Recent Estate Planning Developments

& Newsletter

Winter 2010

Temporary Repeal of Estate & GST Taxes

Under the 2001 Tax Act, estate and generation-skipping transfer taxes are now repealed for 2010. The gift tax remains, at a 35% rate. However, the 2001 Act "sunsets" at the end of 2010. Beginning in 2011, the law will return to the provisions that would have existed if the 2001 Tax Act had never been enacted. Under the old law, the tax rates will be 55% (with an additional 5% surcharge on certain estates) and the applicable credit will only protect $1 million of transfers over your lifetime and at your death. The chart on page 3 compares the gift, estate, and GST taxes in the years 2009, 2010, and 2011.

Estate planning professionals have been convinced that Congress would not let this happen. We were sure that Congress would fix the 2001 Tax Act by enacting a permanent lower rate and a much more generous credit amount (for example, protecting $3.5 million) of transfers.

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Why Did This Occur? Let's briefly review some history. In 2001, when we had a huge budget surplus, and before 9/11, the Administration and Congress attempted to repeal the estate and GST taxes. However, they did not have enough votes (60 in the Senate) to make the repeal permanent. Under the procedural "Byrd Rule", a tax act with less than 60 votes could only last for ten years and then it would "sunset" (go away). Over the past nine years, there have been various attempts in Congress to correct the situation, but the Senate never has been able to muster 60 votes in favor of a solution.

Estate planning professionals thought that the impending repeal would be enough to encourage a compromise. However, Congress has been preoccupied with the health care legislation and the political environment has become increasingly polarized and partisan.

What May Occur Now? Here are the most probable scenarios.

- **Retroactive Compromise.** Sometime during 2010, Congress may reach a compromise. This resolution may be retroactive to January 1, 2010. That is, it may apply to persons who die or make GST transfers in 2010 before enactment of the compromise. In the tax area, there is substantial case law holding that retroactivity is constitutional.
- **Prospective Compromise.** A second scenario is that a congressional compromise may occur, but Congress may decide not to

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make it retroactive. Therefore, it will not apply to the estates of persons who die or make generation-skipping transfers before enactment of the compromise legislation.

- **Gridlock.** A third scenario is that congressional gridlock will occur and Congress will not succeed in enacting a compromise. Then, "sunset" will occur at the end of 2010 and the pre-2001 Tax Act law will apply. Under this old law, the tax rates are 55% and the lower credit amount will only protect $1 million of transfers. "Sunset" will create additional uncertainty because there is concern that sunset may "unwind" certain planning and elections that occurred from 2002 through 2009.

If a compromise is reached, there is a great amount of speculation as to what it will involve. At the present time, the best guesses include some or all of the following:

- Lower rate (perhaps 45%);
- More generous credit (perhaps protecting $3.5 million of transfers, and perhaps inflation adjusted in the future);
- Unification of gift and estate taxes (this would allow gifting of the entire credit amount over a person's lifetime);
- Portability of credit (if the amount protected by the credit is not used when the first spouse dies, that unused amount can be used by the second spouse);
- Repeal of carryover basis;
- Special estate tax relief for family-owned farms and businesses;
- Limit valuation discounts for transfers of interests in family-owned limited partnerships and limited liability companies; and
- Require Grantor Retained Annuity Trusts to have at least a ten-year fixed term.

During 2010 Repeal: Issues That May Affect Your Planning

For persons who make gifts or die during 2010, there are new consequences and issues. Some are advantageous, and some are not. It is important for you to consider having your planning reviewed in light of these matters.

No Estate Tax or GST Tax on transfers at death for persons who die during 2010. However, retroactive legislation may change this.

Gifts During 2010. The gift tax still applies. However, the rate has been reduced to 35%. Tax-free gifting rules remain the same: $13,000 per person per year and $1 million protected by your applicable credit over your lifetime. Again, retroactive legislation may change the rate. For clients who want to attempt to take advantage of the lower 35% rate, without risking a higher rate if retroactive legislation is enacted, there are sophisticated planning techniques which can be used.

Gifts to Grandchildren and Further Descendants. The generation-skipping transfer tax (which had a rate of 45% in 2009) is repealed for 2010. Therefore, outright gifts (or gifts to certain types of trusts) to grandchildren and further descendants are GST tax free. Some people will want to consider aggressive transfers which would take advantage of both the lower gift tax rate (described above) and the lack of any GST tax in 2010. However, again, if Congress reaches a compromise and enacts retroactive legislation, the result might be the imposition of a large GST tax (e.g., at 45%) on these 2010 transfers. For clients who are interested in this type gifting, sophisticated planning approaches exist which may provide safeguards against the imposition of a retroactive GST tax.

Watch our website for updates on the Estate Tax law.

Formula Gifts. Wills and revocable trusts provide directions concerning how assets are to be distributed at death. These directions often are based upon provisions of the Internal Revenue Code which existed before the 2010 repeal. The repeal of these provisions may produce results which you do not desire. For example, a commonly used formula leaves to the surviving spouse's marital trust the amount that would otherwise be taxable under the federal estate tax. Since there is no estate tax during 2010, the marital trust would receive nothing. All the deceased spouse's assets would go to the bypass trust. If the beneficiary of the bypass trust is the surviving spouse, then this result does not change the dispositive plan. But if the beneficiaries of the bypass trust are, for example, the children, then this is a drastic change for the surviving spouse. Further, this type of formula may result in limiting the use of the spousal basis adjustment (see below).

Similarly, some dispositive plans contain directions to set up trusts for grandchildren and further descendants which are dependent upon the amount of the GST exemption available. If there is no GST tax, then these trusts will not be funded with any assets. Another example is a gift to charity which is dependent upon an amount that is exempt from estate tax or is dependent upon an estate tax concept that has been repealed. These gifts may result in nothing going to charity or everything going to charity.

Your will or revocable trust should be reviewed to determine if this type of undesirable result could occur if you were to die during 2010. A codicil to your will or an amendment to your trust can cure this type of problem.

Modified Carryover Basis. "What Congress giveth, it taketh away". For 2010, while there is repeal, a new tax takes effect. Under the old law, when a person died, the basis of his or her property was adjusted to fair market value. This allowed the surviving spouse or beneficiaries to sell assets and avoid capital gain taxes. This was especially beneficial for residents of community property states because both spouses' shares of the community property received a basis adjustment at the

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A Comparison of Gift, Estate & GST Taxes[1]

	2009	2010 Before Congressional Action	2011 and Later If "Sunset" Occurs
Gift Tax Exemption	$1,000,000	$1,000,000	$1,000,000
Maximum Gift Tax Rate	45%	35%	55% with 5% surcharge on cumulative gifts between $10,000,000 and $17,184,000
Estate Tax Exemption	$3,500,000	Unlimited	$1,000,000
Maximum Estate Tax Rate	45%	None	55% with 5% surcharge on estates between $10,000,000 and $17,184,000
Exemption from GST Tax	$3,500,000	Unlimited	$1,340,000 (indexed for inflation since 1999)
GST Tax Rate	45%	None	55%
Adjustment of Basis	All estate assets	$1,300,000 plus additional $3,000,000 for assets passing to surviving spouse	All estate assets

[1] This chart was created by McGuire Woods LLP Private Wealth Services Group.

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first spouse's death. Alaska has an optional community property system.

In 2010, this basis adjustment has been limited to $3 million of appreciation, for transfers to spouses and QTIP marital trusts, and $1.3 million for transfers to others. Planning will be necessary to minimize the effect of this new tax for persons who die in 2010. This planning involves both appropriate ownership of various assets between the spouses and a review of the types of trusts which would receive the assets in 2010.

Creation of New GST Trusts. The ambiguities created by the 2010 situation present opportunities to create new generation-skipping trusts which may avoid or minimize GST taxation in the future. These trusts are often referred to as perpetual trusts. They are created for the benefit of the clients' descendants and can continue as long as the trusts have assets. If a trust is created for grandchildren and further descendants prior to the enactment of further legislation, and if that legislation is not retroactive, then there would be no GST tax on the creation of the trust and any gift tax would be at the lower 35% rate. Further, there are arguments that the "dropdown" rule will avoid GST tax on distributions to grandchildren.

A trust for grandchildren and further descendants created under the will or revocable trust of somebody who dies in 2010 prior to any new legislation, assuming the legislation is not retroactive, will not result in any federal estate tax or GST tax at the decedent's death. Further, because of the definitions used in the estate tax law, a significant argument exists that such testamentary generation-skipping trusts will not be subject to the GST tax at any time in the future.

Clients interested in this type of planning should act immediately before new legislation is enacted.

State Death Taxes. Before 2001, the states shared in the federal estate tax by way of the estate tax credit. This credit was eliminated in 2005 and, as a result, many states enacted separate state estate or inheritance taxes.

Twenty states have this type of separate tax at the present time. On the West Coast, both Washington and Oregon have this type of tax. For clients who own property in states that have their own estate or inheritance tax, planning is necessary in order to defer or minimize this taxation. Interestingly, if Congress fails to act, the state death tax credit will return in 2011, and then many states may eliminate their own separate death tax and go back to sharing a portion of the federal estate tax.

What Should You Do Now?

One alternative would be to do nothing and wait until further legislation occurs. This alternative is based on two premises: the first is confidence that you will not die in 2010; and the second is that you are not interested in taking advantage of any of the planning that the 2010 law may allow.

A more prudent alternative is to make an appointment with your estate planner and review your documents and planning. This review should not take long and will either assure you that no changes are needed or will result in needed changes being accomplished. Further, often such a review may reveal a need for other changes or planning unrelated to the 2010 law which you decide is appropriate for your family.

Watch our Web site. As soon as new developments occur, we will post them on our Web site www.shaftellaw.com. Do not wait for another newsletter as it may not be timely enough to help your situation.

New Ruling Approves Estate Tax Planning Using Alaska Trusts

In 1997, Alaska enacted a new statute which provided that a person could create an irrevocable trust, that the same person could designate himself or herself as a discretionary beneficiary of that trust, and that his or her creditors could not reach the assets in the trust. Initially, this statute was enacted for asset protection purposes. However, it quickly became apparent to estate planners that estate tax minimization planning was a benefit of this new statute. This type of trust has been named a domestic asset protection trust (DAPT). In a state that has not enacted a DAPT statute, a settlor's creditors could reach the maximum amount that the trustee could distribute to the settlor. Consequently, the settlor can "run up" debts, and the settlor's creditors can reach the trust assets to satisfy these obligations. That is, the settlor can "relegate" his creditors to the trust assets. The above-described indirect retention of trust assets prevents the settlor's transfer of assets to the trust from being a completed gift for gift tax purposes. Further, such indirect retention results in the trust assets being included in the settlor's estate and taxed under the federal estate tax.

When Alaska reversed the above policy and provided that creditors could not reach the assets in a DAPT, the settlor no longer had indirect retention of trust assets. As a result, the gift is complete. The IRS agreed with this conclusion in 1998 when it issued Private Letter Rule 9837007. However, at that time, the IRS refused to issue a ruling stating that the assets would not be included in the settlor's estate and taxed under the federal estate tax. The IRS informally explained that it was declining to rule on the estate tax issue because so few states had enacted this new law. However, compelling tax arguments exist that once the above-described type of state law is enacted, the trust assets should not be taxed at the settlor's death under the federal estate tax.

Over the years, twelve states have enacted a similar type statute. Finally, in a ruling released on October 30, 2009, twelve years after the first statute was enacted and after twelve states had enacted such statutes, the IRS finally agreed to rule upon the estate tax issue. Again, the ruling involved an Alaska DAPT. In Private Letter Ruling 200944002, the IRS in one sentence finally rules favorably that a DAPT's assets will not be taxed under the estate tax, stating:

> *In addition, the trustee's discretionary authority to distribute income and/or principal to Grantor does not, by itself, cause the trust corpus to be includible in Grantor's gross estate under § 2036.*

The IRS qualified its ruling by stating that this favorable tax result might not occur if there were an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of the trustee's discretion.

Good news!

Alaska trust not taxed at settlor's death.

This is an extremely important private letter ruling for transfer tax minimization planning. Even though a private letter ruling is not precedent and applies only to the applicant, it is indicative of the Internal Revenue Service's position. For the first time in 12 years, the IRS has agreed that a DAPT may be used to exclude assets from the settlor's gross estate, even though the settlor is a discretionary beneficiary of the trust. This allows clients to use a variety of effective estate planning techniques to minimize their estate taxes, all the while knowing that, if a future emergency arises, the trust's assets can be distributed back to the client. For example, annual exclusion gifting, applicable credit gifting, grantor retained annuity trusts, and sales to grantor trusts, among other techniques, may be used to transfer assets to irrevocable trusts which include the settlor as a discretionary beneficiary.

Residents of Alaska can take advantage of this type of planning. Also, residents of other states that have enacted DAPT laws should be able to create an Alaska trust if they want to take advantage of Alaska's more favorable estate and trust provisions. Nonresidents of Alaska or any other DAPT state may also be able to take advantage of Alaska's DAPT statute depending upon their particular situation.

Defined Value Clauses Approved

Often, clients desire to gift or sell assets that are difficult to value such as stock in closely held corporations, interests in family limited partnerships or family limited liability companies, real estate, and similar assets. An appraisal of the property may be obtained. However, the IRS may challenge the appraised value and argue that it is too low. If the IRS is correct, then out-of-pocket gift tax may have to be paid.

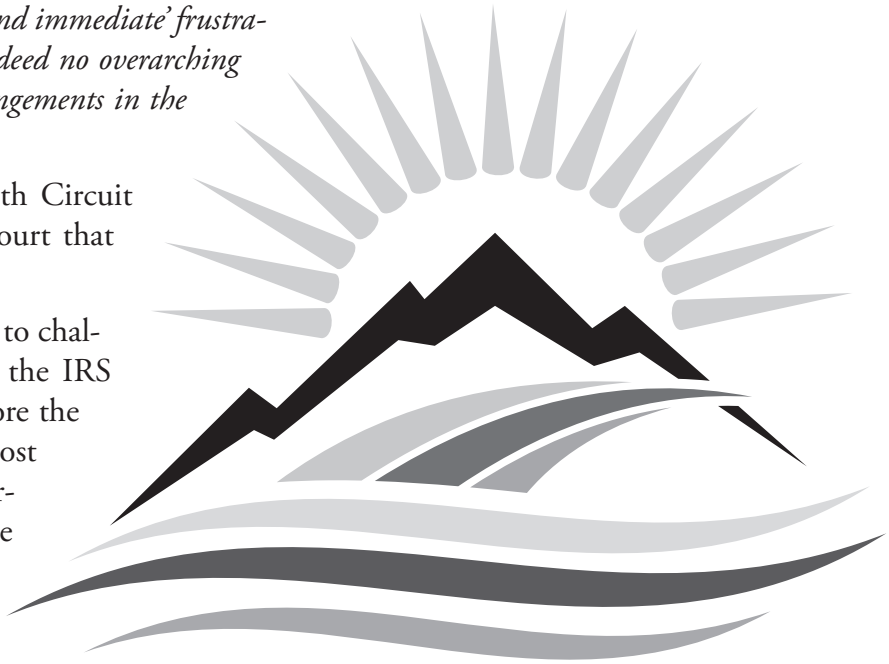
More good news!

In order to provide a safeguard against having to pay out-of-pocket gift tax, estate planners have developed the concept of a defined value clause. Instead of gifting or selling a fixed quantity of the difficult to value asset, a defined value clause fixes only the value of the asset to be gifted or sold. The exact quantity of assets to be transferred remains uncertain until values are finally determined for federal gift tax purposes.

The IRS has challenged these clauses as being against public policy. Until recently, we had only one case involving a defined value clause, *McCord*, which was decided by the Fifth Circuit in 2006. However, for procedural reasons, the public policy issue was not brought before the court.

However, in the past three months we have had two decisions that have fully considered defined value clauses. The first was in *Christiansen v. Commissioner*, decided by the Eighth Circuit in November of 2009. In *Christiansen*, the Eighth Circuit rejected the public policy argument against a formula disclaimer that had the effect of limiting the estate tax exposure of an estate regardless of what values the IRS used in the estate tax audit. More directly on point, on December 7, 2009, the Tax Court decided *Petter v. Commissioner*. *Petter* involved the more common use of defined value clauses in order to limit gift tax exposure when the client makes lifetime gifts and/or sales to grantor trusts. The IRS challenged the effectiveness of the defined value clauses. Judge Holmes upheld the validity of the defined value clauses, and in response to the IRS's public policy argument, stated:

> *"The formulas used to effect these transfers were not void as contrary to public policy, as there was no 'severe and immediate' frustration of public policy as a result, and indeed no overarching public policy against these types of arrangements in the first place."*



The *Petter* case is appealable to the Ninth Circuit Court of Appeals, which is the circuit court that includes the State of Alaska.

The IRS has now had three opportunities to challenge defined value clauses. In *McCord*, the IRS failed procedurally to bring the issue before the court. In *Christiansen* and *Petter*, the IRS lost squarely on the merits. This is very encouraging for the conclusion that defined value clauses will be upheld and are a helpful safeguard against exposure to the payment of out-of-pocket gift taxes if difficult to value assets are revalued on review.

Our Office
Estate Planning Presentations

Clients and professionals have contacted us and requested basic presentations that illustrate estate planning and related subjects such as business succession planning. As a result, we have started a program of offering presentations periodically in our office conference room. Presentations are scheduled for late afternoon and usually last for an hour and a half. One of our attorneys will narrate a PowerPoint presentation for approximately 45 minutes and then we have approximately 45 minutes of discussion and questions. These sessions have been very popular.

You are invited to attend one of these sessions if you would like a refresher in estate planning. Please consider recommending them to your family and friends. If you are a professional, we are happy to host you and your clients for a presentation. Of course, there is no charge or obligation connected with these presentations. We hope that you will find them useful, and we hope that you will consider us in the future for you estate planning needs.

If you are interested, please call Kim (276-6015) to find out the date of the next presentation.

www.shaftellaw.com

You may refer to our website for a variety of information:

Updates on Congress' actions changing federal gift, estate and generation-skipping transfer taxes;

- A "what's new" discussion of developing estate planning subjects;
- New state legislation affecting estate planning;
- A "checklist" for evaluation of your estate planning;
- Discussion of a number of relevant estate planning techniques;
- Our past newsletters;
- Key Alaska estate planning statutes; and
- Many articles which we have written about Alaska estate planning techniques.

Our Staff and their Activities

Dave continues to work with an informal group of attorneys and trust officers to improve Alaska estate and trust law. This group makes recommendations to the Alaska Legislature and works with legislative staff to draft new estate and trust legislation. Several new statutes are now working their way through the legislative process, and we will report on them in our next edition.

Dave has a new article entitled "New Ruling Approves Estate Tax Planning Using Domestic Asset Protection Trusts" which will be published in the national JOURNAL OF TAXATION this spring. This is a nationally recognized tax journal read by sophisticated tax specialists.

We have a new legal assistant. Zachary Miller was born and raised in Anchorage, Alaska. He graduated from the University of Alaska, Anchorage in 2003 with a BA in English and an emphasis in Rhetorical Studies. Right out of college, he became a paralegal and has worked with two law firms and the risk management department of a former Alaskan engineering and construction firm. Zach has experience in construction law and commercial transactions, contract administration and risk management, and workers' compensation management.

Zach looks forward to assisting clients with their estate planning needs including funding and implementing trusts and business entities. Zach's interests include paleontology, art, and gaming. He makes a valiant effort every year to attend a conference about either consumer electronics or vertebrate paleontology.

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