Recent Estate Planning Developments

& Newsletter

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by Shaftel Law Offices, P.C.

The Administration and Congress Agree on a New Tax Act

This Issue is Devoted to Discussing the New Gift, Estate and GST Rules

How Did We Get Here?

In 2001, the Administration and Congress attempted to repeal the estate and generation-skipping transfer (GST) taxes. However, they did not have enough votes (60 in the Senate) to make the repeal permanent. The result was that the 2001 Act could only last for ten years and then it would "sunset" (go away), and the prior law would come back into effect. The 2001 Act, over a nine-year period, phased in reduced tax rates (from 55% to 45%), and increased the applicable exclusion amount (from $1,000,000 to $3,500,000) that each person may transfer without incurring any estate tax. In the tenth year, 2010, the estate and GST taxes were repealed while the gift tax continued at a 35% rate.

GOOD NEWS!

Most of the Gift, Estate & GST changes are very favorable

Estate planning professionals thought that Congress would enact a compromise before the impending repeal in 2010. However, Congress was preoccupied with other issues and failed to act. As a result, for most of 2010 we had repeal of both the estate and GST taxes. As the end of the ten-year period of the 2001 Act loomed closer, we became very concerned that without congressional action we would return to the pre-2001 Act law, which would bring back gift, estate, and GST rates of 55% and a reduced applicable exclusion amount of $1,000,000.

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Congress Enacts The 2010 Act: Estate And GST Taxes Retroactively Enacted And Modified

BAD NEWS!

These changes only last for two years

Finally, in December of 2010 the Obama administration and Congress reached a compromise and enacted the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 ("2010 Act"), effective December 17, 2010. The 2010 Act extends sunsetting of the 2001 Act for two additional years and enacts modifications to that 2001 Act.

Sunsetting at the End of 2012. The 2010 Act is temporary. At the end of 2012, all of its provisions (which include the provisions of the 2001 Act) will no longer be in effect (go away). *The result will be that as we approach the end of 2012, we will again have the need for the Administration and Congress to reach a compromise and enact further legislation, or we will return to the 55% rate and reduced $1,000,000 applicable exclusion amount of the pre-2001 law.*

The Modifications

We know that we have a new law for at least two years. Let's examine the modifications that the Administration and Congress made to the gift, estate, and GST taxes.

Applicable Exclusion Amount. This is the amount which each person can transfer either during lifetime or at death without incurring any gift or estate tax. *This amount has been increased to $5,000,000, indexed for inflation beginning in 2012.*

Reunification of the Gift and Estate Taxes. Prior to the 2010 Act, only $1,000,000 of the applicable exclusion amount could be used for taxfree gifts during lifetime. Under the new Act, *lifetime tax-free gifts can be made up to the full amount of the $5,000,000* applicable exclusion. This is a dramatic change and will allow for valuable planning during the next two years.

Tax Rate. For 2011 and 2012, *the tax rate has been reduced to 35%* for the gift tax, estate tax, and GST tax. This is a substantial improvement over the 45% rate that was in effect in 2009 and the 55% rate that would have taken effect if the 2001 Act had sunsetted.

Deaths In 2010: Choice Between Estate Tax Or Carryover Basis

To understand this choice, we first need to review some history.

Estate Tax and Basis Adjustments. Prior to 2010, when a person died and his or her assets were taxed under the estate tax, the basis of the assets subject to tax was adjusted to fair market value. This was the one "good thing" that occurred at death. This basis adjustment protected beneficiaries from income tax when they sold the assets (the gain taxed when assets are sold is the difference between the sale price and the basis of the assets). Also, this basis adjustment allowed for increased depreciation for many assets.

Carryover Basis. However, when the 2001 Act was enacted, Congress made a trade-off for the planned repeal of the estate tax in 2010. This tradeoff was that while the estate tax would not apply in 2010, a new carryover basis regime would apply. Under this new regime, the basis of assets included in a decedent's estate would not be adjusted to fair market value as of the date of death. Instead, the basis would merely “carry over” and be the same as it was prior to the decedent’s death. While the planned repeal of the estate tax was a good thing for taxpayers, the tradeoff of initiating a carryover basis regime was a disadvantage as income taxes would be higher in future years.

This new carryover basis regime did allow for $1,300,000 of basis adjustment for each decedent and an additional $3,000,000 of basis adjustment for assets transferred to a spouse.

A Choice. When the Administration and Congress reached their compromise in December 2010, they had to decide how to tax the estates of persons who died in 2010. They could have retroactively enacted the estate tax to the beginning of 2010 and repealed the 2010 carryover basis regime. Alternatively, they could have left the carryover basis re gime in effect until December 17 and then enacted the estate tax only prospectively. Instead, they decided to provide a choice. The default rule is that the estate tax is enacted retroactively to the beginning of 2010. However, a personal representative can elect to instead have the carryover basis regime apply.

For any estate under $5,000,000 net worth, the choice will be to have the estate tax apply. The applicable exclusion amount will protect against any estate tax being payable and there will be a full adjustment of basis of all of the assets which will minimize income taxes in the future.

For an estate in excess of $5,000,000, the choice of the carryover basis regime will avoid the payment of any estate tax. However, the estate tax at a 35% rate will have to be compared to the potential income tax cost under the carryover basis regime. The personal representative will have to consider factors such as the amount of estate tax payable currently versus the gain that would be subject to income tax on a future sale of assets, anticipated dates of sale, whether depreciation can be used to derive current income tax benefits, ability to allocate basis adjustments under the carryover basis regime, anticipated future capital gains rates (and ordinary income rates for “ordinary income” property), and the present value of anticipated income tax costs as compared to the current estate tax amount.

Portability Of Unused Applicable Exclusion Amount

The 2010 Act provides that a surviving spouse can use the portion of the applicable exclusion that the deceased spouse failed to use. Some background is helpful in understanding this new provision.

Basic Approach. When wills or revocable trusts are drafted for a married couple, one approach is to provide that when the first spouse dies (the deceased spouse), all of the deceased spouse’s assets are transferred to the surviving spouse. Under the estate tax, an outright transfer to the surviving spouse qualifies for the marital deduction. That is, all of the assets transferred to the surviving spouse are deducted from the deceased spouse’s gross estate. As a result, there is no estate tax on these assets. In this situation, there was no need to use the deceased spouse’s applicable exclusion amount. This amount was wasted. Subsequently, when the surviving spouse died, the surviving spouse’s applicable exclusion amount would be used to reduce the taxes due from the surviving spouse’s estate. However, if these assets were greater than the surviving spouse’s applicable exclusion amount, then estate tax would have to be paid. This estate tax might have been avoided if the surviving spouse could have used the unused amount of the deceased spouse’s applicable exclusion amount. However, that was not the law.

Bypass Trust Approach. Estate planners developed a strategy to use both spouses’ applicable exclusion amounts. When the first spouse died, an amount of the deceased spouse’s assets equal to the applicable exclusion amount would be transferred to a bypass trust. That trust would be for the benefit of the surviving spouse, and the surviving spouse could be the trustee, who would manage investments and make distributions pursuant to an ascertainable standard. The assets in this bypass trust plus all appreciation and accumulated income would not be subject to estate tax at the surviving spouse’s death. They would “bypass” the surviving spouse’s gross estate. When the surviving spouse died, the surviving spouse’s applicable exclusion amount would be used against

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that spouse's assets. This approach, often called the "bypass trust approach" or the "credit shelter trust approach," has been a standard for maximizing the use of both spouses' applicable exclusion amounts.

Portability. Over the years, commentators have suggested that estate planning could be simplified if the unused applicable exclusion amount of the first spouse to die was just transferred to the surviving spouse. That is, it would be made "portable", and therefore a bypass trust would not be needed. The 2010 Act now authorizes this portability. The amount that may be transferred from the deceased spouse to the surviving spouse is called the "deceased spousal unused exclusion amount" (DSUEA), which is the deceased spouse's exclusion amount reduced by the amount of taxable gifts made by the deceased spouse during that spouse's lifetime.

In order for the DSUEA to be available, the personal representative for the deceased spouse must file an estate tax return, compute the DSUEA, and make an irrevocable election that the surviving spouse can use the DSUEA. If this election is made, the statute of limitations does not bar the IRS from reexamination of the deceased spouse's estate tax for purposes of determining the correct amount of the DSUEA.

Privity. Only the last deceased spouse's unused exclusion amount can be used. This is to prevent a person from accumulating more than one spouse's unused exclusion amount through multiple marriages. Further, there is a privity requirement: a spouse may not use a DSUEA which his or her spouse acquired from a deceased spouse. A surviving spouse relying on portability will have to plan carefully to determine the impact of remarriage on the available DSUEA since only the last deceased spouse's DSUEA applies. Some commentators point out that portability will perhaps encourage surviving spouses to search for a future spouse with both a low net worth and short life expectancy. This portability is effective for decedents dying after 2010. It only applies to the applicable exclusion amount and does not apply to the GST exemption.

An Example. Assume that H dies after making $1,000,000 of taxable lifetime gifts. His DSUEA is $4,000,000. W then has an applicable exclusion amount of $9,000,000 (W's $5,000,000 basic exclusion amount plus the $4,000,000 DSUEA from H). W can use this $9,000,000 applicable exclusion amount for lifetime gifts and, to the extent that it is not so used, then it will be available to offset the amount of assets in her estate subject to estate tax.

Portability Versus Bypass Approach. Should clients either not use or eliminate from existing planning the bypass trust approach and instead rely only on portability of the DSUEA? Leaving everything to the surviving spouse and relying on portability offers the advantage of simplicity. Further, all of the assets in the surviving spouse's estate will receive a basis adjusted to fair market value at the surviving spouse's death. This increased basis will minimize future income taxes. This should be compared to the bypass trust where none of its assets receive an adjusted basis at the surviving spouse's death because the assets are not included in the surviving spouse's gross estate for federal estate tax purposes.

However, the advantages for continuing to use the bypass trust approach appear to outweigh relying only on portability.

- The appreciation of, and income earned by, assets in the bypass trust will avoid future estate tax. In contrast, assets transferred to the surviving spouse and their appreciation and accumulated income will be included in the surviving spouse's gross estate for estate tax purposes.
- The deceased spouse's GST exemption can be allocated to assets in the bypass trust. This GST exemption amount is not portable and therefore cannot be transferred to the surviving spouse.
- Non-tax benefits of a trust include asset protection, providing management, and restricting transfers of assets by the surviving spouse.

- Further, at present, portability only continues for two years until the future sunsetting of the 2010 Act.

A More Sophisticated Bypass Trust Approach Has Been Suggested. Commentators recommend continued use of the bypass trust approach and also give an independent trustee the ability to distribute assets outright to the surviving spouse. This will allow for continued reevaluation of the surviving spouse's tax situation when that spouse's death is imminent. If the surviving spouse's assets are less than that spouse's applicable exclusion amount, the independent trustee can distribute appreciated assets from the bypass trust to the surviving spouse. These assets will receive a basis adjustment at the surviving spouse's death and therefore reduce future income taxation.

Election. One consequence of the new portability provision is that federal estate tax returns should be filed for all persons dying on or after January 1, 2011. Under the 2010 Act, an election needs to be made in a federal estate tax return in order to preserve the availability of the unused exclusion amount.

GST Tax

The Generation-Skipping Transfer Tax was retroactively enacted to apply to 2010 but with a tax rate of zero. The reason for having it apply in 2010 was to solve several technical problems created by its repeal in 2010 and reappearance in 2011. For example, the GST exemption of $5,000,000 is now available to be allocated to the fair market value of gifts made in 2010. Further, the GST-advantageous provisions of the 2001 Act are continued through 2012. These include automatic allocations of GST tax exemption, late allocations of GST tax exemption, and qualified severances of trusts.

Deadlines For Returns And Disclaimers

Personal representatives for estates of decedents who died between January 1, 2010, and December 16, 2010, may delay filing the estate tax return until nine months after December 17, 2010. The time for making any disclaimer for property passing by reason of death of a decedent during the above period of time is similarly extended to nine months after the date of enactment. The deadline for filing gift tax returns, which may or may not allocate GST exemption for gifts made during 2010 is April 15, 2011. As of the date of publication of this newsletter, available information indicates that the deadline for filing the return for reporting carryover basis will be October 15, 2011.

What Was Not Enacted?

A number of provisions that were included in various bills in the last several years were not included in the 2010 Act. These included restrictions on valuation discounts in the family setting and requiring grantor retained annuity trusts (GRATs) to have a ten-year minimum term and a remainder interest which has a value greater than zero. These changes would have significantly reduced the effectiveness of many estate planning techniques used to minimize federal estate tax. Also left out were provisions requiring the consistency of basis and the elimination of the estate death tax deduction. *Commentators have speculated that these provisions may well be again on the table when the Administration and Congress revisit the estate tax at the end of 2012.*

What Can We Expect at the End of 2012?

Sunset. As discussed earlier, the 2010 Act only extends the sunsetting of the 2001 Act for two years with certain modifications. This extension and the modifications discussed above will all disappear at the end of 2012 unless the Administration and Congress again agree upon new tax provisions. If sunsetting occurs, then beginning in 2013 we will only have a $1,000,000 applicable exclusion amount and an increased 55% tax rate.

Repeal. In addition to sunsetting, the possibility at the other end of the spectrum is repeal of the estate and GST taxes. Some commentators argue that with the $5,000,000 applicable exclusion amount and the 35% rate that the revenues produced by these taxes do not justify their continued existence.

Another Compromise. In contrast to these polar positions, the Administration and Congress may enact new legislation which either continues the 2010 Act modifications or reduces the exclusion amount (for example, to $3,500,000) and increases the rate (for example, to 45%). The restrictions on valuation discounts, limitations on GRATs, and similar matters not included in the 2010 Act may be included in future legislation.

When the Administration and Congress revisit these taxes in two years, the decision at that time will depend upon the nation's deficit, the need for tax revenues, and the philosophies and politics of those in office after the 2012 election.

Planning During 2011 And 2012

Gifting. The unification of the gift and estate tax now allows each person to make gifts of up to $5,000,000 during that person's lifetime without having to pay any gift tax. Transferring assets by gift during lifetime is much more advantageous than waiting to use the applicable exclusion amount at death for the following reasons:

PLANNING

A TWO YEAR window of opportunity

- **Future appreciation and income** from the gifted assets belong to the donee and therefore are removed from the gross estate of the donor.
- **Often, gifted assets qualify for valuation discount.** For example, if a fractional interest in a parcel of property or a minority interest in a limited liability company is gifted, the value of that interest may be discounted (for example, 30%) due to minority interest and lack of marketability discounts. The larger the gift, the larger the value of the discount.
- **If gifts are made to a grantor trust**, then the grantor can pay the income tax generated by those gifts in the future. This allows the assets in the trust to compound without the reduction of tax payments.

Clawback? The advantage of lifetime gifting of up to $5,000,000 under the 2010 Act needs to be qualified because of a potential future "clawback" of tax benefit. This could happen if future legislation were to reduce the applicable exclusion amount to $3,500,000, or if sunsetting occurs and the exclusion amount is reduced to $1,000,000.

The method used to compute estate tax takes into consideration the gifts made during lifetime and the applicable exclusion amount ($5,000,000 in 2011 and 2012). If the applicable exclusion is reduced, then some commentators have concluded that most of the benefit of being able to gift tax free up to $5,000,000 is lost when estate taxes are computed and paid. This may not be what Congress intended, and future IRS guidance or legislation may eliminate this "clawback." However, this "clawback" disadvantage does not reduce the benefits of getting the appreciation, income, and discounts out of the donor's estate, and the advantage of having the donor pay the income tax on grantor trust assets, as discussed above.

We have no certainty that the $5,000,000 amount will continue beyond the next two years. Therefore, this two-year period is a window of opportunity to take advantage of lifetime gifting up to the $5,000,000 amount. *Lifetime gifting is clearly the best and simplest way to reduce estate taxes.*

LIFETIME GIFTING

The best and simplest way to reduce estate taxes

Use a DAPT. Since 1997, Alaska has authorized the formation of a domestic asset protection trust (technically called a self-settled discretionary spendthrift trust). This type of trust allows a person to form an irrevocable trust, gift assets to the trust, and be a discretionary beneficiary of that trust. Present law indicates that the trust assets will not be included in the donor's gross estate for federal estate tax purposes. The assets in the trust are protected from the donor's creditors. The increase of the gift tax exclusion will allow persons to gift up to $5,000,000 to such a trust. Then, in the future, if the donor needs funds from the trust, an independent trustee can distribute amounts back to the donor.

Sales to Grantor Trust. Some people desire to sell assets to a grantor trust (which may be a DAPT). The increased gift tax exclusion amount will allow them to first gift assets to that trust prior to the sale. A commonly accepted standard is that a trust must have assets worth at least ten percent of the value of assets that it is purchasing. Therefore, the ability to gift tax free more assets to the trust will allow the trust to purchase more assets from the seller.

Grantor Retained Annuity Trust (GRAT). Since restrictions on GRATs were not enacted in the 2010 Act, we can continue to form "zero-out" GRATs with fixed terms less than ten years. This will be attractive for persons who have used up their gift tax exclusion amount or have other planned uses for that amount.

Qualified Personal Residence Trust. This type of trust is a very effective way of making a leveraged gift of a personal residence with the owner retaining the use of the residence for a period of years. The increased gift tax exclusion amount will allow some people to use this approach who previously did not have enough exclusion to cover the amount of the gift that occurs.

Life Insurance Trust. The increased gift tax exclusion amount will allow for gift tax free transfer of funds to the trust which the trustee can use to pay for premiums on the life insurance policies.

Unmarried Couple Planning. Unmarried couples have difficulty equalizing their estates because they do not qualify for the gift tax marital deduction. Similarly, at the death of the first to die, there is no marital deduction for assets transferred to the survivor. The increased gift tax exclusion amount will now allow for easier equalization of net worth and also will protect from estate tax up to $5,000,000 of the survivor's assets.

State Estate Tax Planning. Alaska no longer has a state estate tax. However, several other states do have such a tax which applies to assets located in that state (for example, Washington). Gift planning may save significant state estate taxes because gifts are not included in the state gross estate base.

Simplification and Implementation of Existing Planning. Many persons have existing planning designed to substantially reduce their federal estate taxes. The ability to make gifts up to $5,000,000 will often allow this existing estate planning to be simplified, or will assist in its implementation. For example, loans may be forgiven, and promissory notes owed to grantor trusts can be forgiven or transferred to others.

Review of Existing Estate Planning Documents. Existing estate planning documents should be reviewed to see if transfers are based on formulas which may have unexpected results. For example, a provision in a will or trust may state that the "applicable exclusion amount" is to be used to fund a trust for grandchildren, and all of the rest of the property is to be distributed in equal shares to children. This provision may have been drafted when the applicable exclusion amount was $1,000,000, and that may well have been what the client had in mind. The increase of the exclusion amount to $5,000,000 might have the effect of transferring $5,000,000 to the grandchildren.

Similar problems can occur for formula transfers that are based upon the amount that is "free of estate tax." This amount could be $5,000,000, or it could be the entire estate if the personal representative elects not to have the estate tax apply in 2010. These are just a few examples.

What Should You Do?

REVIEW YOUR PLANNING

We highly recommend that you review your existing estate planning in view of the changes made by the 2010 Act. We are available to help you analyze your situation and implement any changes that you desire. The present substantial benefit provided by the increase of the exclusion amount to $5,000,000 is only certain for two years. We cannot be sure what the law will provide after that time.

We continue to provide periodic estate planning presentations at our office as discussed on page 8.

Our Office Estate Planning Presentations

Clients and professionals have contacted us and requested presentations that illustrate estate planning and related subjects such as business succession planning. As a result, we have 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, and more information about the 2010 Act. 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 your estate planning needs.

If you are interested, please call our office (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.

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