Recent
Estate Planning
Developments
& Newsletter
Winter 2013
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Estate Planning in 2013

PERMANENCE!

(UNTIL CONGRESS ACTS AGAIN)

Since 2001, when Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001, the federal gift, estate, and generation-skipping transfer taxes have been clouded by uncertainty. That Act was designed to repeal the estate and generation-skipping transfer taxes (GST) over a ten-year period. However, Congress did not have the 60 votes in the Senate required to make the repeal permanent. The result was that the 2001 Tax Act could only last ten years and then would "sunset" (go away) and the prior law would come back into effect.

During December 2010, the Administration and Congress "punted" and agreed to extend the ten-year period for two additional years through 2012. Ambiguity continued. We were again faced with the possibility that the provisions of the

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2001 Tax Act would sunset, and we would go back to pre-2001 transfer tax law. Under that law, the applicable exclusion amount would only be $1,000,000, and the tax rate would vary between 55% and 60%. Also, a number of very helpful GST provisions would go away.

In fact, the sun did set. On December 31, 2012, the sun dipped below the horizon, and we went back to pre-2001 transfer tax law. However, as it is prone to do, the sun immediately rose the next day when Congress grasped the sinking orb and yanked it back over the horizon by passing the "American Taxpayer Relief Act of 2012" (ATRA) on January 1.

For the first time in twelve years, we now have a permanent law with respect to the federal gift, estate, and generation-skipping transfer taxes. We are no longer faced with the threat of the law sunsetting and our going back to the pre-2001 provisions. Of course, "permanence" only means until Congress acts again. As we will discuss further, below, we are expecting further legislation this year.

But first, let us focus on the important permanent provisions of ATRA.

Applicable Exclusion. During 2013, each of us has a lifetime $5,250,000 applicable exclusion amount. This is the new $5,000,000 applicable exclusion amount, and it will increase each year to adjust for inflation. This means that each of us can transfer a total of $5,250,000 without being subject to the federal estate tax. Further, this amount is unified with the gift tax. This means that each of us can use up to all of this applicable exclusion amount during life for tax-free gifts. To the extent that a person does not use it during his or her lifetime, the remaining amount will be available to use for transfers at death.

The permanence of this $5,000,000 applicable exclusion amount eliminates the threat of "clawback" for clients who have gifted large amounts during 2011 and 2012.

GST Exclusion. Similarly, during 2013, each of us has $5,250,000 of federal generation-skipping transfer tax exemption. This amount is keyed to the applicable exclusion amount and will be adjusted for inflation every year. This GST exclusion amount means that we can protect from the generation-skipping transfer tax $5,250,000 worth of assets transferred outright or in trust to grandchildren or further generations.

Tax Rate. Under the pre-2001 law, this tax rate varied between 55% and 60%. In 2012, the rate was 35%, and the Administration proposed that it be raised to 45%. A compromise was reached, and the new tax rate for gifts, estates and GST transfers is 40%.

GST Procedural Provisions. The 2001 Tax Act enacted a number of favorable GST procedural provisions. These included automatic allocations of GST exemption to lifetime transfers and to GST trusts, qualified severance of trusts for GST purposes, and late allocations of GST tax exemption. These provisions are now permanent.

Portability. The 2010 Tax Act, which extended the 2001 Tax Act for two years, included a provision that allows a surviving spouse to use the portion of the applicable exclusion that the deceased spouse failed to use. This portability approach is now made permanent. It is discussed further below.

Everything is Indexed. The applicable exclusion amount, the GST tax exemption amount, the annual exclusion, and similar amounts will all be indexed for inflation.

Annual Exclusion. This is the tax-free gift amount which each of us can gift every year to as many people as we desire. For 2013, the indexed annual exclusion amount is $14,000. For example, each of us can gift $14,000 to each child and grandchild. Gifts of these amounts to trusts can be made if the trusts are drafted appropriately.

ARE WE HOME FREE NOW?

The now permanent and generous applicable exclusion and GST exemption amounts, and the other provisions described above, are a big relief. We now can rely on what the law is with respect to these matters and not be worried that it will revert to dramatically lesser amounts and less useful provisions. “Sunset” is no longer on the horizon with respect to transfer taxes.

Tax Reform. However, unfortunately, we are not home free with respect to changes in this tax area. There has been much discussion about upcoming “tax reform” in 2013. Both parties and the Administration have indicated that such reform needs to be considered this year in order to accomplish fiscal goals. Budget deficits per year are twice the normal range. The Administration has linked tax reform to reducing deficits. The background work for tax reform has already been done. Congressional staff have already reviewed a number of proposals. In March, the President will make his budget submission. Then the two key Congressional committees will hold hearings and markup proposed bills.

Proposals. The Treasury Department’s 2013 proposals for tax reform have already been submitted (in what is known as the “Greenbook”) to Congress for its consideration. ***These Treasury Department proposals include the following:***

Valuation Discount. Under present law, interests in limited partnerships, limited liability companies, closely held corporations, fractional interests in real property, and similar interests, often qualify for discounts in value due to lack of control, lack of marketability, and various features of the business entity involved. Such discounts often are between 20% to 40%. These discounts can be used with respect to transfers among family members or family trusts.

The Treasury Department has indicated that it would like to limit or prohibit these discounts with respect to transfers among family members or to trusts for family members. A number of proposed techniques for limiting these discounts have been discussed.

Grantor Trusts. A grantor trust is a trust which is ignored for federal income tax purposes. Further, the grantor (the person who forms the trust) can have transactions with the trust (for example, sales or exchanges) which are tax-free. Irrevocable grantor trusts are frequently used in sophisticated estate planning. These include Alaska self-settled discretionary spendthrift trusts (DAPTs), qualified personal residence trusts (QPRTs), many life insurance trusts, and perpetual trusts. Their use allows for income tax-free planning, coupled with the exclusion of the assets in these trusts from the federal estate tax.

The Treasury Department has proposed that (1) the assets of a grantor trust be included in the grantor’s estate for estate tax purposes, (2) any distribution from a grantor trust to a beneficiary during the grantor’s lifetime be subject to the gift tax, and (3) if the grantor trust ceases to be a grantor trust during the grantor’s lifetime, then all of the assets in the trust will be subject to the gift tax.

If enacted, this is a very broad and dramatic change which would eliminate the usefulness of irrevocable grantor trusts for estate tax reduction planning.

GRATs. This proposal requires that a grantor retained annuity trust have a minimum duration of ten years. In order to get the benefits of a GRAT, the grantor has to live during the entire fixed term of the GRAT. For this reason, many GRATs have been designed to last relatively short periods of time; for example, two years or five years. By requiring that a GRAT last for at least ten years, the Treasury Department is creating more of a risk that the grantor will die during the fixed term of the GRAT, and therefore will not achieve the exclusion of the GRAT's remaining assets from the federal estate tax.

Limit Duration of GST Tax Exemption. Alaska and many other states have eliminated the restrictions on how long a trust can last. This is important because under present law, if assets are kept in a trust from generation to generation, and if they are protected by GST exemption, then no further gift, estate, or GST taxes will apply to those assets. The Treasury's Greenbook proposal would limit the duration of such GST exempt trusts to 90 years. After that time, the trusts would not be exempt from generation-skipping transfers in the future. That is, if distributions then were made to grandchildren or further generations, those distributions would be taxable under the generation-skipping transfer tax.

Surprises. The above proposals are not limitations on what a new tax reform law might contain. Often, there are unpublished and undiscussed changes that emerge from Congress' conference rooms at the last minute. There is probably an increased risk of surprises during the 2013 tax reform effort due to the need for additional revenue for the maintenance of various programs.

Effective Date. Generally, the effective date for future tax legislation is either when the legislation is introduced or when it is ultimately passed. Tax reform legislation could be retroactive to the beginning of 2013, although this appears unlikely. Assets in trusts which are already in existence should be grandfathered from the new provisions. However, transfers of assets into existing trusts, or new trusts, after the effective date of the new tax provisions will be subject to those provisions.

PLANNING APPROACHES UNDER THE NEW PERMANENT LAW.

Here are some planning approaches for three categories of family estates, depending upon their net worth, under the new permanent provisions.

Estates Less Than $5,000,000—Simplification. If a married couple or single person has a net worth less than $5,000,000, including retirement accounts and life insurance, and they are convinced that their net worth will never exceed that amount, then life is now simplified. Previously, we needed a bypass trust and one or more marital trusts to use both spouses' $1,000,000 applicable exclusion amounts and their GST exemption amounts. Now we can eliminate these trusts, and all of the complex provisions that went with them. A married couple's wills or joint revocable trust can direct that when the first spouse dies all of the assets go to the survivor. The survivor's $5,250,000 applicable exclusion amount, and similar GST exemption amount, will protect all of the assets from estate tax and GST tax at the survivor's death. ***Therefore, joint revocable trusts and wills for a family net worth that falls in this category can be greatly simplified.***

Clients will still want to consider using Alaska self-settled discretionary spendthrift trusts (DAPTs) and perpetual trusts for asset protection for themselves and their descendants. In addition, such trusts may be important for the clients' children if their future net worth may exceed the limits of this category. Also, if life insurance is the only asset which could push assets over the $5,250,000 amount, then the insurance policy should be owned by a life insurance trust or a perpetual trust.

Estates Between $5,000,000 and $10,000,000—Portability, or Not. This has now become a very topical planning area because of the permanence of portability. Some background is helpful in understanding the portability approach.

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. Using this basic approach, and the marital deduction, 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 the 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 also 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 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 authorized portability, and the 2012 Act has made it permanent. The amount that may be transferred from the deceased spouse to the surviving spouse is called the "deceased spousal unused exclusion amount" (DSUE), 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 DSUE to be available, the personal representative for the deceased spouse must file an estate tax return, compute the DSUE, and make an irrevocable election that the surviving spouse can use the DSUE. 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 DSUE.

Last Spouse, and 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 DSUE 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 DSUE since only the last deceased spouse's DSUE 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 only applies to the applicable exclusion amount and does not apply to the GST exemption.

An Example.[1] Assume that H dies after making $1,000,000 of taxable lifetime gifts. His DSUE is $4,000,000. W then has an applicable exclusion amount of $9,000,000 ($5,000,000 basic exclusion amount plus the $4,000,000 DSUE 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.

Advantages of Portability. Portability provides clients with a net worth of between $5,000,000 and $10,000,000 with the advantage of simplicity. They can forego the use of the bypass trust approach, and instead, the first spouse can leave all of his or her assets to the surviving spouse. The surviving spouse can use that spouse's $5,000,000 exclusion amount along with the deceased spouse's $5,000,000 amount and protect $10,000,000 from estate tax.

Further, all of the assets in the surviving spouse's estate (the $10,000,000 of assets) 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 approach where none of the assets in the bypass trust receive an adjusted basis at the surviving spouse's death.

This simplicity, plus the adjustment in basis of all the family's assets at the surviving spouse's death, will lead many couples to decide to have their estate plans rewritten.

Disadvantages of Portability. There is a cost associated with the simplicity of portability. Segregating out the first-spouse-to-die's assets and placing them in a bypass trust assures that the appreciation of those assets will avoid future estate tax. But if instead the deceased spouse's assets go outright to the surviving spouse, then the appreciation of these assets will be subject to estate tax at the surviving spouse's death. The amount of the anticipated estate tax needs to be compared with portability's income tax savings when all of the family's assets receive an adjustment of basis at the death of the surviving spouse.

[1] The examples used below ignore inflation adjustments.

Another disadvantage of portability is that it does not apply to the GST exemption amount. That is, the deceased spouse's unused GST exemption cannot be transferred to the surviving spouse. Therefore, if assets greater than $5,000,000 were transferred to grandchildren or further descendants, they would be subject to the GST tax. In contrast, the bypass trust approach could protect up to $10,000,000 of assets that could be transferred to grandchildren or further descendants.

Finally, there are non-tax benefits to using a trust which include asset protection, providing management, and restricting transfers of assets by a surviving spouse.

Again, families in this $5,000,000 to $10,000,000 will still want to consider using Alaska self-settled discretionary spendthrift trusts (DAPTs), life insurance trusts, and perpetual trusts for the reasons discussed in the "Less Than $5,000,000" category, above.

In summary, clients in the $5,000,000 to $10,000,000 category will need to carefully evaluate the pros and cons of portability versus the bypass trust approach (and similar trust approaches). There is no "one size fits all" solution in this category. ***Clients who decide to use portability, rather than the bypass trust approach, will be able to greatly simplify their joint revocable trust or wills.***

Families With a Net Worth Greater Than $10,000,000—Urgency Remains. Planning in this area has not changed and is very time sensitive. ***This urgency is caused by the pending tax reform, which has been discussed above.*** Valuation discounts, sales to grantor trusts, renting assets from grantor trusts, paying income taxes generated from assets in grantor trusts, GRATs, perpetual trusts, and possibly other techniques may be eliminated or severely curtained by tax reform later in 2013.

Therefore, clients with a net worth greater than $10,000,000 will want to immediately consider significant planning techniques which are designed to reduce estate taxes at the death of the surviving spouse or at the death of the single client. The following techniques, among others, are very effective: bypass and marital trusts approach, lifetime gifting, sales to grantor trusts, GRATs, QPRTs, and Alaska self-settled discretionary spendthrift trusts. Again, ***if such techniques are implemented now, and assets are transferred to the trusts prior to any tax reform, then such assets should be grandfathered and not subject to the tax reform changes.***

Wandry v. Commissioner. A defined value clause is an important technique which is used as a gift tax safeguard when difficult to value assets are gifted or sold to an irrevocable trust. The IRS has challenged the use of these clauses, and *Wandry* is the fifth of a series of cases where the courts have rejected the IRS's challenges.

When a defined value clause is used, you state the gift or sale amount in the formula. If after an audit the value of the assets has increased, then the excess amount belongs to an excess beneficiary. In the first four cases, this excess beneficiary has been a charity. *Wandry* is the first case where the excess beneficiary is the client. That is, the excess amount remains with the client rather than going to a charity. In *Wandry*, the Tax Court held for the taxpayer. The IRS appealed and then dropped the appeal. The IRS has published a nonacquiescence, which means that it may contest similar cases in the future.

Our office uses an escrow trust to implement the defined value clause approach. We think this effectively counteracts arguments used by the IRS when it is attempting to contest these clauses.

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 planning in 2013. 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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