis is more attractive because of the lower gain. If all the rates (capital gains, estate, and gift) increase, the level of appreciation that must be reached correspondingly increases, and the spread between the rates becomes relevant. Even if all the rates increase, the closer the capital gains tax rate is to the estate and gift tax rate, the more the

stepped-up basis of inherited property is valuable to beneficiaries and the more appreciation is needed to make a lifetime gift tax efficient.

## **VIII. NEW INCOME TAXES**

### **A. NEW SURTAX ON NET INVESTMENT INCOME**

The healthcare reform enacted in 2010 imposes a new 3.8 percent surtax on the passive investment income of certain taxpayers, including trusts and estates, for taxable years beginning after 2012. This added tax burden on trust income may make accumulation trusts less attractive because trusts are subject to the surtax at a much lower threshold than individuals. Trusts otherwise exposed to the surtax may avoid it by distributing trust income to beneficiaries, particularly those below the tax thresholds that apply to individuals. In the case of a trust or estate, the 3.8 percent surtax applies to the lesser of (i) the undistributed net investment income and (ii) the excess of adjusted gross income over a threshold amount. The threshold amount for trusts and estates is the amount at which the top income tax, inflation-adjusted bracket begins – expected to be approximately \$12,000 for 2013. In contrast, the threshold amount is \$250,000 for a married couple filing jointly and \$200,000 for a single individual. This new surtax should be taken into account in structuring and administering irrevocable trusts.

For purposes of the new surtax, investment income generally includes capital gains as well as interest, dividends, annuities, rents, and royalties but excludes distributions from IRAs, qualified plans, and the like. Importantly, business income derived from a passive activity with respect to the trust or estate is investment income for this purpose.

### **B. ADDITIONAL 0.9 PERCENT MEDICARE TAX**

In addition to the 3.8 percent Medicare surtax on net investment income, higher income taxpayers will also be subject to an additional 0.9 percent Medicare tax effective January 1, 2013 on earned income. The additional Medicare tax applies to the portion of wages received in connection with employment in excess of \$250,000 for joint returns.

## **IX. PORTABILITY**

### **A. WHAT IS PORTABILITY?**

Since 1948, married couples have been able to file joint income tax returns, so that all income of the two spouses is taxed at the same rate, no matter which of them earned it. Similarly, married couples have been able to “split” gifts, so that all taxable gifts by the two spouses are treated as made one-half by each of them, no matter which of them actually made the gifts. For many years, it has been thought to be a good idea to make that same “joint return” approach available for estate tax purposes, so what in effect are the estate tax exemptions of both spouses could be used by either of them. Under this approach, if the estate tax exemption is \$5.25

million, and the first spouse to die used none of the exemption, then the second spouse to die could use both exemptions, for a total of \$10.5 million.

The joint return approach for the estate tax would have to work a bit differently than the approach for income and gift tax returns, which are filed annually. The exemption of the surviving spouse could not be used by the first to die, but the same effect could be achieved if the first to die left everything to the surviving spouse, which would qualify for the marital deduction in the estate of the first to die. To return to the illustration, assume one spouse has an estate of \$7 million, the other has an estate of \$3 million, and the exemption is \$5 million.

1. If the wealthier spouse died first and left the entire \$7 million estate to the surviving spouse, the surviving spouse would have an estate of \$10 million and could shelter it from tax by the use of both \$5 million exemptions.
2. If the less wealthy spouse died first and left the entire \$3 million estate to the surviving spouse, the surviving spouse would again have an estate of \$10 million and could shelter the entire \$10 million from tax by the use of both \$5 million exemptions.
3. The first result could have been achieved before 2011 if the wealthier spouse simply left \$5 million to a “credit shelter trust” that used a \$5 million exemption and left the \$2 million balance to the survivor, whose \$5 million estate would then also escape tax. But the second result could *not* have been achieved under prior law, because even if the entire \$3 million estate were left in a credit shelter trust, the survivor’s \$5 million exemption would not be enough to shelter the survivor’s \$7 million estate from tax.

The survivor’s use of the exemption not used by the first to die in effect allows the unused exemption of the first to die to be “portable” to the survivor, hence, the popular label of this approach as “portability.”

Portability is a simplification that achieves greater fairness for married couples with combined estates below twice the exemption amount. But one of the challenges to implementation has been to make it work in the modern context of multiple marriages. The idea of “collecting” unused exemptions from a number of predeceased spouses was viewed as unseemly, but the potential “anti-abuse” rules to distinguish “real” marriages from tax-avoidance marriages or to trace exemptions to “appropriate” spouses could have been even more outrageous. A breakthrough occurred in 2006 in the drafting of the House-passed bills, the “Permanent Estate Tax Relief Act of 2006” (“PETRA”) and the “Estate Tax and Extension of Tax Relief Act of 2006” (“ETETRA”), which fell just a few votes short of being taken up for consideration in the Senate. The statutory language to implement portability in those bills avoided awkward and complex anti-abuse rules by simply limiting any decedent’s use of exemptions from previous spouses to the amount of that

decedent's own exemption. In other words, no one could more than double the available exemption by accumulating multiple unused exemptions from previous spouses. This approach would be imperfect, because it could deny legitimate portability to persons who had been widowed more than once, but it would operate roughly to prevent the misuse of portability by collecting unused exemptions from tax-motivated arrangements inappropriately designated as "marriages." The 2010 Tax Act, which finally enacted portability into law, went still further by limiting portability to just one predeceased spouse, the "*last* such" deceased spouse.

## **B. PORTABILITY REGULATIONS**

On June 15, 2012, the Treasury Department and the IRS released temporary regulations,<sup>11</sup> effective immediately, and corresponding proposed regulations.<sup>12</sup>

Under Internal Revenue Code section 2010(c)(5)(A), which the 2010 Tax Act added, portability is not allowed "unless the executor of the estate of the deceased spouse files an estate tax return on which such amount is computed and makes an election on such return that such amount may be so taken into account. Such election, once made, shall be irrevocable. No election may be made...if such return is filed after the time prescribed by law (including extensions) for filing such return." The regulations confirm that the timeliness of the estate tax return is determined in the usual way whether or not a return is otherwise required for estate tax purposes. In other words, even if the value of the estate is less than the threshold for requiring an estate tax return – currently \$5.25 million – the return must be timely filed to elect portability. The preamble to the regulations explains this requirement by stating that "[t]his rule will benefit the IRS as well as taxpayers choosing the benefit of portability because the records required to compute and verify the DSUE amount (which is what the regulations call the portable exemption, technically the 'deceased spousal unused exclusion amount') are more likely to be available at the time of the death of the first deceased spouse than at the time of a subsequent transfer by the surviving spouse by gift or at death, which could occur many years later." But the regulations do not indicate how, if at all, such a return might be "audited."

The regulations confirm that the election is made merely by filing an estate tax return (unless the election is affirmatively disavowed) and may be made by an appointed executor or administrator or, if there is none, any person in possession of any property of the decedent. This reflects the notion of what is often called a "statutory executor," after the definition in Internal Revenue Code section 2203. Such a "non-appointed executor" could (and often will) be the surviving spouse.

In what is perhaps the most significant and welcome provision, the regulations provide special rules for reporting the value of property on an estate tax return filed to elect portability but not otherwise required for estate tax purposes, most notably, for 2013, a return for an estate smaller than \$5.25 million. Specifically, the value of

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<sup>11</sup> T.D. 9593, 77 FED. REG. 36150 (June 18, 2012).

<sup>12</sup> REG-141832-11, 77 FED. REG. 36150, at 36229.

property qualifying for a marital or charitable deduction (which does not use any exemption anyway) need not be stated, if the executor “exercises due diligence to estimate the fair market value of the gross estate.” As amplified by the new instructions to the estate tax return, the regulations allow this requirement to be satisfied by provision of the executor’s “best estimate of the value,” rounded up to the next highest multiple of \$250,000. More rigorous valuation of marital or charitable deduction property is still needed in the case of formula bequests, partial disclaimers, partial QTIP elections, split-interest charitable transfers, and eligibility for special tax treatment that is affected by values, such as installment payment of estate tax.

But it is clear that in the paradigm case of a married couple with a home, modest tangible personal property, bank account, and perhaps an investment account – all possibly jointly owned – and life insurance and retirement benefits payable to the survivor, the requirements for completing an estate tax return to elect portability have been made relatively manageable, especially considering that the surviving spouse is likely to be the “non-appointed executor” with respect to all the property.

The regulations favorably and helpfully resolve an apparent conflict between the statute and the legislative history that has occupied the attention of commentators since the 2010 Tax Act was enacted, clarifying the application of portability when a surviving spouse remarries and then predeceases the new spouse. As additional clarifications, the regulations address ordering rules when a surviving spouse uses some of the “DSUE amount,” even from more than one deceased spouse, for both lifetime gifts and transfers at death.

The regulations also provide that when property of the last deceased spouse has passed to a qualified domestic trust (QDOT) for the surviving spouse, the surviving spouse will not be able to use portability until the final QDOT distribution or the termination of the QDOT, typically upon the surviving spouse’s death, a rule that will usually prevent the surviving spouse from using portability for gifts. And they clarify that the estate of a nonresident who is not a U.S. citizen may not use the DSUE amount of a predeceased spouse, except to the extent allowed under a treaty.

The regulations also reiterate, without elaboration or example, the statutory authority of the IRS to examine estate tax returns of a decedent, even after the period of limitations on assessment has run, but only for the limited purpose of determining the decedent’s DSUE amount for use by the surviving spouse if the portability election has been made.

On October 4, 2012, the IRS released a revised Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, to reflect changes in the Form 706 required to account for portability. The revised Form 706 has a new Part 6 – Portability of Deceased Spousal Unused Exclusion (DSUE), and the revised Form 706 provides that the only action required to elect portability of the DSUE amount is to file a timely and complete Form 706. Under the revised Form 706, a taxpayer can opt out of electing the transfer of any DSUE to the surviving spouse by

checking a box on Section A of Part 6 labeled “Denial of Portability.” In addition, Section C of Part 6 provides the method of calculating the amount of the DSUE to be transferred if there is no election out of portability.

### **C. PORTABILITY ISSUES**

Being a part of the 2010 Tax Act, prior to the American Taxpayer Relief Act, portability was scheduled to last only two years. In other words, it applied only if the predeceased spouse died in 2011 or 2012, and only to transfers by gift or at death by the surviving spouse after the predeceased spouse’s death and on or before December 31, 2012. . Those who drafted the 2010 Tax Act, those who worked on the regulations, and the Administration’s budget proposals obviously have envisioned portability as a permanent concept. That vision has now come to fruition.

Even though we did not know whether portability would be made permanent, it is prudent to assume that it would be and most practitioners preparing a Form 706 in 2011 or 2012 made the election (unless the decedent used the entire exemption or it was very unlikely that the surviving spouse’s total estate would exceed the exemption). That included not only the estates of decedents who died in 2012, which are addressed by the regulations and the 2012 estate tax return, but the estates of decedents who died in 2011, for which the return was due nine months after death or, if timely extended, 15 months after death.<sup>13</sup>

To the extent that the smallest estates may have the most unused exemption to pass on and therefore need the election the most, it might be hard to see portability as a simplification, especially as long as a return that is not required for estate tax purposes is still required to make the portability election. The regulations have done a great deal to make portability workable with minimum burden. Additional relief from the due dates, or from the return requirement itself, will have to come from Congress.

### **D. PORTABILITY VERSUS THE CREDIT SHELTER TRUST**

A popular rationale for portability is that it permits married couples to achieve the benefits of a credit shelter trust without going to the trouble of creating and administering such a trust. This is especially true for couples with assets whose combined estates exceed the amount of one exemption but not the amount of two exemptions. Thus, the appeal of portability is like a “middle class” tax benefit, although “middle class” may need a specialized definition to fit into the reach of the estate tax.

Even so, especially in the largest estates, a credit shelter trust will still offer advantages over portability, including professional management and asset

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<sup>13</sup> In Notice 2012-21, 2012-10 I.R.B. 450, released on February 17, 2012, the IRS granted a six-month extension of time to file the federal estate tax return to make the portability election in the case of married decedents who died in *the first six months* of 2011 with gross estates no greater than \$5 million. Thus, the first extended returns for decedents who died January 1, 2011, and the first unextended returns for decedents who died July 1, 2011, were both due April 2, 2012 (because April 1 was a Sunday).

protection for the surviving spouse, protection of the expectancy of children from diversion by the surviving spouse, especially in cases of second marriages and blended families as well as remarriage of the surviving spouse, and preservation of the predeceased spouse's exemption even if the surviving spouse remarries, the exemption is reduced, or portability sunsets. A credit shelter trust, unlike portability, will shelter appreciation and accumulated income during the surviving spouse's life from estate tax and will permit use of the predeceased spouse's GST exemption, because portability applies only to the gift and estate taxes. A credit shelter trust can also avoid the filing of an estate tax return for the predeceased spouse's estate, if the estate is not so large as to otherwise require a return.

On the other hand, for many couples, portability will offer advantages. Chief among these is the simplicity it is intended to achieve, including relief of any concern about the titling of assets. Thus, in the previous example of one spouse with an estate less than the exemption and the other spouse with an estate greater than the exemption, portability can permit full use of the less wealthy spouse's full exemption even if that spouse dies first. A perfectly drafted credit shelter trust in the less wealthy spouse's estate planning documents would still need portability to accomplish that. In addition, a simple bequest to the surviving spouse, relying on portability, could provide greater perceived security for the surviving spouse by eliminating the intervention of a trust and could also provide a second step-up in basis for appreciated assets at the surviving spouse's death. Where the protection of a trust is still desired, a QTIP-style trust can provide that protection but still obtain the second basis step-up. Finally, portability can be relied on, even in conjunction with a credit shelter trust, to eliminate *state* estate tax on the first estate in states with an estate tax and no state-only QTIP election.

## **X. PRESERVING FLEXIBILITY IN DOCUMENTS**

Because of the uncertainties with our tax system and in our economy, one cannot predict when and how the transfer tax landscape may change. In light of this general unpredictability, maintaining flexibility in estate planning documents continues to be an imperative. Many states have recently enacted legislation that provides additional planning flexibility. Techniques and features permitted under these new laws include:

1. Self-settled spendthrift trusts under which the grantor may be a beneficiary;
2. Decanting, which allows assets to be placed in a new trust for the beneficiaries;
3. Directed trustees who are protected when acting on the instructions of a "trust director"; and
4. Trust protectors who may make changes to carry out the grantor's objectives.

Estate planners should use drafting techniques that allow maximum flexibility to react to future changes in the law and changes in family circumstances. Beneficiaries, executors, trustees, and advisors will always need to evaluate the tax and other effects of exercising the powers or options that provide this flexibility, but the techniques discussed in this section may allow optimum flexibility to carry out the intention of a grantor or decedent or maximize available tax benefits in an uncertain transfer tax landscape.

#### **A. POWERS OF APPOINTMENT**

The use of powers of appointment allows a donor to make a gift to an irrevocable trust without having to make too many decisions about what may be best for future beneficiaries in an unknown tax climate. A donor creating an irrevocable trust for unmarried children may be reluctant to guess whether there will be grandchildren and whether they should inherit outright or through long-term trusts. Granting limited powers of appointment to the children to let them decide what is best for their own children, if any, is the best arrangement in many situations. If GST exemption is allocated to the trust at creation, the child will have the ability to exercise the power of appointment in a way that creates a generation-skipping trust to avoid estate taxes at the death of the child and at the deaths of the child's descendants.

The inclusion of powers of appointment in other estate planning documents allows beneficiaries to take a "second look" at a trust after its creation and when it becomes irrevocable. A testamentary power of appointment permits a current beneficiary who holds the power to make prospective changes that may affect future beneficiaries, effective upon the death of the current beneficiary. In contrast, an *inter vivos* power of appointment permits a current beneficiary to transfer property to other beneficiaries during the beneficiary's lifetime. An *inter vivos* power of appointment may appear less favorable initially because of possible adverse tax consequences, but *inter vivos* powers allow a beneficiary to provide an immediate benefit for the permissible appointees if appropriate to do so. The holder of an *inter vivos* power of appointment does not need to wait until his or her death to implement the flexibility provided by the grantor.

Estate planners must also be mindful of the tax treatment of general and limited powers of appointment. The holder of a general power of appointment is treated as owning the appointive property for estate tax purposes. If the holder dies holding the general power of appointment, the appointive property will be included in the holder's estate. Likewise, the exercise of a general power of appointment during the holder's life may trigger gift tax liability for the holder. In contrast, the holder of a special or limited power of appointment (that is, one that is not exercisable in favor of the holder, the holder's estate, the holder's creditors, or creditors of the holder's estate) is not treated as owning the appointive property for estate tax purposes. However, adverse GST tax consequences may still apply.

**Testamentary Powers of Appointment.** A testamentary power of appointment allows an estate plan to react to changes in the law or in family circumstances



without locking in any such changes until the death or incapacity of the holder of the power. A testamentary power of appointment may allow (i) the distribution of trust principal to a trust designed to better address new tax laws, (ii) the retention of more property for future generations if permitted by changes to the GST tax, or (iii) the distribution of property outright to beneficiaries if neither tax nor non-tax reasons justify the continued existence of a trust.

In drafting testamentary powers of appointment, individuals and their advisors should consider the permissible appointees of the power of appointment (for example, whether permissible appointees should be limited to the spouse or descendants) and whether the donee may appoint trust assets outright or in further trust. The ability to appoint trust assets in further trust requires consideration of restrictions on the duration of the new trust, the distribution of trust assets at trust termination, the ability of the donee to create separate trusts, or other aspects of the future disposition of the trust assets.

***Inter Vivos Powers of Appointment.*** The exercise of an *inter vivos* general power of appointment will be treated as a gift by the holder of an amount equal to the value of the trust interest transferred as a result of the holder's exercise of the power. Further, an *inter vivos* power of appointment may cause otherwise excludable trust property to be taxed in the holder's estate. The adverse tax consequences of *inter vivos* powers of appointment may be lessened through the use of the holder's annual exclusion amount. The 40 percent gift tax rate may lessen the tax sting. In some cases, the resulting gift by the holder (that is, the value of the trust interest surrendered by the holder) may be zero or have a nominal value. For example, if a trustee has discretion to make distributions to a surviving spouse for health and support needs that are not adequately provided for out of the surviving spouse's other assets and income, and the surviving spouse has significant independent assets, the value of the trust interest surrendered by the surviving spouse will have little value because of the unlikelihood that the surviving spouse could receive trust distributions.

## **B. DISCRETIONARY DISTRIBUTIONS**

The dispositive provisions of a trust provide guidance to the trustee on how and when trust assets may be distributed to trust beneficiaries. Permitting a trustee to make discretionary distributions to beneficiaries is a simple way to grant a trustee the flexibility to adapt to changing circumstances. Some individuals may not feel comfortable granting a trustee what may seem like unfettered discretion. These concerns may be alleviated by carefully selecting the initial trustee or trustees, including a corporate or other independent trustee, naming a successor trustee or providing a procedure for selecting the successor trustee, and directing when and under what conditions a trustee may be removed. The following is a list of drafting pointers and considerations with respect to discretionary distributions:

1. Be specific and clearly define the distribution standard;

2. Consider the combination of ascertainable and non-ascertainable standards;
3. Consider the use of an independent trustee or trust protector to make discretionary distributions under a non-ascertainable standard;
4. Permit the trustee to “decant” or distribute trust principal to a qualified trust for the benefit of the beneficiary, such as a new trust better designed to address current tax law;
5. Permit a surviving spouse who is the beneficiary of a marital trust to make annual exclusion gifts to children;
6. Permit the trustee to make unequal distributions to beneficiaries with no requirement of later equalization;
7. Allow the trustee to consider a beneficiary’s changing needs and circumstances, including other assets that may be available to the beneficiary, the beneficiary’s maturity level, the beneficiary’s need for asset protection, and whether the beneficiary would be motivated by the creation of an incentive system; and
8. Limit the discretionary power of a trustee to distribute trust property to himself or herself as a trust beneficiary to an ascertainable standard to prevent such power from being treated as a general power of appointment.

### **C. TRUST PROTECTORS**

Trust protectors serve as the watchful eyes over an irrevocable trust. Trust protectors can be granted, among other important powers, the power to amend an individual’s estate plan. For example, a trust protector can be granted the power to make administrative changes to a trust, such as changes to the procedures for the removal and appointment of trustees or changes to trustee investment provisions. A grantor may also allow a trust protector to make substantive changes to trust terms to address changes in tax laws or other legal, financial, or familial circumstances that may impact the trust. Some grantors may also choose to grant a trust protector the authority to make substantive changes affecting the beneficiaries of the trust, such as adding or removing beneficiaries, directing discretionary distributions, or altering an existing beneficiary’s interest in the trust. The authority of a trust protector can also be limited to specific transfer tax regime changes, for example by permitting the trust protector to act if the estate tax is permanently repealed or if it no longer applies to the grantor’s estate.

The selection of a trust protector requires careful consideration. Grantors may wish to appoint a trusted individual or advisor or a committee to serve as trust protector. Often, if the grantor is unable to name a trust protector in the trust agreement, a provision may be included permitting one or more beneficiaries, trustees, or third parties to appoint a trust protector if one is needed in the future. Grantors should

also consider how and when a successor trust protector should be appointed. The grantor of the trust usually should not serve as the trust protector because of potential adverse tax consequences. From a non-tax perspective, careful consideration should be given to naming a current or future beneficiary as trust protector because of the risk of potential abuse of the power and possible liability to the other beneficiaries. Exoneration and indemnification provisions in the trust document may shield the trust protector (whether a beneficiary or otherwise) from liability and encourage them to accept the role as watchdog over the trust.

#### **D. POWERS OF ATTORNEY**

Most individuals with comprehensive estate plans have a durable general power of attorney, whereby the individual or principal grants one or more agents the authority to act on the principal's behalf during the principal's life or upon the principal's incapacity. Powers of attorney may be used to add flexibility to an existing estate plan, but their effectiveness ceases at the principal's death. For example, a power of attorney may be used to grant the agent the power to make gifts to individuals and charities (either annual exclusion gifts or large lifetime gifts) or the ability to create, modify, or revoke a trust on behalf of the principal.

To be effective and induce reliance by third parties, estate planning related powers should be expressly granted and well defined. The Uniform Power of Attorney Act requires that a principal expressly grant an agent the authority to create, amend, revoke, or terminate *inter vivos* trusts, make gifts, and disclaim or refuse an interest in property, including a power of appointment. Planners should carefully review applicable state laws to see if similar requirements apply. When granting the agent a power to make gifts, the principal may wish to name permissible beneficiaries specifically or categorically or permit the agent to make large gifts consistently with the principal's pattern of lifetime giving. When granting the agent the power to deal with the principal's trust, the principal may wish to limit the agent's power to transferring assets to a revocable trust or condition certain powers on the principal's incapacity. In any event, powers of attorney for estate planning purposes should be durable to survive the principal's incapacity.

#### **E. DECANTING**

A number of states have enacted decanting statutes that allow a trustee to appoint trust assets in favor of another trust with new or modified terms that may better address changes in the tax law. Decanting statutes are also useful tools for dealing with changes in beneficiary circumstances, consolidating trust assets for administrative purposes, modifying trustee provisions (such as removal powers, appointment of successor trustees, and trustee compensation) or investment provisions, changing the situs or governing law of the trust, and correcting drafting errors. One major benefit of state decanting statutes is that the trustee may act without court approval.

States that have enacted decanting statutes include Virginia, New York, Alaska, Delaware, Tennessee, Florida, South Dakota, New Hampshire, North Carolina, Arizona, Nevada, Ohio, Michigan, Missouri, Indiana, Rhode Island, Illinois, and Kentucky. The state statutes vary in form with respect to whether (1) the beneficiaries' interests in the old and new trust must be similar, (2) the beneficiaries must be identical in the old and new trust, (3) a trustee who is also a beneficiary may exercise the decanting power, (4) the trustee must provide notice to the beneficiaries, and (5) the decanting statute permits the transfer of a trust to another state or applies to trusts that move into the state.

Grantors living in jurisdictions that have not enacted decanting statutes may wish to consider including the following provisions in a trust agreement:

1. A broad change of situs provision that allows the trustee to move the trust to a jurisdiction with a decanting statute;
2. Broad distribution provisions that specifically permit the trustee to distribute assets to one or more new trusts for the benefit of some or all of the beneficiaries;
3. An *inter vivos* power of appointment that permits a beneficiary to appoint trust property to a trust with different terms; and
4. A merger provision, taking into account any requirements under state law for the merger of trusts.

Grantors and their advisors may also wish to consider other state trust law provisions, including the Uniform Trust Code provisions adopted by many states and discussed below.

## **F. UNIFORM TRUST CODE**

The Uniform Trust Code, adopted by many jurisdictions, provides statutory fixes for common trust problems. Unlike state decanting statutes, many of these provisions require court consent. Nonetheless, these statutory provisions provide flexibility to grantors, trustees, and beneficiaries in dealing with irrevocable documents.

Section 411 of the Uniform Trust Code allows the modification of trusts by consent. A non-charitable irrevocable trust may be modified upon the consent of the settlor and all beneficiaries, even if modification is inconsistent with a material purpose of trust. Additionally, a non-charitable irrevocable trust may be modified upon the consent of all beneficiaries if the court concludes modification is not inconsistent with a material purpose of trust. Specific provisions govern who may initiate an action to approve or disapprove a proposed modification and who must signify consent. Court approval may be required.

Section 412 of the Uniform Trust Code permits the modification of trusts because of unanticipated circumstances. Under this section, a court may modify the administrative or dispositive terms of a trust if, because of circumstances not anticipated by the settlor, modification will further the purposes of the trust. A court may also modify administrative provisions if continuation of the trust on its existing terms would be impracticable or wasteful or impair the trust's administration. Court approval is required, and the court will consider the settlor's probable intent before permitting modification.

Section 415 of the Uniform Trust Code permits reformation to correct mistakes. A court may reform the terms of a trust to conform the terms to the settlor's intention if it is proved by clear and convincing evidence that both the settlor's intent and the terms of trust were affected by a mistake of fact or law. Action under this section must meet the high standard of clear and convincing evidence.

Section 416 permits modification of a trust to achieve the settlor's tax objectives. Under this section, a court may modify the terms of a trust in a manner that is not contrary to the settlor's probable intention to achieve the settlor's tax objectives. Further, the court may provide that such modification operates retroactively. This section may be critical for estates of decedents who die having not considered the effect of an increased exemption amount on their estate plan and its beneficiaries. Section 416 is an important tool when settlor's intentions are thrown off track by tax law changes.

Lastly, section 417 of the Uniform Trust Code permits the merger and division of trusts. Under this section, a trustee may combine two or more trusts into a single trust or divide a trust into two or more separate trusts if the result does not impair the rights of any beneficiary or adversely affect the achievement of the purposes of the trust. The trustee must provide notice to all qualified beneficiaries of the trust and will need to consider how tax attributes (for example, charitable deductions, capital loss carry forwards, and net operating losses) will be divided among the trusts.

In states that have not adopted the Uniform Trust Code, other trust laws may provide different ways in which to maintain flexibility in irrevocable documents.

## **G. SUMMARY**

Estate planning must continue even in times of uncertainty, and irrevocable trusts will continue to play an important role in this planning. Trusts offer many non-tax benefits, including disability protection, asset protection, protection of privacy, avoidance of probate, income tax planning, and greater protection against challenges to an estate plan.

The techniques addressed above allow individuals to defer decisions on how and when property will be distributed to beneficiaries. A grantor can place limits on how decisions will be made and what needs of beneficiaries or other matters should

be considered. Although the above drafting techniques and other tools may not be appropriate in all circumstances, their inclusion in a comprehensive estate plan will provide flexibility in permitting grantors, trustees, and beneficiaries to adapt to changing circumstances. The techniques described above can be invaluable for continued planning under the uncertain tax laws while maintaining the flexibility necessary to react to what Congress may do in the future.

## **XI. IMPACT OF STATE DEATH TAXES ON PLANNING**

Before the 2001 Tax Act, almost every state imposed a state death tax equal to the federal state death tax credit available under Internal Revenue Code section 2011. In addition, several states had stand-alone inheritance taxes. The 2001 Tax Act reduced the federal state death tax credit in stages from 2002 through 2004 and eliminated it in 2005, replacing it with a deduction under Internal Revenue Code section 2058. The 2012 Tax Act retained the federal deduction for state death taxes. Thus, those states that tied (or “coupled”) their state death tax to the amount of the current federal state death credit do not have a state death tax for decedents dying in 2013.

Several states did not lose their state death taxes because of the phase-out of the state death tax credit under the 2001 Tax Act because those states did not tie their state death taxes to the current federal state death tax credit. Instead, those states had tied their state death taxes to a prior year’s state death tax credit. These were sometimes referred to as “decoupled” states. Other states that faced the loss of their state death taxes acted to retain their state death taxes by various means, such as decoupling the state tax from the federal credit, determining the state tax by reference to pre-2001 Tax Act law, or imposing a stand-alone state death tax regime. In addition, the states that retain a state death tax often have lower thresholds for the imposition of the state death tax than the federal threshold.

Planning for individuals who reside in one of these states or who have property subject to a state tax is more complicated than planning for individuals who are not subject to separate state death taxes. The states that currently have a separate state death tax (and their thresholds for tax) are:

<b>State</b>	<b>Type of Tax</b>	<b>2013 Estate Tax Filing Threshold</b>
Connecticut	Stand-Alone Estate	\$2,000,000
Delaware	Estate	\$5,250,000
District of Columbia	Estate	\$1,000,000
Hawaii	Stand-Alone Estate	\$5,250,000
Illinois	Estate	\$3,500,000
Indiana	Inheritance <sup>14</sup>	
Iowa	Inheritance	
Kentucky	Inheritance	
Maine	Estate	\$2,000,000

<sup>14</sup> Indiana’s inheritance tax is being gradually phased out and will end on December 31, 2021.

State	Type of Tax	2013 Estate Tax Filing Threshold
Maryland	Estate and Inheritance	\$1,000,000
Massachusetts	Estate	\$1,000,000
Minnesota	Estate	\$1,000,000
Nebraska	County Inheritance	
New Jersey	Estate and Inheritance	\$675,000
New York	Estate	\$1,000,000
North Carolina	Estate	\$5,250,000
Oregon	Estate	\$1,000,000
Pennsylvania	Inheritance	
Rhode Island	Estate	\$910,725
Tennessee	Inheritance <sup>15</sup>	
Vermont	Estate	\$2,750,000
Washington	Stand-Alone Estate	\$2,000,000

The effective combined federal and state tax rate for estates subject to tax in those states that are decoupled from the current federal state death tax credit varies depending upon whether the state permits the taxpayer to take into account the federal deduction in calculating the state tax. Internal Revenue Code section 2058 allows a deduction for the state death tax in calculating the taxable estate, which generally resulted in an iterative (or algebraic) calculation. In some of those states, however, the state law does not allow a deduction for the state tax in calculating the state tax itself. This avoids the iterative calculation, but it changes the effective state and federal tax rates. The federal estate tax return (Form 706) was redesigned to accommodate the calculation of tax in such a state by providing a separate line for calculating a “tentative taxable estate” net of all deductions except state death taxes, a separate line for deducting state death taxes, and a separate line for the federal taxable estate. The “tentative taxable estate” in effect was the taxable estate for calculating the state tax (but not the federal tax) in such a state.

## **XII. CHARITABLE PLANNING IN 2013**

Statistics about charitable giving during the Great Recession confirmed that individuals and corporations not only reined in their spending during 2008 and 2009, but also decreased their charitable giving. According to *Giving USA*, 2008 saw the largest drop in annual giving in more than 50 years at 5.7 percent.<sup>16</sup> But, donors continued to give with donations of \$303.75 billion to charity in 2009 (as compared to \$315.08 billion in 2008).<sup>17</sup> Since then, there has been little growth in charitable giving, with *Giving USA*, 2012<sup>18</sup> finding

<sup>15</sup> Tennessee’s inheritance tax is being gradually phased out and will end on December 31, 2015.

<sup>16</sup> Strom, “Charitable Giving Declines, a New Report Finds,” *NY Times* (June 9, 2009) available at <http://www.nytimes.com/2009/06/10/us/10charity.html>.

<sup>17</sup> “U.S. Charitable Giving Falls 3.6 Percent in 2009 to \$303.75 Billion,” available at <http://www.philanthropy.iupui.edu/news/2010/06/pr-GUSA2010.aspx>.

<sup>18</sup> Hall, “Donations Barely Grew at All Last Year, ‘Giving USA’ Finds,” available at <http://philanthropy.com/article/Donations-Barely-Grew-at-All/132367/>.

growth in charitable giving in 2011 of only 0.9 percent after adjustments for inflation with estimated donations totaling \$298.4 billion, representing an 11 percent decline over charitable giving before 2008. But, despite these declines, substantial wealth continues to be transferred to charities each year. This indicates that, for many people in the United States, philanthropy is important and, while the amount of charitable giving may be impacted by the current tax uncertainties and economic downturns, many people continue to give generously despite declines in their portfolios and their uncertainty over future tax rates.

This continuing desire to fund charitable causes does, however, require advisors to work with donors to enable them to give “smarter.” Also, scheduled increases in the income tax rates, including the capital gains rate, may make charitable gifts (and particularly charitable gifts of appreciated property) more attractive than in the past as philanthropically inclined individuals search for ways to minimize their income tax burden.

There are also certain gift techniques that are particularly attractive and others that require the exercise of greater caution in the current low-interest rate environment. The section 7520 rate used to value many types of planned charitable is at 1.0 percent in January 2013 where it remained until October 2012 when it went up slightly to 1.2 percent.<sup>19</sup> Historically low section 7520 rates favor certain planned giving techniques, such as charitable lead annuity trusts and gifts of a remainder interest in a residence or farm. But, the low section 7520 rates may make certain gift techniques, such as charitable remainder trusts, inaccessible for certain younger donors and will impact the donor’s income tax charitable deduction for certain planned gifts.

**A. EFFECT OF ESTATE TAX UNCERTAINTY ON BEQUESTS AND OTHER TESTAMENTARY TRANSFERS**

While many claim that the estate tax laws do not deter a charitably inclined donor from leaving assets to charity at death, taxes do affect many donors’ planning and decisions. It is clear that, if Congress does not act, the estate tax benefits of charitable bequests or other testamentary charitable gifts will increase in 2013. Many donors who were not considering charitable dispositions in the estate plan may be more willing to do so as the cost of the gift to the donors’ families will be less if the estate tax rate is higher and the exemption amount is lower in 2013.

Donors who are considering leaving assets to charity at death, whether outright or through some type of planned giving vehicle, should closely monitor the unpredictable activity in Congress on the estate tax laws.

**B. EFFECT OF LOW SECTION 7520 RATES ON CHARITABLE GIVING TECHNIQUES**

Fluctuations in the section 7520 rate used to value many types of charitable gifts, including charitable lead trusts, charitable remainder trusts, charitable gift annuities, and remainder interests in personal residences or farms can have a dramatic effect

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<sup>19</sup> I.R.C. § 7520.



in certain circumstances on the amount of a donor's income or transfer tax charitable deduction. The rates, which vary monthly, have ranged from a high of 11.6 percent in 1989 to a low of 1.0 percent in July, August, September 2012 and January 2013. These low rates offer some opportunities and pitfalls when planning a charitable transfer using one of these vehicles.

**Charitable Lead Annuity Trusts Offer Unique Opportunities.** While charitable lead unitrusts are not affected significantly by fluctuations in the section 7520 rate, charitable lead annuity trusts are affected by the section 7520 rate and lower section 7520 rates generally increase the value of the charitable lead interest. With a charitable lead annuity trust, a fixed amount is paid to a charitable beneficiary for either a term of years or during someone's lifetime. Upon expiration of the term, the remaining assets of the trust pass to the donor's designated beneficiaries (frequently children in the case of a charitable lead annuity trust because of GST tax considerations). Unlike charitable remainder trusts, there are no limits on the number of years of the charitable term and no minimum or maximum annuity amount.

While the donor is not entitled to an income tax charitable deduction upon the establishment of the charitable lead annuity trust unless it is structured as a grantor trust for federal income tax purposes, the donor is entitled to an estate or gift tax deduction for the value of the charitable lead interest. Assuming a non-grantor trust, the trust will be entitled to an income tax charitable deduction each year for amounts of its gross income paid to charity under the terms of the trust agreement.<sup>20</sup> Because the present value of the remainder interest (i.e., the transfer to the children) factors in the delay in the children's receipt of and control over the trust assets, these assets are valued at a discount, resulting in a smaller transfer or gift to the children.

Although the value of the charitable interest is limited to the value of the property transferred to the trust, it is possible for a donor to create a charitable lead annuity trust with a charitable interest equal (or nearly equal) to the value of the property transferred to the trust. With these so-called "zeroed out" charitable lead annuity trusts, the remainder interest passing to the non-charitable beneficiaries would be equal to zero or of nominal value, and the donor would incur no (or nominal) gift or estate tax as a result of the creation of the trust. With lower section 7520 rates, the remainder interest can be reduced to zero with shorter terms and lower payouts than would be the case at higher section 7520 rates. The following table shows payout rates and trust terms that "zero out" the remainder value in a charitable lead annuity trust assuming a 1.0 percent section 7520 rate and quarterly payments made at the end of each quarter to charity.

***CHARITABLE LEAD ANNUITY TRUST FOR TERM OF YEARS***  
**Payout Rates to Zero Out or Produce Nominal Remainder Value**

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<sup>20</sup> I.R.C. § 642(c).

Trust Term in Years	Payout Rate
10	10.520%
15	7.185%
20	5.522%
25	4.524%
30	3.861%

With a zeroed out charitable lead annuity trust, if the trustee's investment of the transferred assets yields a higher return than the section 7520 rate during the trust term, the excess return passes to the children free from transfer tax.

**Example.** Consider a donor who wishes to contribute \$100,000 annually to her favorite charities for 20 years. She transfers \$1,810,938 to the trust and directs annual charitable payments of \$100,000 (or 5.522 percent of the value of the initial assets contributed to the trust). At the end of the 20-year term, the trust assets are to be distributed to her daughter. Assuming the section 7520 rate is 1.0 percent, the donor is entitled to a gift tax charitable deduction equal to the amount transferred to the trust and there is no gift to the daughter for gift tax purposes. During the 20-year term of the trust, the trust assets earn an annual return of 5 percent. At the end of the charitable term, the trustee will distribute the remaining assets, worth \$793,160, to the donor's daughter, free of transfer tax. If the trust assets earn an annual return of 7 percent, the distribution to the donor's daughter at the end of the charitable term will be \$1,546,489.

**Gift Annuities Still Offer Benefits Despite Low Rates.** In uncertain economic times, many donors favor the security of fixed payments offered by a charitable gift annuity, as well as the simplicity of establishing a gift annuity. With a gift annuity, the donor transfers assets to a qualified charitable organization in return for the charitable organization's agreement to pay the donor or another beneficiary an annual annuity for life. For income tax purposes, the donor is entitled to an income tax charitable deduction equal to the difference between the fair market value of the property transferred and the value of the annuity contract. A portion of the income received by the donor will be taxable as ordinary income, while a portion may be exempt from federal income tax. If the gift consists of appreciated property, the transfer is treated as a "bargain sale" (i.e., part gift, part sale). Assuming the donor is the annuitant, any capital gains attributable to the sale portion of the gift are reported over the donor's lifetime.

Many donors like the certainty of receiving an annual fixed amount. Of course, because a charitable gift annuity is a contract with a particular charity, the financial viability of the charity can present a risk to the donor. Any donor entering into a gift annuity arrangement with a charity should undertake appropriate due diligence

before making the transfer to determine the financial stability and longevity of the charity.

The current low section 7520 rates significantly reduce the available charitable deduction for the gift associated with a gift annuity. But, for a donor interested in tax-free income and not concerned with the amount of the charitable deduction, the low section 7520 rates have a significant and advantageous impact on the exclusion ratio, which is the amount of the annuity payments that will be excluded from income each year for federal tax purposes.

**Example.** If a donor who is age 65 gives property in return for a 4.7 percent annuity, which is the current rate recommended by the American Council on Gift Annuities,<sup>21</sup> with a 7.0 percent section 7520 rate, the donor's charitable deduction is 55.7 percent and the exclusion ratio for the annuity payments is 47.08 percent. If the section 7520 rate is 1.0 percent, however, the donor's deduction decreases to 25.1 percent, while the exclusion ratio increases to 79.71 percent.

Other problems can arise with charitable gift annuities if the value of the charitable gift is not at least 10 percent. The debt-financed property provisions of the unrelated business income tax rules that apply to charities provide that the charity will not have debt-financed property as a result of entering into the gift annuity arrangement if, among other requirements, the value of the annuity payable to the donor or other annuitant is less than 90 percent of the value of the property transferred to the charity.<sup>22</sup> Charitable gift annuities for younger annuitants can easily run afoul of these rules, even when using the American Council on Gift Annuities' recommended rates. For example, the recommended rate for an annuitant who is 38 years old is 2.9 percent. Using a section 7520 rate of 1.0 percent, the value of the donor's annuity interest exceeds 95 percent. This transaction would run afoul of the debt-financed property rules, and the charity would most likely be unwilling to enter into the arrangement under these terms.

**Gifts of a Remainder Interest in a Personal Residence or Farm Offer Favorable Deduction Despite Retained Interest.** Unlike most planned giving vehicles where the donor retains an interest and which are adversely impacted for donor deduction purposes by low section 7520 rates, the charitable deduction for a gift of a remainder interest in a personal residence or farm is enhanced by a lower section 7520 rate. The federal tax laws allow a charitable deduction for income, estate, and gift tax purposes for a charitable gift (not in trust) of a donor's personal residence (including a vacation home or second residence) or farm, even though the donor retains an estate in the property for life or a term of years. The donor may

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<sup>21</sup> The rates recommended by the American Council on Gift Annuities can be found at <http://www.acga-web.org/giftrates.html>.

<sup>22</sup> I.R.C. § 514(c)(8)(A).

either retain a life estate or give one to others, and the life estate may be for one or more lives.<sup>23</sup>

Many donors have charitable commitments but have watched their liquid assets decline in value as a result of the economic downturn. Others continue to be wary about large transfers to charity as a result of tax and economic uncertainty. For a donor interested in satisfying a charitable commitment or obtaining an income tax charitable deduction currently, a gift of a remainder interest in a personal residence or farm may be appropriate as it will have little, if any, immediate impact on the donor's lifestyle and liquidity.

**Existing Charitable Remainder Trusts Offer Opportunities.** Many donors are unwilling to consider charitable remainder trusts currently not only because of the tax and economic uncertainty but also because of the depressed values of the charitable remainder interests with low section 7520 rates. But for donors with existing charitable remainder trusts, the low section 7520 rate may offer an opportunity for additional income tax planning.

During the booming stock market of the 1990s, many people took advantage of the opportunity afforded by charitable remainder trusts to make tax-deductible contributions to charity while at the same time reserving what was expected to be substantial future income on the donated property. The expectations of these donors have not been realized in many cases as a result of the Great Recession. The disappointment has been particularly sharp for those who established charitable remainder unitrusts as donors have watched trust values, and correspondingly unitrust payments, decline. For those who established charitable remainder annuity trusts, many are faced with the uncertainty as to whether the trust will have sufficient assets to satisfy the annuity payments during the full term of the trust and whether the charitable beneficiary will ever reap any benefits from the trust. For a donor who may not need the income and still wishes to make a sizable contribution to the charitable remainderman, the time may be appropriate to consider a gift of the donor's unitrust or annuity interest to the charitable remainderman. The donor will be entitled to an income tax charitable deduction for the value of the annuity or unitrust interest, and the charitable remainderman will be able to use the assets in furtherance of its mission immediately.

## C. SUMMARY

As the significant dollar amounts given to charity each year indicate and despite recent declines in the amount given to charity, Americans continue to find ways to fund charitable endeavors despite economic and tax uncertainties. For those individuals who want to continue to achieve their philanthropic goals, there are unique opportunities created by the current environment. For those willing to see the silver lining, favorable and tax-advantaged charitable giving opportunities are available.

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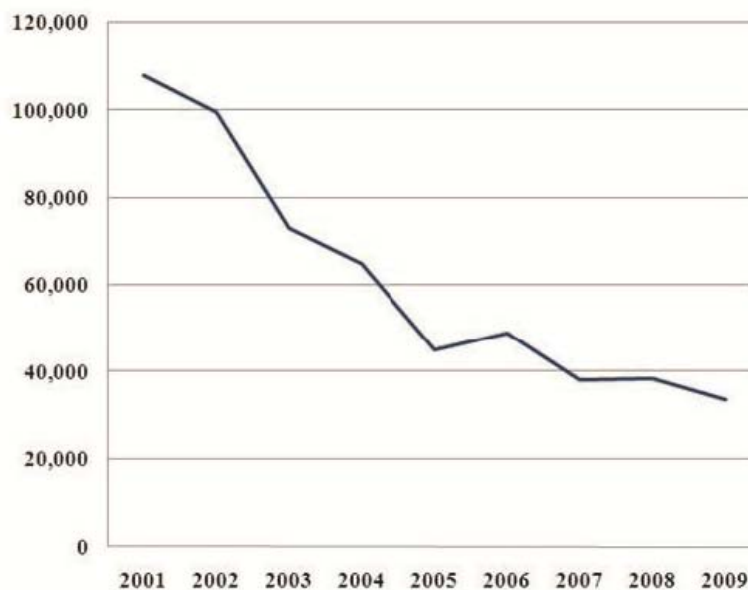
<sup>23</sup> I.R.C. § 170(f)(3)(B); Treas. Reg. § 1.170A-7(b)(3), (4).

### XIII. THE FUTURE OF ESTATE PLANNING

- A. The uncertainties surrounding the U.S. Transfer tax system and the worldwide economy have caused many clients and financial advisors to wonder what the future of estate planning and tax planning will be. During the last several years, the United States has experienced significant economic volatility and constant changes and uncertainties in the tax laws. Since 2009, there have been two different gift tax rates, three estate tax rates, and four different estate tax exemptions. Despite the myriad of changes, many estate planners have not changed their practices. Many clients today are given the same trust agreements, with the same terms, that were recommended to their parents.
- B. The future of estate planning will be determined by many factors. In particular, tax reform and demographic changes will likely alter the way that estate planners advise clients. Changing transfer tax laws should change the plans and techniques that estate planners recommend and implement. As the country's demographics shift, so too should the terms of a typical estate plan. Estate planners need to anticipate these changes and educate themselves about how properly to adapt to the changes to provide appropriate advice to clients. Because clients' needs are ever-changing, tomorrow's planning should not mirror today's.

#### C. TAX REFORM

1. Between 2001 and 2009, as the exemption increased from \$675,000 to \$3.5 million, the number of estate tax returns filed correspondingly decreased. The graph below, sourced from the IRS Statistics of Income, shows that during this time period the total number of filed estate tax returns fell by almost 70 percent.



2. Nevertheless, during that same time frame, the amount of estate tax collected by the IRS decreased only by roughly 10 percent.

<b>Size of Gross Estate</b>	<b>2000 Amount of Tax Collected</b>	<b>2009 Amount of Tax Collected</b>	<b>Comparison of 2009 to 2000</b>
Under \$5.0 million	\$139,629,621	\$73,908,168	(\$65,721,453)
\$5.0 million < \$10.0 million	\$23,286,561	\$36,254,509	\$12,967,948
\$10.0 million < \$20.0 million	\$15,253,132	\$25,319,240	\$10,066,108
\$20.0 million or more	\$39,233,112	\$59,092,781	\$19,859,669
All Returns	\$217,402,426	\$194,574,699	(\$22,827,727)

3. Given that the total revenue did not decrease substantially as the number of estate tax returns filed dropped sharply, Congress may be inclined to keep or reinstate higher exemptions because doing so may not significantly diminish revenue. So, we would not be surprised if Congress acts, either before or after the beginning of 2013, to reinstate the \$5.0 million estate and gift tax exemption on a long-term basis.

4. **Responding to a Higher Exemption.** An increased gift and estate tax exemption should generally lead to less estate tax planning work for clients with a net worth of \$10 million or less. With a \$5.0 million exemption, married clients with \$10.0 million or less will require little estate tax planning, if any. Fewer individuals will be subject to the federal estate tax so fewer families will require any estate tax planning. The planning emphasis for clients with a net worth of \$5.0 million or less should be income tax planning, non-tax considerations in estate planning such as asset protection, and business succession planning. Estate tax planning for those clients will be a secondary consideration.

On the other hand, an increased gift and estate tax exemption should also lead to additional estate tax planning for ultra-high net worth clients. The increased exemption creates greater opportunities for lifetime gift planning. Clients may choose to make more gifts during their lifetimes using a variety of tax planning techniques to freeze or reduce the value of their estates.

5. **Portability.** Portability will further reduce the amount of estate tax planning that couples with assets valued at \$10.0 million or less will require, although this might be offset somewhat by increased needs after the first spouse dies. Even with respect to high net worth clients, estate planners will likely adapt to portability by recommending fewer basic two-trust plans (i.e., a credit shelter trust and a marital trust) and instead using

portability to take advantage of the surviving spouse's ability to use the remaining estate tax exemption of the first spouse to die. Whether an estate planner recommends that a client create a credit shelter trust will depend on many factors, particularly the income tax basis of the client's property and the need for asset protection, but the estate planner must be well versed in these considerations and the portability rules to advise clients properly.

6. **State Death Taxes.** Currently, 22 states and the District of Columbia have a separate state death tax. The economic downturn, loss of state revenues, and state budget shortfalls may lead many states that lack a state death tax to enact new state death tax legislation. Between 2009 and 2011, four states, Delaware, Vermont, Hawaii, and Illinois, have either reinstated their state death tax or lowered the threshold for taxation. However, some states, including Virginia, Wisconsin, Illinois, Kansas, and Oklahoma, have phased-out or eliminated their state death taxes at different points during the period from 2002 to 2010. As discussed in section IX, the variation in state laws since the enactment of the 2001 Tax Act has and will continue to result in an increase in estate planning complexity for individuals domiciled or owning property in states with a state death tax. In the past, individuals have explored numerous techniques for dealing with state death taxes, such as change of domicile, creation of legal entities to hold real property and tangibles, and the use of lifetime gifts. We expect these techniques will continue to be important in addressing the varying and changing state death tax legislation.

#### **D. CHANGING DEMOGRAPHICS**

Changes in the demographics of the United States and the typical client and his or her family will significantly affect estate planning norms and the questions estate planners should ask their clients in crafting estate plans for these clients.

**Family Planning Later in Life.** In the U.S., individuals are marrying later and more than ever are choosing not to marry at all. The table below, sourced from the 2010 United States Census, shows that the median age of marriage has continued to increase in the last two decades.

<b>Year</b>	<b>Males</b>	<b>Females</b>
1990	26.1	23.9
2000	26.8	25.1
2005	27.0	25.5
2010	28.2	26.1

Similarly, women are having children later in life and having fewer children. The median age of women for their first childbirth in 1970 was 21.4 and by 2006 had risen to 25.0. Advances in reproductive technology have contributed to births at

later ages and the traditional two-parent heterosexual family is not always reflective of today's estate planning clients and their children. Childbearing for unmarried women reached record levels in 2008, with more than 40.6 percent of all births to unmarried women, with the most dramatic increase in non-marital births among women over the age of 30.

**An Aging Population.** Americans are living longer and the percentage of our population over age 65 is expected to dramatically increase in the next 20 years. Individuals over age 65 represented 8.1 percent of the total population in 1950. That percentage increased to 12.8 percent in 2009 and is projected to reach 20.2 percent in 2050 with a sharp increase from 2010 to 2030 as the "baby boom" generation reaches age 65. Young people are also increasingly mobile resulting in geographic separation between generations of families and less ability for children to care for their aging parents.

#### **E. RESPONDING TO DEMOGRAPHIC CHANGES**

**The Typical Client.** These demographic shifts, along with the increase of non-traditional families because of new fertility options and co-habitation of unmarried couples, are changing the estate planning environment. Estate planners should review their default drafting choices, particularly marital deduction planning, and communicate with clients about their goals and family circumstances to account for these changes.

**Adjusting Trust Provisions for Later Principal Distributions.** As individuals choose to marry and have children later, the financial pressures of starting a family are potentially experienced later in life than in the past. Estate planners should consider increasing the typical ages at which trustees are required to make principal distributions to the beneficiaries under standard trust documents and also providing for later trust termination dates to provide continued financial support as children mature and start families at a later age.

**Expanding Powers of Appointment.** As more clients' children choose not to have children of their own, estate planners should consider revising typical default provisions for the disposition of trust property to a child's descendants at death. By expanding *inter vivos* or testamentary powers of appointment, beneficiaries without descendants can make alternative dispositions of the trust property that are consistent with the grantor's overall estate planning objectives.

**Planning for Unmarried Couples.** With more individuals in committed relationships choosing not to marry, state intestacy laws may not adequately reflect the desired disposition of an individual's assets upon his or her death. Further, important aspects of the federal estate and gift tax laws such as the marital deduction and portability will not be available to unmarried couples. Estate planners must consider these factors, adapt their usual practices, and advise their clients accordingly.



**Communication about Age-Related Issues.** Practitioners will also begin responding to an increased number of elder law matters as their clients age, live longer, have more healthcare needs, and have longer retirement income needs. As the current trend of children living farther away from their parents continues, clients may rely more on non-relatives for care and on their advisors for increased services such as routine bill paying and administrative matters. Estate planners must also be aware of elder law issues and the potential for elder financial abuse and should consider ways in which they can protect their clients through changes to their estate planning documents, powers of attorney, and advance medical directives.

**F. SUMMARY**

While it is difficult to predict how Congress will act and the future opportunities tax reform will present, demographic changes in our population are already taking shape. Changes in the population and the tax laws have altered and will continue to alter the estate planning landscape. Estate planners and financial advisors need to be aware of these changes and educate themselves about potential opportunities to adapt properly and be in a position to advise clients appropriately.

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