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NEWSLETTER

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EVENTS:

Presentation and Continuing Education:x
Business Transition Planning Workshop. Business succession planning. Wednesday, January 25, 2012 at 8: a.m.. Presented in part by Bradford N. Dewan Blue Summit Wealth Management. ***Conference Information***.

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LEGISLATIVE UPDATE

FALLING INTEREST RATES ALLOW FOR GIFTING AT SUBSTANTIALLY REDUCED TAX VALUES

Timothy Polacek and DeEtte L. Loeffler

In January 2012, the interest rate used to value gifts of future interests decreased to 1.4%, the lowest rate ever, and reflects a considerable decline from its more traditional long-term average of 5.0% in December 2007. For persons who intend to make large gifts in 2012 and apply a portion of their $5,000,000 lifetime gift exemption, there is a fantastic window of opportunity for gifting *future* interests to children at dramatically low values.

Gifting Future Interests Using GRATs and QPRTs

A gift can be structured by having the donor retain the benefits of an asset for a period of years and, thereafter, having the remainder interest pass to the donee. The passing of such a remainder interest is referred to as a "future" interest gift because while the gift is made now the property is transferred to the donee at a future date. Because the gift is delayed far into the future, its value for transfer tax purposes is much lower than an outright gift of a present interest in the property. For persons who either need to retain an income stream, or use of an asset, future gifts can be an excellent way of removing appreciation in value from the donor's taxable estate at death.

The most commonly used techniques for making future interest gifts are the Grantor Retained Annuity Trust (GRAT) and Qualified Personal Residence Trust (QPRT). Each of these trusts has been approved by Congress and the Internal Revenue Code set forth clear rules that apply to these trusts. This allows certainty in determining gift values and reduces IRS audit scrutiny.

To illustrate, assume a 55 year old donor owns a $1,000,000 commercial real property that is subject to a 20 year, triple net lease that produces income at 6.25% annually. Provided the donor has other assets to give long-term financial security, this property could be placed into a GRAT having a term of 20 years, and the donor could receive an annual $61,000 payment from the trust. At the end of the term, the property would pass to the donor's children. Because interest rates are at an all-time

low, the value of this gift would be only $49,953 and the property would pass to the next generation for a very nominal gift value. In comparison, the same transfer would have resulted in a $293,830 gift had it been made in 2007 when interest rates were at 5.0%. This example demonstrates the window of opportunity that now exists for gifting similar type high income assets.

Alternatively, consider the situation where the same donor has a $1,000,000 vacation home that he wants to keep in the family for future generations. In such case, the transfer of the property into a QPRT having a term of 20 years would allow the donor to retain the full use of the property, pay all expenses during the term, and have the property transfer to the children in 2032, all for a $536,000 taxable gift. Although this gift is larger than the GRAT gift in the above example, it reflects a 46% discount to value and would use only a small portion of the donor's current lifetime $5,000,000 gift exemption.

In evaluating these techniques, an asset is transferred to an irrevocable trust and the donor must survive the term of the trust. In drafting the trust, the terms can be customized to reflect a shorter term of years in order to provide a higher level of certainty that the gift will be completed as planned.

How Interest Rates Effect Future Gift Values

Low interest rates increase the value of the donor's retained interest compared to high interest rates. This means that the taxable value of the remainder interest that will pass to the next generation will be lower in periods when interest rates are depressed, as is currently the case.

Many professionals are anticipating higher interest rates in the future as a result of the large national debt that must be repaid. If interest rates rise in the future, as expected, it is very likely that the first quarter of 2012 will be viewed as an advantageous period for taking advantage of low interest rates. Moreover, if the lifetime gift exemption is decreased in 2013 to $1,000,000 due to the scheduled lapse of the Bush Tax Cuts, the present window of opportunity for making large non-taxable gifts will close.

Customized Planning

GRAT and QPRT estate planning techniques not only involve calculating the value of the gift, but also require additional consideration as to the factors that will exist at the end of the selected term. Depending on the identity and age of the donees, additional planning may be appropriate. For example, gifts of limited partner interests or non-voting stock might be better for transfers to grandchildren who will lack the experience and maturity of older generations. Similarly, gifts of real property to children that will vest at a future date can be combined with tenancy-in-common agreements that anticipate possible future events such as divorce, bankruptcy or the need for cash to pay long-term health care expenses. Depending on the asset, additional contracts or agreements may be drafted to minimize the risk that the donee's circumstances have changed dramatically.

In dealing with these types of issues, a GRAT can be structured so that the donor possesses a power to remove the gifted asset from the trust and replace it with an asset of equal value. This is known as a "substitution power" and can be used by the donor at any time during the GRAT term to replace the gifted property with a more suitable asset. This type of a power makes a GRAT a very flexible device for long-term planning.

WHY PORTABILITY MAY SIMPLIFY MANY ESTATE PLANS

Timothy C. Polacek and DeEtte L. Loeffler

In late 2010, Congress decided that a surviving spouse could reduce future estate taxes by applying the unused exemption of deceased spouse. This change was quite remarkable because, previously, the unused exemption of a deceased spouse could not be transferred to a surviving spouse and simply disappeared. Essentially, Congress made the estate tax exemption "portable" for married persons (hence the transfer of the exemption is now referred to as "Portability") and there is a good chance it will become one of the most important aspects of future estate planning.

Under this new law, many couples are worrying less about estate tax because their combined available exemptions generally exceeds their net worth. Spouses are also less worried about having to engage in more complex planning to ensure none of their estate tax exemptions are wasted. Instead, the primary concern has shifted to whether Congress will make the new law permanent or allow it to lapse at the end of 2012.

The New Era of Portability

To understand how Portability works, let's assume a married couple has a community property estate of $6 million. Upon the death of a spouse in 2012, his one-half share of the estate, $3 million, is less than the current $5 million estate tax exemption, so any estate tax is covered by this exemption. If the couple's plan provides for the deceased spouse's share to pass into a bypass trust to shelter $3 million of assets from estate tax at the survivor's death, the surviving spouse will have a taxable estate of only $3 million (representing the other one-half of the $6 million estate). Further, by electing Portability, the $2 million unused estate tax exemption of the deceased spouse is carried over to the survivor to give her a combined $7 million estate tax exemption.

Alternatively, if the couple's plan provides for all assets to pass into a single "survivor's trust," the survivor would have a $6 million estate. Upon her demise, estate tax would not be owed by the surviving spouse because the current $5 million estate tax exemption and the $2 million carried over exemption (assuming Portability is elected) is sufficient to pay the tax.

As demonstrated above, the election of Portability and the amount of the estate tax exemption are critical components in analyzing one's estate tax liability. Although today's asset values have fallen from past amounts, many couples remain concerned that Congress will decrease the amount of the estate tax exemption. For most couples, understanding Portability and keeping abreast of current information regarding the future amount of the estate tax exemption will be the primary factors in arranging their estate plans.

Qualifying For Portability

To qualify for Portability, certain requirements must be satisfied. First, both the deceased spouse and the surviving spouse must die in a year in which Portability applies. Second, *the executor for the first deceased spouse must file a timely estate tax return even if no taxes are due*. Third, only the unused exemption of the most recently deceased spouse is available for use, so remarriage can affect the available exemption.

There has been little discussion regarding the permanence of Portability and the current $5 million estate tax exemption. However, President Obama's 2012 budget proposal includes a $3.5 million exemption and a 45% maximum estate tax rate. Most likely, the outcome of the national elections at year-end will determine the future of these provisions. In the meantime, estates are advised to take advantage of Portability to the greatest extent possible, given the substantial tax savings it conveys. Executors and trustees should file estate tax returns to make the Portability election or, if such action is not taken, they should obtain written consent from beneficiaries approving the decision not to pursue the benefits of Portability. The failure to obtain such consent will be magnified if Congress allows the current $5 million exemption to lapse at year end, returning the exemption to $1 million (and a maximum 55% tax rate).

What Happens to Bypass Trust Planning?

For modest size estates (e.g., less than $2 million), the biggest planning issue will be whether to leave assets entirely to a single survivor's trust or to have assets pass into a traditional bypass trust to reduce the size of the survivor's taxable estate. The answer to this question will depend on each couple's circumstances, goals and objectives. For example, those who wish to be able to take the step-up in income tax basis on assets at the second death may prefer to forgo bypass planning.

If a couple believes Portability and/or the $5,000,000 estate tax exemption will be made permanent, may want to opt out of the more cumbersome bypass trust planning and simply elect to use a Survivor's Trust. To minimize risk, plans can be drafted so the surviving spouse can disclaim assets at the first death so that property can be placed into a bypass trust. This will cause all of the assets to pass to the survivor's trust unless circumstances warrant also funding a bypass trust. Whether a bypass trust will be necessary for most couples will depend on the need to receive the benefits that stem from such planning, namely, creditor protection and financial security to the survivor, with greater protection of the inheritance rights of the remainder beneficiaries (e.g. children and/or grandchildren).

Bypass trusts will likely remain popular with younger business owners who desire asset protection, and couples who want to ensure assets will be available for long-term care and the next generation, as occurs in many blended families where the heirs of the surviving spouse may be different than those of the deceased spouse. Further, in cases where there are assets that are likely to appreciate considerably in value, placing such property into a bypass trust will remain an attractive option for the surviving spouse (unless capital gains are a more pressing consideration). Because Portability does not apply to non-citizens, such spouses with estates larger than the estate tax exemption will continue to need bypass

planning. Finally, because Portability does not apply to the generation skipping tax exemption, the only way to preserve the first spouse's exemption for future generations is through the use of a bypass trust. In all instances, the advice of professional advisors will be of great value to families who need to evaluate their options and needs.

Who May Benefit From Portability

Certain estates will benefit more from Portability than others. Those estates valued above the current individual estate tax exemption and those estates whose value will grow beyond the individual estate tax exemption can take advantage of Portability. For example, couples with net worth between $2 and $10 million can avoid estate tax at the first death using typical bypass planning. However, if the exemption is allowed to decrease to $1 million per person in 2013, such estates could face a tax at the second death. Electing portability would allow the surviving spouse to take advantage of exemption that would otherwise be wasted at the first death to increase the amount exempted from tax at the second death. For example, a couple with $7 million at the first death would fund $3.5 million in each of the Survivor and Bypass Trusts. At the second death in 2013, the surviving spouse's estate would be subject to estate tax on $2.5 million ($3.5 - $1 exemption). However, if Portability had been elected and applies in 2013, then the taxable estate would be $1 million ($3.5 million, less $1 million (exemption), less $1.5 million (Portability), greatly reducing the tax to be paid.

Others who may benefit from Portability include those with large pensions or IRAs. These assets typically pass to the surviving spouse outside the trust, and can result in the surviving spouse receiving more than one-half of the combined estate. Portability allows the survivor to shelter some or all of these assets from estate tax at the second death almost as though these assets had been funded into a bypass trust at the first death.

Portability is also valuable where the separate property estate of one spouse is significant compared to the other assets. In the past such spouses have sometimes been encouraged to make lifetime gifts to the less wealthy spouse (or the community property) to "equalize" the amount of property expected to pass to the Survivor and Bypass trusts. Portability allows the wealthier spouse to take advantage of the other spouse's remaining estate tax exemption without losing ownership and control over assets and their final disposition (this is also true, however, with the use of martial trust planning).

Gift Planning For Unused Exemption

A surviving spouse can exempt additional lifetime gifts from tax by applying unused exemption that has become Portable. However, the surviving spouse's own exemption must be consumed first. For example, assume John dies in 2012 with a $3 million estate and a $5 million exemption, and the executor files an estate tax return to elect Portability. Marsha, his surviving spouse, could then make lifetime gifts of up to $7 million during her lifetime (her current $5 million exemption, plus the $2 million Portable exemption of John) without incurring a gift tax.

How Unused Exemption Can Be Lost

A surviving spouse who remarries and survives the new spouse is limited to using the exemption of the most recently deceased spouse. For example, assume John dies in 2011 with an estate valued at $3 million and his executor files an estate tax return to elect Portability. Marsha, his surviving spouse, then marries Paul who subsequently dies with an estate of $4 million. Marsha will only be able to use Paul's smaller $1 million Portable exemption. Thus, planning the estates of second marriages requires considerable attention and analysis.

How to Make the Election

In order to elect Portability, the executor or trustee must file an estate tax return even when a return would not otherwise be required. Although it may be tempting for the executor to simply estimate the asset values in this situation, this would be unwise as the amount of the Portable exemption will depend on the how much of the first decedent's exemption was used at his death. (In addition, the value of assets for purposes of future capital gains tax depends on their value at the time of the decedent's death). Executors/Trustees are therefore encouraged to use professional appraisers to determine values so that these values can be supported in a future audit by the IRS. Moreover, if the surviving spouse survives a significant period of time after the first death, it may be difficult if not impossible to determine these values later. All valuation information should be kept with the surviving spouse's important papers so that it is available to the surviving spouse's executor after death.

Finally, because the election must be made by the executor of the estate (who might not be the surviving spouse), it is important to consider whether or not the person selected as executor will cooperate with the wishes of the deceased spouse in this regard.

Remaining Issues

Not everything about Portability is beneficial. As noted above, estates must determine whether or not to incur the cost of filing the estate tax return for an estate that otherwise would not require the return, to include not only return preparation, but also the cost of appraisals. In addition, making the election holds open the statute of limitations for the IRS to challenge the values used on the decedent's estate tax return until after the death of the surviving spouse. As it may be decades before a surviving spouse dies, the survivor must maintain good records to support the value of the remaining unused exemption.

Finally, questions remain about the impact of Portability. First, it is unclear whether Congress will act in 2012 to make Portability permanent (or at least extend it). In addition, there remains uncertainty over the possible "claw back" if the estate tax exemption is reduced in the future (although there is a bill pending in Congress regarding this problem). Hopefully Congress with resolve both issues in the coming year to increase certainty for estate planning.

Legislative Update: New Amnesty Program for International Accounts

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The IRS continues to seek voluntary reporting of off shore accounts by U.S. citizens and residents. Taxpayers who voluntarily report such accounts under the new program will pay a penalty (generally 27.5% of the highest aggregate balance in the foreign bank account/entity or of the value the assets over the prior 8 years). Reduced penalty amounts of 5% or 12.5% remain available for some taxpayers, but penalties for taxpayers in highest tax bracket have gone up. The Taxpayer must also file amended tax returns, and pay back taxes (plus penalties and interest) on the back taxes. There is no deadline for filing, but program terms may change at any time.

If you would like to receive further information regarding the topics in this or past newsletter, or if you would like to let us know any issues or topics you would like to see addressed in future newsletters, please contact us at (619) 239-7777 or newsletter@mmpph.com.

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