Estate Planning After the American Taxpayer Relief Act of 2012

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I. The Law Prior to the American Taxpayer Relief Act of 2012 ("ATRA")

A. 2012 Law

1. 35% top rate for estate, gift and GST tax.

2. $5.12 million estate, gift and GST tax exemptions.

3. Portability of estate tax exemption between spouses.

4. 35% top income tax rate.

5. 15% top rate on long term capital gains and qualified dividends.

B. What 2013 Law Would Have Been Without ATRA

1. 55% top rate for estate, gift and GST tax, with additional 5% surtax on estates between $10 million and $17,184,000.

2. $1 million estate and gift tax exemptions; GST exemption of $1 million adjusted for inflation since 1997 (~ $1.4 million in 2013).

3. No portability of estate tax exemption between spouses.

4. 39.6% top income tax rate.

5. 20% top rate on long term capital gains; dividends taxed at ordinary income rates.

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6. 3.8% surtax on net investment income under Affordable Care Act (Obamacare) for high income earners.

7. Potential for "clawback" as a result of decreased transfer tax exemptions.

II. Summary of American Taxpayer Relief Act of 2012 ("ATRA")

A. Transfer tax provisions and certain income tax provisions are permanent (unless changed by future legislation).

B. Transfer tax provisions

1. 40% top rate for estate, gift and GST tax.

2. $5 million estate, gift and GST tax exemptions, indexed for inflation after 2011 ($5.25 million in 2013). Estate and gift tax exemptions are unified.

3. Portability is permanent.

4. Sunset provisions of 2001 and 2010 Acts were repealed. This means that the following provisions are now permanent:

a. Automatic allocation of GST exemption to lifetime transfers to GST Trusts under Code § 2632(c);

b. Qualified severances of trusts permitted for GST purposes pursuant to Treas. Reg. § 26.2642-6;

c. 9100 relief available for late GST exemption allocations;

d. State death tax credit is converted to a deduction for state death taxes. Thus, no Florida estate tax;

e. Qualified Family Owned Business Interest (QFOBI) deduction under Code § 2057 eliminated;

f. Expanded estate tax conservation easement rules under Code § 2031(c); and

g. Increase in the number of permitted shareholders or partners from 15 to 45 for purposes of Code § 6166.

5. "Clawback" is no longer an issue because exemptions did not decrease from prior law.

C. Relevant income tax provisions

1. Top income tax rate of 39.6% for taxable income in excess of $400,000 for unmarried individuals and $450,000 for married couples filing jointly.

2. Top rate of 20% for long term capital gains and qualified dividends for taxpayers in the 39.6% income tax bracket.

3. Phase out of itemized deductions under Code § 68 for single taxpayers with adjusted gross income in excess of $250,000 or married couples filing jointly with adjusted gross income in excess of $300,000.

4. For 2013, individuals who have reached age 70 ½ years can make tax-free distributions from individual retirement plans to charities of up to $100,000. Distributions to donor-advised funds do not qualify. (Note: This is the same provision that applied from 2006 through 2011.)

   a. This provision was not in effect for 2012 prior to ATRA. However, ATRA permits taxpayers who made a qualified charitable distribution in January 2013 to elect to treat the distribution as having been made in 2012. In addition, a taxpayer who took a distribution from an IRA in December 2012 may treat that as a qualified charitable distribution to the extent cash was transferred to a charity prior to February 1, 2013 and it otherwise qualified as a qualified charitable distribution.

D. What provisions on the President's "wish list" were not included in ATRA?

1. Basis consistency for income and transfer tax purposes

   a. Basis of an asset for income tax purposes would be required to be the same as the basis of the asset for estate or gift tax purposes (subject to subsequent adjustments).

   b. Query whether this would be fair to the recipient of the property because he or she may not have been involved in the filing of the estate tax return or the audit negotiations.

2. Modify rules on valuation discounts

   a. Revise Code § 2704 to add additional category of applicable restrictions that would be disregarded in valuing transferred assets.

   b. IRS apparently has already drafted regulations, but they have not been released, perhaps because the IRS believes these regulations would not be valid without legislative changes to Code § 2704.

3. Limitations on Grantor Retained Annuity Trusts (GRATs)

   a. 10 year minimum term; maximum term of grantor's life expectancy plus 10 years.

   b. Value of remainder interest must be greater than zero.

c. Annuity amount cannot decrease during GRAT term.

4. 90 year limitation on GST exemption

   a. On the 90th anniversary of the creation of the trust, the inclusion ratio would be increased to 1, effectively making all generation-skipping transfers from the trust thereafter subject to GST tax.

5. Transfer of life insurance policies

   a. Require a person or entity who purchases an interest in an existing life insurance contract with a death benefit equal to or exceeding $500,000 to report the purchase price, the buyer's and seller's taxpayer identification numbers (TINs), and the issuer and policy number to the IRS, to the insurance company that issued the policy, and to the seller. This is intended to increase compliance and ensure that those who are required to pay income tax on death benefits (because of the transfer-for-value rules) actually do so.

   b. Modify the transfer-for-value rules to ensure that exceptions to that rule would not apply to buyers of policies. Upon the payment of any policy benefits to the buyer, the insurance company would be required to report the gross benefit payment, the buyer's TIN, and the insurance company's estimate of the buyer's basis to the IRS and to the payee. This is intended to curb the ability of investors to structure purchases in a manner avoid paying income tax on death proceeds. It is unclear at this point how this proposal could affect estate planning related transfers of life insurance policies.

6. Elimination of RMD rules for qualified plans or IRAs of an individual with aggregate balances of $75,000 or less.

7. Inclusion of grantor trusts in grantor's gross estate

   a. If a trust is a grantor trust, then (i) assets would be includible in grantor's gross estate for estate tax purposes, (ii) distributions from the trust would be treated as gifts and (iii) conversion to non-grantor trust status would be treated as a gift.

   b. Same rules would apply to 678 trusts if the deemed owner sells assets to the trust (which could be intended to limit the use of Beneficiary Defective Trusts (BDITs)).

   c. Revenue projections are small ($910 million over 10 years) and there are a lot of details to work out. Therefore, this is unlikely to be part of legislation in the near-term. Consider the impact this could have on the use of irrevocable life insurance trusts (ILITs) and Spousal Lifetime Access Trusts (SLATs).

8. Extension of Code § 6324 lien thoughout the Code § 6166 deferral period. Currently, the Code § 6324(a)(1) lien expires approximately 5 years before the due date of the final payment of deferred tax under Code § 6166.

III. Planning for 2013 and Beyond

A. Refresher on Portability

1. “Portability” means that the personal representative of a deceased spouse’s estate may elect to transfer any unused estate tax exemption at the deceased spouse’s death to the surviving spouse. The unused exemption is known as the “Deceased Spousal Unused Exclusion” amount or the “DSUE” amount.

2. Portability is intended to provide a married couple the opportunity to utilize the exemptions of both spouses even if the couple failed to plan prior to the death of the first spouse. For example, assume H has $10.5 million of assets in 2013 and W has $0. Without portability, if W died in 2013 (without any assets), W’s $5.25 million exemption would be lost. When H later dies in 2013, estate tax would be due on the $5.25 million of assets in excess of H’s $5.25 million estate tax exemption. With portability, no estate tax would be due upon H’s death because H could add W’s unused $5.25 million exemption to H’s exemption, thus giving H a total exemption of $10.5 million.

3. Surviving spouse can use the DSUE of the deceased spouse to make gifts during the lifetime of the surviving spouse. Gifts by the surviving spouse use the DSUE amount first before using the surviving spouse’s exclusion amount.

4. GST exemption is not portable. First spouse must use it or lose it.

5. The DSUE amount is not indexed for inflation (even though the surviving spouse’s exemption is indexed for inflation).

6. ATRA contained a technical correction to Code § 2010(c)(2), which is intended to clarify that the Deceased Spousal Unused Exemption (“DSUE”) amount “ported” to a surviving spouse includes the DSUE amount the deceased spouse acquired upon the death of his or her prior spouse.

   a. Example −Assume Wife survives Husband 1 and Wife’s applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million DSUE from Husband 1). Wife remarries and then predeceases Husband 2. Wife made no taxable transfers and has a taxable estate of $3 million, which she leaves to children from her first marriage. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's DSUE, which is $4 million (Wife's $7 million applicable exclusion amount less her $3 million taxable estate). Accordingly, Husband 2's applicable exclusion amount is increased by $4 million, i.e., the amount of Wife's DSUE . Joint Committee on Taxation Technical Explanation of TRA 2010, Ex. 3.

B. Use of Portability vs. Credit Shelter Trust

1. *Portability Decision Is Complex* - Because the portability provisions have now been made permanent, married clients may be more inclined to proceed with fairly simple "all to spouse" will planning, relying on portability to take advantage of both spouses' estate exemptions, rather than using more complicated trust planning. From the planner's perspective, this is a more complex decision involving a variety of factors.

2. *Situations Favoring Portability* - Situations favoring an approach leaving all of the assets to the surviving spouse and relying on portability include:

   a. A competent spouse who can manage assets;

   b. Client's desire for simplicity and to avoid using trusts;

   c. First marriage or no children existing from prior marriage of either spouse;

   d. Clients who are more interested in obtaining a basis step up at death of surviving spouse rather than getting future appreciation out of their estate (although basis step up may still be available through trust planning described in Section C below);

   e. Situations in which it is undesirable to retitle assets among spouses prior to death;

   f. There is a residence or other assets (such as large retirement accounts) that would be difficult to administer in a trust;

   g. Consumption of surviving spouse is expected to exceed growth rate of assets; and

   h. Desirability of the surviving spouse to be able to use the DSUE to create a trust following the first spouse's death that would be a grantor trust as to the surviving spouse.

3. *Reasons for Using Trusts even with Portability* – There are various reasons for continuing to use credit shelter trusts at the first spouse's death and not rely on portability including:

   a. The DSUE is not indexed for inflation;

b. The DSUE from a predeceased spouse will be lost if the surviving spouse remarries and survives his or her next spouse;

c. Growth in the assets of a credit shelter trust are excluded from the gross estate of the surviving spouse;

(1) Example: Assume Wife dies in 2013 with a $5.25 million estate and that Husband has a $0 estate. If all assets are transferred from Wife for the benefit of Husband, what is the impact of relying on portability vs. using a credit shelter trust if the assets grow by 6% per year until Husband's death 20 years later? Assume Husband's exemption grows by 2.45% per year due to inflation. The DSUE is not indexed for inflation.

	Portability	Credit Shelter Trust
Starting Balance	$5,250,000 (W) + $5,250,000 (H) $10,500,000	$5,250,000
Balance at end of 20 years	$ 5,250,000 (DSUE) + $ 8,520,000 (H) $13,770,000	$16,837,461
Amount subject to estate tax	$16,837,461 gross estate -$13,770,000 exemption $ 3,067,461	$0
Estate tax (40%)	$1,226,984	$0

d. There is no portability of the GST exemption;

e. There is no statute of limitations on values for purposes of determining the DSUE that begins to run from the time the first deceased spouse's estate tax return is filed whereas the statute of limitations runs on values if a credit shelter trust is funded at the first spouse's death;

f. Credit shelter trust could be funded with discounted / hard-to-value assets when there may be a low audit risk at the first spouse's death;

g. Credit shelter trust assets protected from creditors, predators and divorce;

h. Credit shelter trust provides a mechanism for the management of assets if the surviving spouse is incompetent or otherwise unable to properly manage assets;

i. Individuals other than the surviving spouse can be included as beneficiaries of the credit shelter trust, which allows assets to pass to beneficiaries other than the spouse without the surviving spouse using exemption to make gifts; and

j. Predeceased spouse can control the disposition of the credit shelter trust assets during the surviving spouse's lifetime and upon the death of the surviving spouse. This is extremely important for blended families / second marriages.

4. *Planning for Blended Families is Critical*. In a blended family situation, substantial inequities may result if the credit shelter approach is not used.

a. If the assets are left outright to the surviving spouse, the spouse may give or bequeath the assets to persons other than the first deceased spouse's descendants (or may favor some over others of those descendants in ways that the deceased spouse would not have wanted).

b. If even a QTIP trust is used, the surviving spouse may be able to take steps that would significantly disadvantage the deceased spouse's descendants even though the assets are "protected" in a QTIP trust.

(1) For example, if the executor makes a QTIP election and elects portability, the surviving spouse will have the DSUE amount from the deceased spouse and could make gifts of the surviving spouse's assets to his or her own descendants utilizing all of the DSUE amount and his or her gift exemption amount. (Alternatively, the surviving spouse could make a gift using just the DSUE amount, and at death might leave all assets owned by the surviving spouse to his or her descendants.) At the surviving spouse's death, the QTIP trust is required to reimburse the surviving spouse's estate for taxes attributable to the QTIP trust assets pursuant to Code § 2207A. In effect, the first deceased spouse's descendants would not have benefitted at all from the first deceased spouse's exemption amount.

(2) This could be addressed in a prenuptial agreement or other marital agreement, to provide that the portability election would be made if the surviving spouse agreed to waive reimbursement rights from the QTIP trust. For example,

the decedent's will could direct the executor not to make the portability election unless the surviving spouse agrees to waive the right to be reimbursed for estate taxes from the QTIP trust at the surviving spouse's subsequent death.

c. Use of credit shelter trust to assure that the first deceased spouse's descendants are treated fairly avoids these complexities.

C. Structuring Revocable Trusts and Wills

1. Review estate planning documents to determine whether they need to be revised as a result of 2012 gifts.

a. Should testamentary gifts be made directly to trusts created to hold 2012 gifts instead of establishing new trusts at death?

b. Does the grantor have the means to continue paying income tax on grantor trusts after 2012 gifts?

c. Does the donor need to remove specific gifts contained in his or her testamentary documents because these were effectively satisfied by 2012 gifts?

d. Does the formula clause for estate and/or GST tax exemptions used in the Will or Trust of the Donor or Donor's spouse need to be revised?

2. With higher exemptions, it is important to keep in mind the following non-tax reasons when structuring estate plans:

a. Asset protection planning;

b. Planning for disability and incompetency of recipients;

c. Business succession planning;

d. Planning for marital and other dissolutions;

e. Charitable giving;

f. Avoidance of litigation (enhanced when there is more to fight over);

g. Planning to minimize state death taxes (in many states);

h. Planning for spendthrift children; and

i. Planning for clients with real estate in more than one state, including ownership, asset protection, state income taxation, spousal rights, and probate issues.

3. Clients with less than $5.25 million net worth

a. The major focus for estate planning for clients having assets under $5.25 million will be (i) core dispositive planning, (ii) income tax planning and (iii) preservation and management of assets.

b. *Transfer Taxes Generally Irrelevant.* Transfer taxes will generally be irrelevant for clients in this range. One issue clients will face is whether to make the portability election at the death of the first spouse. Filing an estate tax return and making the election will be preferable in most cases. The assets must be valued in any event for basis purposes, and the portability regulations allow a relaxed reporting procedure to merely list assets qualifying for the marital deduction rather than listing values of each of the assets. Filling out the estate tax return will not be overly onerous. If an estate tax return is not filed to make the portability election, the planner will want a written waiver letter signed by the personal representative (and perhaps the surviving spouse and other beneficiaries).

c. *Core Dispositive Planning.* Clients will continue to need estate planning documents disposing of their assets among their desired beneficiaries and coordinating beneficiary designations to achieve the desired result.

d. *Income Tax Planning.* While transfer taxes may be irrelevant, income tax issues will remain. A key issue for clients in this range will be preserving a step-up in basis at the death of each spouse. There are several ways to accomplish this which are discussed in Section III.C.4 and III.C.5 below.

e. *Preservation and Management of Assets; Trust Planning.* A key decision will be whether to use trusts as part of the estate plan for non-tax reasons. Non-tax reasons that a trust may be appropriate include:

(1) The surviving spouse is not capable of managing assets;

(2) There is a second marriage / blended family and each deceased spouse wants to control where his or her assets will pass;

(3) The parties have a concern about the spouse’s remarriage or undue influence; or

(4) There is a need for asset protection or divorce protection.

If a trust is used, consider allowing discretionary income and principal distributions for health, education, support and maintenance – not for tax reasons but to ensure that distributions are made when needed. Consider making distributions to children or others subject to the consent of the spouse. Give the spouse a lifetime or testamentary general power of appointment in order to achieve a step up in basis at the surviving spouse's death. Be aware, however, that if asset protection is a concern, creating an enforceable right in the spouse to a "HEMS" distribution or granting a general power of appointment is not desirable.

f. *Rethinking Traditional Planning Concepts.* In light of the fact the transfer taxes are largely irrelevant (absent "winning the lottery" or a change in future transfer tax laws), planners will need to rethink traditional planning concepts. For example, steps that are taken to assure qualification for the annual exclusion, to avoid retained interests in trusts, etc. may no longer be necessary. Clients may opt for owning life insurance outright instead of creating irrevocable life insurance trusts.

g. *Focus on Maintaining Standard of Living.* Rather than focusing on strategies for wealth transfer, these clients may focus more on having sufficient assets to maintain the spouses during their retirement years.

h. *Qualified Retirement Plans.* A large part of planning for retirement will be to structure withdrawals from qualified retirement plans so that they can last for the lifetimes of the spouses.

i. *Elder Law/Medicaid Planning.* For clients with modest means, planning for long-term and nursing home care is important.

j. Asset Protection Planning.

(1) *Tenancy by the Entireties.* Florida law provides that assets held as tenants by the entireties are protected from the creditors of an individual spouse. However, a creditor of both spouses could reach assets owned as tenants by the entireties. Additionally, these assets will become subject to the creditors of the surviving spouse upon the death of the first spouse to die.

(2) *Qualified Retirement Plans.* Florida law generally protects assets held in qualified retirement plans (including inherited IRAs) from creditors' claims.

(3) *Life Insurance and Annuities*. Florida law generally protects the cash surrender value of life insurance policies issued upon the lives of residents of Florida and annuity contracts issued to residents (Fla. Stat. § 222.14).

k. *State Transfer Taxes*. About half of the states have state estate taxes with exemptions considerably lower than the $5 million indexed federal exemption. For example, New York has a $1 million exemption. Planning to avoid state transfer taxes is important for clients who have property in those states.

4. Clients with $5.25 million - $10.5 million net worth

a. In addition to the planning issues discussed above, a primary estate planning decision for clients in this range will be whether to use a credit shelter trust or rely on portability at the first spouse's death. The key to planning for these clients is <u>flexibility</u>.

b. Possible Planning Approaches

(1) *All to spouse with optional disclaimer to credit shelter trust* - This structure permits the surviving spouse to determine upon the death of the predeceased spouse whether to have any assets pass to a credit shelter trust or whether it would be preferable to transfer the assets outright and rely on portability.

(a) Disclaimed assets in credit shelter trust do not get a basis adjustment at death of surviving spouse.

(b) Disclaimer must be made within 9 months of decedent's death even if due date of estate tax return is extended.

(c) Caution: Surviving spouse cannot hold a power over the disclaimed property in the credit shelter trust as trustee or otherwise to make distributions or appoint assets unless limited by an ascertainable standard. Otherwise, the disclaimer will not be a qualified disclaimer for tax purposes.

(2) *All to QTIPable trust for spouse (including possibility of a Clayton QTIP)* – This plan has the potential to provide an optimal approach because it would (i) provide asset protection for trust assets, (ii) permit a basis adjustment for income tax purposes for trust assets at the death of the surviving spouse, (iii) permit the GST exemption of the predeceased spouse to be used for QTIP assets by virtue of

a "reverse QTIP election" under Code § 2652(a)(3) or for assets passing to the non-QTIP trust and (iv) permit the DSUE amount of the predeceased spouse to be ported to the surviving spouse.

(a) All assets could pass to a single trust that is QTIPable. If the QTIP election were made in respect to all of the assets, then the deceased spouse's applicable exclusion amount would not be used and the DSUE amount could pass to the surviving spouse. If the QTIP election were made in respect to only a fraction or percentage of the assets, then a portion or all of the deceased spouse's applicable exclusion amount would be used, reducing or eliminating the DSUE amount that could pass to the surviving spouse. If a partial QTIP election is made, the trust should be divided into two separate trusts. The drawback to this planning is that all of the assets would be held under the same terms regardless of whether the QTIP election were made – including mandatory income to the surviving spouse.

(b) A variation of this planning, and perhaps even more beneficial, would be to use a "Clayton" provision, providing that any portion of the assets that otherwise would pass to the QTIPable marital trust over which the QTIP election was not made instead would pass to a credit shelter trust. The credit shelter trust could include beneficiaries other than the surviving spouse and allow discretionary, rather than mandatory, distributions. The surviving spouse also could have preference in distributions of the credit shelter trust.

(c) Personal representative has up to 15 months after death (assuming an election is filed to extend the due date of the estate tax return) to decide whether to make a QTIP election. This is 6 months longer than disclaimer planning.

(d) Caution: Some have questioned whether Rev. Proc. 2001-38, 2001-1 CB 1335 precludes the use of this strategy. Rev. Proc. 2001-38 generally provides that the IRS will ignore a QTIP election "where the election was not necessary to reduce the estate tax liability to zero." If portability applies, the election is not required to reduce the estate tax liability to zero, so literally, the Rev. Proc. might apply. However, most commentators believe that Rev. Proc. 2001-38 does not preclude making a QTIP election even though the estate is relying on portability. The purpose of Rev. Proc. 2001-38 was to prevent an inadvertent QTIP election from precluding the use of the first deceased spouse's estate tax exemption amount. Since the DSUE amount may be utilized by the surviving spouse as a result of portability, the Rev. Proc seems to not be relevant to this situation (although the IRS has not issued guidance on whether it will apply in this scenario).

(3) Exemption gift to Credit Shelter Trust with a power in an independent person to (i) make distributions for any purpose and/or (ii) grant a general power of appointment in the surviving spouse.

(a) Authorizing an independent person to make distributions for any purpose will permit assets to be distributed to the surviving spouse if it is determined that it will be more beneficial to have these assets included in the surviving spouse's gross estate, and, thus, receive a basis adjustment.

(b) Authorizing an independent person to grant the surviving spouse a general power of appointment provides flexibility to cause the assets in the credit shelter trust to be includible in the surviving spouse's gross estate, and, therefore, receive a stepped-up basis, if the trust assets would not incur estate tax or it would be more beneficial to pay estate tax and get the income tax basis step up than avoid subjecting the trust assets to estate tax.

5. Clients with more than $10.5 million net worth

a. Traditional planning strategies for large estates will generally continue to apply in addition to many of the planning issues discussed above.

(1) Formula division of assets between marital and credit shelter trusts.

(2) Retitling assets to ensure each spouse has sufficient assets to fund a credit shelter trust at the death of the first spouse.

b. *Using Portability and the DSUE to Create a Grantor Trust.* One planning technique for large estates instead of using a credit shelter trust that was not available prior to portability may be to transfer assets outright to the surviving spouse at the first spouse's death (together with the deceased spouse's exemption via portability) and then have the surviving spouse make a gift to a grantor trust shortly after receiving the assets to utilize the DSUE amount.

(1) Gift by surviving spouse uses DSUE prior to using the surviving spouse's exemption.

(2) Payment of income tax by the surviving spouse effectively means that the trust assets will grow income tax free to the trust beneficiaries.

(3) Grantor trust status could be terminated at any time, including if the income taxes on the trust assets become too burdensome for the surviving spouse.

(4) Although assets will generally acquire a date of death basis at the death of the first spouse, this technique means that the assets will not obtain a date of death basis at the death of the surviving spouse unless further planning is done. For example, the surviving spouse could repurchase the assets prior to death, which would not have any income tax consequences because the trust is a grantor trust. See Rev. Rul. 85-13. The surviving spouse could also substitute high basis assets owned by the surviving spouse for low basis assets held in the trust prior to death if the surviving spouse has a power of substitution.

(5) Grantor trust can own S corp. stock without having to make an ESBT or QSST election.

(6) Surviving spouse can sell assets to or borrow assets from the grantor trust without creating income tax.

6. *Addressing the Portability Election in your Documents.* Regardless of a client's wealth, it is important to draft provisions into your Wills, Trusts, Prenuptial Agreements and Postnuptial Agreements that address whether the portability election will be made, who will have the authority to decide whether to make a portability election, who will bear the costs associated with filing the portability election, etc.

a. A will could designate whether the personal representative would be required or have the discretion to make or not make the portability election. An alternative is to require the executor to make the election if the spouse so requests, or perhaps to require that the executor make the election unless the spouse directs that the election not be made.

b. The expense of preparing an estate tax return to make the portability election must be borne by someone. Even with the simplifications allowed by the temporary and proposed regulations of not having to list the values of each asset passing to the surviving spouse or charity, the expense in preparing the estate tax return to make the election still could be significant. The will can address whether the estate or surviving spouse would pay the expenses of making the election.

c. If the expense, which is an estate transmission expense, is allocated to the share of the surviving spouse, it will reduce the marital deduction. As long as the expense is claimed as a deduction on the estate tax return, it will not affect the DSUE amount. If, however, the expense instead is claimed on the fiduciary income tax return, then to avoid the imposition of estate tax at the first death, the expense would have to be offset by the use of a portion of the deceased spouse's applicable exclusion amount, reducing the DSUE amount passing to the surviving spouse.

d. Providing for portability in a prenuptia1 / postnuptial agreement is important as well. The surviving spouse may not be the person responsible for making the portability decision. If portability is addressed in the prenuptia1 / postnuptial agreement, consider whether these provisions will permit the terms of a spouse's will or trust to override the terms of the prenuptia1 / postnuptial agreement with respect to portability.

D. Income Tax Planning

1. Application of 3.8% Medicare surtax on Net Investment Income under Affordable Care Act

a. Section 1411 imposes a surtax (in addition to federal income taxes) of 3.8% on the unearned income of individuals, estates, and trusts for taxable years beginning <u>after</u> December 31, 2012.

b. For individuals, the tax is 3.8% of the <u>lesser</u> of:

(1) the individual's modified adjusted gross income in excess of a threshold amount ($200,000 for individuals and $250,000 for couples); or

(2) the individual's net investment income for the year.

c. For estates and trusts, §1411(a)(2) imposes a tax equal to 3.8% times the <u>lesser</u> of:

(1) the estate's or trust's adjusted gross income (as defined in §67(e)) in excess of the highest income tax bracket threshold ($11,950 for 2013); or

(2) the estate's or trust's undistributed net investment income.

d. 3.8% surtax is never imposed on more than net investment income, regardless of the amount of gross income.

e. The threshold for individuals is not indexed. The threshold for estates and trusts is the dollar value for the highest income tax bracket for estates and trusts, which is indexed, but which is a very low number.

f. *Grantor Trusts.* The Medicare tax is not imposed on grantor trusts, but items of income, deduction or credit are treated as if they had been received or paid directly by the grantor for purposes of calculating that person's individual net investment income.

g. Net investment income includes gross income from interest, dividends, rents, royalties, annuities, gains from the disposition of property, passive activities (i.e., not including income derived in the ordinary course of a trade or business), less "properly allocable" expenses. §1411(c)(1). Several types of income are specifically excluded from investment income, including (i) distributions from IRAs in qualified plans, (ii) non-passive trade or business income, (iii) tax-exempt income and tax-exempt annuities, and (iv) guaranteed payments from partnerships.

2. Passive vs. non-passive income for purposes of 3.8% surtax

a. Passive income is included in both AGI and net investment income for purposes of the 3.8% surtax. However, the 3.8% surtax generally does not apply to income generated from a trade or business in which the taxpayer is "active" for purposes of Code § 469.

b. To be treated as income from a non-passive activity, there must generally be (1) a trade or business and (2) material participation by the taxpayer.

(1) Passive activity rules for trusts and estates have never been written. The IRS position is that trusts and estates are not

treated as individuals for this purpose and that the *trustee* must be involved directly in the operations of the business (in the boots, in the mud on the cattle ranch, walking the ranch on a continual basis, etc.). In *Carter v. United States*, 256 F. Supp.2d 536 (N.D. Tex. 2003), the trust operated active ranch operations, and the trustee hired a ranch manager (who was not a trustee). The IRS maintained that was not material participation for the trust because the trustee individually did not materially participate. However, the Texas District Court concluded that material participation should be determined by reference to all persons who conducted the business on the trust's behalf, including employees as well as the trustee.). The IRS has non-acquiesced in this decision.

(2) Technical Advice Memorandum 200733023 provides that merely labeling a person involved in the business as a "special trustee" will not suffice. The determining factor is whether the special trustee had powers that could be exercised solely without the approval of another trustee. If so, material participation of the special trustee would suffice.

(3) If a trust owns an interest in an active trade or business operation, a planning consideration will be whether to name some individual who is actively involved in the business as a co-trustee. If that is done, income attributable to the business would not be subject to the 3.8% Medicare tax.

c. *Rental Income*. Rental income is generally passive for purposes of the 3.8% surtax. There is an exception for real estate professionals that devote 750 hours to working in the real estate business. Otherwise, taxpayers must meet two tests to be for rent to be excepted from being net investment income: (i) material participation, and (ii) the rental income activity is a trade or business.

d. Real estate is often held in separate entities to isolate liability. If real estate that is used in a business is held in a separate entity from the operating company, such rental income generally will not be trade or business income unless the real estate company is in the trade or business of leasing multiple similar real properties. Therefore, it is important to consider whether restructuring to avoid the 3.8% surtax will be beneficial.

3. Year-end analysis / distributions to reduce income tax

    a. Distributions from an estate or trust to beneficiaries in a lower tax bracket may reduce the income subject to high rates on ordinary and capital gains income, as well as reducing the income subject to the 3.8% tax. The savings may be even greater if there are state income taxes imposed on the trust.

    b. This may put additional pressure on fiduciaries to make distributions. Of course, the fiduciary must look to the distribution standards in the trust agreement to determine the extent to which these tax considerations come into play. If the distribution is based solely on the health, education, support, and maintenance of the beneficiary, the trustee may not have the authority to take into consideration tax effects of distributions. Giving a non-beneficiary trustee the authority to consider tax implications may broaden the ability of the fiduciary to consider these tax implications of distributions. Even so, the fiduciary would generally treat taxes as merely one factor to be considered in the overall factors that the fiduciary considers in determining the appropriateness of distributions.

4. 65 day election

    a. Under the 65 day rule, the fiduciary may elect to treat distributions made during the first 65 days following the close of the taxable year as if they had been made on the last day of the prior year. §663(b).

    b. This may become more prevalent going forward because it permits a fiduciary to assess the tax situation after the close of the tax year.

5. Ability to distribute capital gain as income from a trust

    a. Capital gains are an item of net investment income and, therefore, will incur a 20% tax and the 3.8% surtax if the trust is in the top income tax bracket (i.e., > $11,950 in 2013). While distributions to beneficiaries generally reduce both adjusted gross income and net investment income, capital gains cannot be distributed without authority in the trust instrument or state law for doing so. Code § 643.

    b. Since Florida does not currently statutorily authorize a fiduciary to distribute capital gains as income, a trust instrument should be drafted to either mandate how distributions are allocated against various types of taxable income or give the trustee discretion to allocate capital gains to income that is distributed.

c. The ability to distribute capital gains could result in these gains being taxed at the beneficiaries' lower brackets rather than 23.8% if they remained in the trust.

6. Converting Grantor Trusts to Non-Grantor Trusts

a. Income generated in a grantor trust is included in the income of the grantor and taxed at the grantor's rates even if distributions are made to beneficiaries. Since grantors often find themselves in high income tax brackets (and will likely find themselves subject to the 3.8% surtax), income taxes can potentially be saved by converting a grantor trust to a non-grantor trust, and subsequently making distributions of income to beneficiaries in lower income tax brackets.

b. Caution: Converting a grantor trust to a non-grantor trust may not be as simple as releasing a power of substitution or other Code § 675 power. Code § 674 can be difficult to overcome depending on the terms of the trust and who is serving as trustee.

c. Caution: Converting a grantor trust to a non-grantor trust can also have income tax consequences because the conversion is effectively treated *for income tax purposes* as the grantor transferring assets to the trust at the moment of conversion. Rev. Rul. 77-402; Treas. Reg. § 1.1001-2(c), ex. 5.

7. Fiscal year election (for those estates/Code § 645 trusts on extension or those estates that have not filed a return)

a. For estates that have yet to file an income tax return, a fiscal year ending November 30, 2012 should be considered. The first tax year of the estate can be less than 12 months. The increased income tax brackets under ATRA and 3.8% surtax apply to tax years beginning on or after 1/1/2013 and, therefore, would not apply to income of the estate for the year from 12/1/12 to 11/30/13 (unless distributions were made to beneficiaries).

b. Fiscal year election is made on the first filed return, even if it's a late return.

c. Tax years indicated on a Form SS-4 are not binding. Further, the filing for an automatic extension of time to file does not establish a tax year. Treas. Reg. § 1.441-1(c).

d. An election can be made pursuant to Code § 645 to treat a decedent's revocable trust as part of the estate for income tax purposes for a limited period of time following the decedent's death. This results in the trust having the same tax year as the estate instead of a calendar year. The election must be made by filing Form 8855 no later than the due date (including any extensions) for filing the Form 1041 for the estate for its first taxable year. There is no relief for a missed Code § 645 election.

e. **NOTE: AN ESTATE OR QUALIFIED REVOCABLE TRUST SEEKING TO MAKE AN ELECTION TO HAVE A FISCAL YEAR ENDING 11/30/12 MUST FILE A RETURN OR EXTENSION OF TIME TO FILE A RETURN BY MARCH 15, 2013. IF A TIMELY RETURN IS NOT FILED, THE FISCAL YEAR ELECTION CAN BE MADE ON THE FIRST FILED RETURN FOR THE ESTATE (EVEN THOUGH THE RETURN IS LATE), BUT A CODE § 645 ELECTION CANNOT BE MADE FOR THE QUALIFIED REVOCABLE TRUST.**

8. Claiming deductions on Form 1041 instead of Form 706

a. When estate tax rates were significantly higher than income tax rates, administration expenses were routinely claimed on an estate tax return rather than an estate income tax return. Now that income tax rates can exceed the estate tax rate, the analysis is significantly more difficult.

b. Consider that deducting expenses on Form 1041 may subject them to the 2% floor on miscellaneous itemized deductions under Code § 67 and, therefore, some benefit of the deduction may be lost if these expenses are claimed on Form 1041.

9. Strategies to preserve basis step-up at death of first spouse

a. *Repurchase of Appreciated Asset for Cash or High Basis Property (Not a Note).* Assets with substantial appreciation that have been transferred to a grantor trust could be repurchased by the grantor before death. Most conservatively, the grantor should use cash to repurchase the assets.

(1) If the donor does not have sufficient other assets, repurchase will be difficult. One alternative would be for the grantor to borrow funds from an outside lender, and use the cash proceeds to purchase the appreciated assets. The loan could be repaid following the grantor's death.

(2) There is uncertainty regarding the income tax consequences if a note is used to repurchase property from the grantor trust. The trust's basis in the note may equal the grantor's basis in the reacquired asset so that the payment of the trust's note would ultimately generate gain.

(3) An obvious difficulty with this strategy is that the repurchase must occur prior to the death of the donor, but the date of death is unpredictable. Standby purchase instruments might facilitate fast implementation of the repurchase transaction.

(4) Section 1014(e) may apply if the purchase is from a grantor trust owned by the spouse and therefore treated as a gift under §1041. In this situation, the purchased asset would not receive a basis adjustment at death.

b. *Using Freeze Partnership.* A donor may make a gift of the common interest while retaining the preferred interest in a preferred partnership. The common interest would be valued at an amount at least equal to 10% of the partnership value. The effect is to transfer cash flow and appreciation in excess of the preferred return and liquidation preference of the retained preferred interests.

(1) The preferred interest will be structured to satisfy the §2701 requirements (which, among other things, would require a cumulative return), so that the retained preferred interest is not valued at zero for gift tax purposes.

(2) The preferred interest would be includable in the gross estate at death and would be eligible for a basis step up. The key, for basis purposes, is that a §754 election would allow a corresponding step up to the partnership's inside basis in underlying assets.

(3) This structure requires the payment of a preferred return to the donor, which may be difficult if the yield under on the underlying assets is not sufficient.

c. *Unwinding Entity Planning.* Clients that have previously entered into estate planning transactions, such as creating entities for discounting purposes, may want to reverse the effects of some of those transactions. Dissolving or restructuring an entity may avoid valuation discounts that would otherwise limit basis adjustments at the owner's death.

d. *Triggering Estate Tax Inclusion.* Because of the permanent large indexed estate tax exemption, the client who will not have to pay any federal estate tax may want to take steps purposefully to cause previously transferred assets to be included in the gross estate in order to receive the basis step-up. This could be desired where the income tax cost of the loss of basis step-up outweighs the estate tax savings because the appreciation is not sufficient.

(1) The trustee (or some other party) may have discretion to grant the settlor a limited power of appointment. The limited power of appointment could be as broad or narrow as desired, as long as it allowed the possibility of shifting benefits from one beneficiary to another. If so granted, this would cause inclusion in the grantor's estate under §2038 (and that section is based on powers that the grantor actually holds at death and not on the retention of interests at the time of the original transfer). To protect the independent third party, the instrument might exonerate the independent party from liability with respect to the decision to grant the power of appointment regardless of whether it is exercised. The instrument could provide that the independent third party has no obligation to inquire as to whether the authority should be exercised. Another approach would be to provide that the independent party has no authority to grant the power of appointment until requested in writing to do so by a designated class of persons.

(2) A formula power of appointment in the trust agreement may cause estate inclusion in desired circumstances. The grant of the testamentary power of appointment to the grantor could conceivably be by a formula. The trust instrument could give the donor a formula testamentary power of appointment to the extent that an amount equal to 40% of the excess of the date of death value over the date of gift value is less than an amount equal to 23.8% (i.e., 20% capital gains rate + 3.8% Medicare tax on net investment income) of the excess of the date of death value over the basis of the property (substituting the current tax rates). The disadvantage of the formula approach, if it operates immediately after the creation of the trust, is that it creates an estate tax inclusion period (ETIP), which would preclude immediate allocation of GST exemption to the trust.

(3) Moving from an asset protection jurisdiction to jurisdiction in which the grantor's creditors can reach the assets may cause estate inclusion.

(4) The estate may take the position that there was an implied agreement of retained enjoyment. For example, the parent may continue living in the house in a QPRT or other trust to which a residence was transferred without paying rent to trigger Code § 2036(a)(1). However, the IRS conceivably may not take the position in that type of circumstance that

the failure to pay rent, based on the changed circumstances, reflects an implied agreement to retain the interest at the outset (which is a requirement under Code § 2036(a)(1)). As another example, if a parent has given undivided interests in a vacation home to children, the parent may start using the vacation home exclusively without paying rent in a similar attempt to trigger an implied agreement of retained enjoyment under Code § 2036(a)(1).

10. Strategies to Preserve Basis Adjustment Upon Surviving Spouse's (or Other Donee's) Death

If a trust is created for the surviving spouse at the decedent's death (for example, in a standard credit shelter trust), the estate tax may not be a concern at the surviving spouse's subsequent death, and building in flexibility to allow a step-up in basis at the spouse's death is important. These strategies also apply if a parent makes transfers and wants to leave the flexibility for the donees to obtain a basis step up if their estates subsequently have no estate tax concerns.

a. *Broad Distribution Powers*. One method of causing estate inclusion if the surviving spouse has no estate tax concerns (which might occur, for example, because of indexing of the estate tax exclusion amount over a long term of the surviving spouse's subsequent lifetime) is to give the independent trustee broad authority to make distributions to the surviving spouse, in the absolute discretion of the trustee. An advantage of this approach is its simplicity, but possible fiduciary concerns exist in exercising the authority to make outright distributions of all or most of the trust assets to the surviving spouse. Further, there are timing concerns because distributions must be made prior to death, which may be sudden and unexpected.

b. *Independent Party With Power to Grant General Power of Appointment.* The trust agreement could give an independent party the power to grant a general power of appointment to the surviving spouse. It could be a power exercisable only with the consent of a non-adverse party if the settlor wishes to place some controls over the surviving spouse's unbridled ability to redirect where the assets will pass. The power could be limited to the ability to appoint the assets to the surviving spouse's creditors. However, there are timing concerns because the power must be granted prior to death, which may be sudden and unexpected.

c. *Formula General Power of Appointment.* The general consensus is to discourage the use of formula general powers of appointment granted to the extent that the power would not result in the payment of estate taxes. There is concern that the beneficiary could have indirect control over all of the trust assets as a result of the formula grant of the power, meaning that the beneficiary would have a general power over all of the trust assets for tax purposes. If the formula operates without regard to the availability of a marital or charitable deduction, the formula no longer accurately grants a general power to cause basis step-up even though there would be no estate tax.

d. *Delaware Tax Trap.* Another alternative to leave the flexibility to cause inclusion in the beneficiary's estate is to use the "Delaware tax trap." Delaware law at one time (perhaps still) provided that if someone exercises a power of appointment to grant a presently exercisable power of appointment to another person, even a *limited* power of appointment, that grant of the new power is treated as a vesting of property for purposes of the rule against perpetuities. The original power could be exercised to appoint the assets in further trust, with a new perpetuities period running from the date of exercise, which means that the trust could be extended indefinitely without having the assets subjected to estate tax. Sections 2041(a)(3) and 2514(d) were enacted to prevent avoiding the estate tax indefinitely by successive exercises of limited powers of appointment and creating new powers in other persons of new presently exercisable limited powers of appointment. Section 2041(a)(3) provides that property subject to a non-general power of appointment (which would generally not cause inclusion under § 2041) will cause estate inclusion under that section if the power holder exercises the power of appointment "by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power."

The decision of whether to trigger estate inclusion in the beneficiary's gross estate is totally up to the beneficiary. If the beneficiary wants to trigger estate inclusion, the beneficiary would exercise the original power to create a presently exercisable general power of appointment in someone else. That would cause estate inclusion in the original power holder's gross estate under § 2041(a)(3).

A negative aspect of causing estate inclusion in that manner is that the assets would also have to be included in the successor power holder's gross estate as well (because the second power holder would hold a general power of appointment).

11. Using pot trusts to sprinkle income among beneficiaries in lower brackets.

    a. Income producing assets can be gifted into a pot trust with several beneficiaries (such as grantor's descendants). At the end of each year, the trustee can sprinkle the trust income among beneficiaries in lower brackets in a manner that will reduce the cumulative tax burden on the total income.

    b. Distributions are limited by the terms of the trust and fiduciary duties. Therefore, the terms of a trust should expressly permit the trustee to consider the overall income tax effects in making distributions to beneficiaries.

12. Nonqualified-nongrantor CLTs

    a. A non-qualified non-grantor charitable lead trust (NNCLT) is designed to provide the grantor with an unlimited income tax charitable deduction. It is used by high income grantors whose itemized deductions are significantly cut back under Code § 68. Under this technique, the grantor contributes income producing assets to the NNCLT. The NNCLT distributes all income annually to charities and receives an unlimited charitable deduction under Code § 642(c). The grantor's income tax is reduced because the grantor does not receive the income from the assets contributed to the NNCLT. Thus, the grantor receives, in effect, a deduction for the entire amount of income distributed to charities.

    b. With the new phase out of itemized deductions under Code § 68 (see II.C.3 above), this technique may provide substantial benefits to high-income taxpayers.

    c. This technique works particularly well with assets that produce a consistent stream of income.

    d. The NNCLT provides that all income must be annually distributed to charities, which means it is not a qualifying charitable trust under Code §§ 170, 2055 and 2522. Because the NNCLT is non-qualifying, the grantor does not receive an income or gift tax charitable deduction for the contribution to the trust.

    e. Because the NNCLT is non-grantor, the trust is subject to normal Subchapter J income tax rules, including the unlimited charitable deduction under Code § 642(g) for income distributed to charities.

    f. The NNCLT is designed so that the gift to the trust is incomplete for tax purposes. This avoids gift tax consequences on funding the trust, and the NNCLT will be included in the grantor's estate for estate tax purposes. This treatment can be accomplished by the grantor retaining the right to annually designate a qualified charitable organization as the recipient of the trust's income. When the grantor annually designates the charitable recipient of the trust's income, he will be deemed to have made a completed gift. However, the gift will be of money and not an interest in trust, and, therefore, should qualify for the gift tax charitable deduction. If the trust's income is in excess of the annual exclusion amount (currently, $14,000), the grantor will be required to file a gift tax return.

g. If the grantor does not retain the remainder interest in the NNCLT, he will have made a completed gift of that interest.

h. The NNCLT is not subject to the private foundation rules.

E. Gifting strategies

1. Advantages of making gifts

a. Despite the fact that gifts are included in the base for calculating the estate tax, tax advantages of making gifts include:

(1) removal of appreciation/income of gift assets from the gross estate;

(2) utilizing fractionalization discounts;

(3) paying income taxes on income from grantor trusts to further "burn" the donor's gross estate;

(4) if the donor lives three years, gift taxes paid are removed from the gross estate (after exemptions have been used, gifting $100 to a donee costs $140 ($100 gift plus $40 gift tax), but bequeathing $100 costs $166.67 ($100 bequest plus $66.67 of estate tax); and

(5) the ability to allocate GST exemption so that the same advantages apply for generation-skipping purposes as well.

b. The most obvious non-tax advantage of making gifts is to allow donees to enjoy the gift assets currently.

c. **Perhaps the most important advantage of the increased gift exemption for many individuals will be the "cushion" effect** — the ability to make gifts in excess of $1 million, but considerably less than $5 million, with a high degree of comfort that a gift tax audit will not cause gift tax to be imposed (perhaps even if "aggressive" valuations are used).

d. *Keep in Mind Downside of Depreciation*. If the gifted asset depreciates in value, the client will be worse off, from a transfer tax standpoint, than if the gift had not been made in first place.

e. *Sample Specific Gifting Strategies*. Possible gifting strategies in an environment of a large $5 million indexed gift exemption include the following:

(1) Gifts to Dynasty trust to utilize $5 million GST exemption (or making a late allocation of GST exemption to previously created trusts if the donor does not want to make further gifts);

(2) Forgiveness of outstanding loans to children;

(3) Gifts to grantor trusts, and leveraging grantor trusts with loans or sales from the grantor;

(4) Equalizing gifts to children or grandchildren;

(5) GRATs (GRATs will continue to be advantageous even with the permanent $5 million indexed gift exemption);

(6) Life insurance transfers (including the ability to “roll out” of split dollar arrangements);

(7) Deemed Code § 2519 transfers from QTIP trusts;

(8) QPRTs;

(9) Gifts to same-sex couples;

(10) Make a large gift requiring payment of gift tax, to reduce the estate tax if the donor survives three years (after exemptions have been used, gifting $100 to a donee costs $140 ($100 gift plus $40 gift tax), but bequeathing $100 costs $166.67 ($100 bequest plus $66.67 of estate tax); this opportunity is more realistic now that we have “permanent” transfer tax provisions and the possibility of repeal has receded; and

(11) Defined value formula transfers.

f. Gift strategies that provide some benefit to Grantor and/or Grantor’s Spouse include:

(1) Borrowing of trust funds by grantor;

(2) Spousal lifetime access trust (“SLAT”) and/or exercise by beneficiaries of special powers of appointment;

(3) “Non-reciprocal” trusts;

(4) Self-settled trusts established in asset protection jurisdictions;

(5) Sale for a note or annuity rather than making a gift of the full amount to be transferred;

(6) Transferring residence to trust or co-tenancies between grantor/spouse of grantor and trust;

(7) “Reverse defective grantor trust” transaction in which the donor purchases (including through the exercise of a substitution power) or borrows assets gifted to trust;

(8) Preferred partnership freeze;

(9) Turning off grantor trust status (to at least minimize the continuing cost to the grantor);

(10) Payment of management fees to the grantor;

(11) Inter vivos QTIPable trust; and

(12) Retained income gift trust.

g. Additional Strategies for Donors who have used all of their Exemption

(1) GRAT strategies;

(2) Remainder purchase marital trusts;

(3) Installment sales to grantor trusts or to spousal grantor trusts;

(4) Installment sales by beneficiary to section 678 trusts or to QSSTs;

(5) Low interest loans;

(6) Any of these strategies may involve family limited partnerships, LLCs or other family entities.

2. Using inflation adjustment to exemptions

   a. *Exemption Amount Increased for 2013*. The gift/estate/GST exemption amount is indexed. It increased to $5,120,000 for 2012 and to $5,250,000 for 2013 (~2.5% increase). In addition, the gift tax annual exclusion increases to $14,000 in 2013.

   b. Many clients have adopted an annual gifting program designed to take advantage of the annual gift tax exclusion. For clients who have fully utilized their estate and gift tax exemption amount, they may now adopt an annual program to take advantage of the increase in the estate and gift tax exemption due to the cost-of-living adjustment.

3. Use caution when gifting low basis assets

   a. Gifts can be disadvantageous from an overall tax cost perspective if the loss of a basis step up more than offsets the estate tax savings as a result of removing appreciation/income from the asset and the other advantages of gifts listed above.

   b. The differential between the 40% estate tax rate and a 20% (really 23.8% including the Medicare tax on net investment income) capital gains rate makes the basis concerns significant. The advantage of making a gift is that the appreciation is not subject to estate tax; but the disadvantage is that there is no step up in basis for that asset at death. Stated differently, there may have to be a substantial amount of appreciation in order for the 40% estate tax savings on that appreciation to offset the loss of basis step up on the *full* value of the asset.

4. Gifting through the use of DSUE

   a. Surviving spouse can use the DSUE of the deceased spouse to make gifts during the lifetime of the surviving spouse. Gifts by the surviving spouse use the DSUE amount first before using the surviving spouse's exclusion amount.

   b. If a surviving spouse remarries and his or her new spouse dies before him or her, then the surviving spouse will lose the remaining DSUE from spouse 1 and acquire the DSUE of spouse 2. Therefore, it is important in larger estates that a surviving spouse utilize the DSUE of a predeceased spouse through lifetime gifting so that the DSUE of a prior spouse will not be lost as a result of the death of a subsequent spouse.

   c. GST exemption is not portable. First spouse must use it or lose it.

d. The DSUE amount is not indexed for inflation (even though the surviving spouse's exemption is indexed for inflation).

5. Allocations of GST exemption

a. Making a late allocation of GST exemption to existing trusts

(1) An individual who is treated as the "transferor" of trust assets under Code § 2652(a) can make a late allocation of GST exemption to transfers made in prior tax years. A late allocation cannot be made by an individual to a trust if the individual is not treated as the "transferor" under Code § 2652(a).

(2) Late allocations are based on the fair market value of the property on the date the election is made. However, the property can instead be valued on the first day of the month during which the allocation is made. Treas. Reg. § 26.2642-2(a)(2). The value of the property at the time of its initial contribution to the trust is irrelevant.

(3) If existing trusts are not currently structured as dynasty trusts, consider decanting or judicially or nonjudicially modifying the trusts to make it dynasty and then make a late allocation of GST exemption.

b. *Lapsing General Power of Appointment Held by Person With Modest Assets to Utilize That Person's GST Exemption.* In making a gift to a trust for descendants, consider providing that the client's parent would be a discretionary beneficiary (together with the client's issue) and that the parent would have an inter vivos general power of appointment over the trust, which will lapse at some point in the current year. The lapse of the general power of appointment is treated as a gift by the parent, but the parent's $5 million indexed gift exemption would fully cover the gift. No estate tax concerns would arise at the parent's death if the parent's other assets, even when added to the gift amount, would not be sufficient to cause the estate tax to apply at the parent's death. (*Having a "permanent" $5 million indexed estate tax exemption makes this strategy realistic.*) When the parent makes a transfer subject to transfer tax, the parent is treated as the transferor of the trust for GST purposes (§2652(a)(1)), and the parent could allocate his or her GST exemption to the trust. In that situation, the parent should not continue as a beneficiary of the trust after the lapse of the general power of appointment if the trust is not created in a "self-settled trust state", or else the parent's creditors might be able to reach the trust assets which might cause inclusion in the parent's estate under §2036(a)(1) and cause an ETIP, which would preclude the parent from being able to allocate the parent's GST exemption until the end of the ETIP.

6. Examples

a. Straight Gift

The following table illustrates the benefits of a $5,000,000 gift in 2013 assuming a $20,000,000 estate of a single person, 5% appreciation in all assets, an annual 2.45% increase in the cost of living and death occurs in 2023 (i.e., 10 years). Note that the projected estate tax exemption would be approximately $6,690,000 in 10 years.

Gift		No Gift
$15,000,000	Estate After Gift	$20,000,000
$24,433,419	Death in 2023 (i.e., 10 years)	$32,577,893
$5,000,000	Adjusted Taxable Gift	$0
$29,433,419	Tax Base	$32,577,893
$9,097,368	Tax	$10,355,157
$15,336,051	Net Estate	$22,222,736
$8,144,473	Value of Gift in 2023	$0
$23,480,524	Net Estate to Heirs	$22,222,736
$1,257,788	Benefit to Heirs	

b. Gift of DSUE Amount

The following table illustrates the benefits of a $5,000,000 gift in 2013 assuming a $20,000,000 estate of a widower that received a $5,000,000 DSUE from his late wife, 5% appreciation in all assets, an annual 2.45% increase in the cost of living and death occurs in 2023 (i.e., 10 years).

Gift		No Gift
$15,000,000	Estate After Gift	$20,000,000
$24,433,419	Death in 2023 (i.e., 10 years)	$32,577,893
$5,000,000	Adjusted Taxable Gift	$0
$29,433,419	Tax Base	$32,577,893
$7,097,368	Tax	$8,355,157
$17,336,051	Net Estate	$24,222,736
$8,144,473	Value of Gift in 2023	$0
$25,480,524	Net Estate to Heirs	$24,222,736
$1,257,788	Benefit to Heirs	

c. Installment Sales to Grantor Trusts and Spousal Grantor Trusts

An installment sale to a grantor trust is a traditionally used strategy for shifting future appreciation, primarily through (1) the grantor's payment of the trust's income taxes under the grantor trust rules, (2) future appreciation of the sold assets in excess of the interest rate on the note to the grantor (typically using the AFR as the interest rate), and (3) fractionalization discounts. A corollary strategy is a sale to a "spousal grantor trust." If a sale is made to a grantor trust for the client that is created by the client's spouse, no gain would be recognized on the sale transfer as a result of §1041. As with "standard" sales to grantor trusts, the combined income/appreciation of the trust assets in excess of the small interest rate on the note will be excluded from the client's estate. The client may be particularly willing to engage in transfer planning opportunities with this trust because the client is a discretionary beneficiary of the trust.

A particular tax advantage of this transaction is that the client could be given a power of appointment. If the sale results in a gift element, it would be an incomplete gift. That portion of the trust would continue to be included in the grantor 's estate, but the client would have achieved the goal of transferring as much as possible as the lowest possible price without current gift tax exposure. Gain would not be recognized on the sale, but a downside to this approach is that the selling spouse would recognize interest income when the spouse's grantor trust makes interest payments (although the spouse would likely receive an offsetting investment interest deduction). *Gibbs v. Commissioner,* T.C. Memo 1997-196.

A concern with this approach is that the full appreciation in the asset that is "sold/given" to the trust would be included in the grantor's gross estate, less a §2043 consideration offset for the value of the consideration (i.e., the note amount). A preferable approach would be to use a defined value transfer approach, to transfer a fraction of an asset in the sale transaction. For example, if the asset is believed to be worth $1 million, the formula could transfer a fraction of the asset with a numerator of $1 million and a denominator equal to the finally determined gift tax value the property. The combined defined value clause and incomplete gift trust gives protection against the gift tax and minimizes potential estate inclusion.

Possible disadvantages of this strategy are: (i) a substantial seed gift to the trust will be necessary before the client's makes the sale to the trust; (ii) there is a potential step transaction risk; and (iii) if the client is deemed to be the "transferor" of the property that is sold to the trust, the client's creditors may be able to reach the trust assets.

The following table illustrates the benefits of maximizing a sale to a grantor trust using a seed gift of $5,250,000. This technique is particularly effective now give the historically low interest rates

FMV of Gift to Dynasty Trust:	$5,250,000
Pre-Discount Value of Limited Partnership Interests Sold to Trust:	$75,000,000
Discount Applied to Limited Partnership Interests:	30.00%
Term Note:	25
Applicable Federal Rate:	2.66% (Long-Term AFR)
Down Payment on the Promissory Note:	$5,250,000
Estate and Gift Tax Rate:	40.00%
Net Growth During the Grantor's Lifetime:	10.00%
Net Growth After the Death of the Grantor:	10.00%
Value of Partnership's Assets (No Discounts) Sold to Dynasty Trust:	$75,000,000
Discounted Value of Partnership Interest Sold to Dynasty Trust:	$52,500,000
Total Discounted Value of Dynasty Trust Assets (with Gifts):	$57,750,000
Net Value of Dynasty Trust Assets at End of Note (no Discount):	$641,745,444
Amount Given to Trust:	$5,250,000
Amount Removed from Estate:	$641,745,444

The following table illustrates the benefits of wealth compounding over two (2) generations assuming a ten percent (10%) appreciation rate. The figures are based on the illustration above.

	One Generation Trust	Perpetual Dynasty Trust
Grantor Dies (25 yrs): Taxes: Value of Trust:	$641,745,444 $0 $641,745,444	$641,745,444 $0 $641,745,444
One Gen. (55 yrs): Taxes: Value of Trust:	$11,198,074,408 $4,479,229,763 $6,718,844,645	$11,198,074,408 $0 $11,198,074,408
Two Gen. (85 yrs.): Taxes: Value of Trust:	$117,239,822,994 $46,895,929,197 $70,343,893,796	$195,399,704,989 $0 $195,399,704,989

F. Traditional Non-Tax Planning

1. Despite the decreased need for transfer tax planning, there are numerous other non-tax reasons for estate planning, including:

a. Planning for the disposition of the client's assets at his or her death.

b. Asset protection planning.

c. Planning for disability and incompetency of recipients.

d. Business succession planning.

e. Planning for marital and other dissolutions.

f. Charitable giving (for its own sake, and because income tax considerations will still be relevant and techniques, such as lifetime charitable remainder trusts to facilitate diversification, would not be affected at all).

g. Life insurance planning (other than to provide funds to pay taxes).

h. Fiduciary litigation (enhanced because more to fight over).

i. Retirement planning.

j. Planning to pay state death taxes (in many states).

k. Using business entities to accomplish nontax objectives.

l. Planning for spendthrift children.

m. Planning for clients with real estate in more than one state, including ownership, asset protection, state income taxation, spousal rights, and probate issues (in addition to state estate tax).

IV. 2012 Follow up

A. Complete trust and gifting documentation

1. Ensure signatures obtained from all requisite parties.

2. Notice beneficiaries.

3. Update entity records.

B. Educate clients about trust administration

1. Fiduciary duties; accountings; notice beneficiaries; create investment plans.

2. If grantor intends to continue using gifted assets, make arrangements for payment of fair rental value (e.g., vacation homes, art).

3. Donees must plan for payment of expenses generated by gifted assets.

C. Gift tax reporting

1. Estimated 500,000+ gift tax returns will be filed for 2012 gifts compared to 220,000 in 2011.

2. Preparers must understand the gifts and the provisions of the recipient trusts. Planners who were involved in the 2012 gifts should be preparing or at least reviewing the 2012 returns to ensure the plan is carried out appropriately. The consequences of a missed election or improper GST exemption allocation could be costly.

3. Create an individual file for the gift tax return separate from the gifting transaction to help protect the attorney-client privilege or accountant-client privilege as opposed to the return preparation.

4. Do not rely on automatic allocations of GST exemption. Affirmatively opt in or opt out of automatic allocation pursuant to Code § 2632(c).

5. Use formulas to allocate GST exemption instead of a fixed amount if there is any potential dispute regarding the value of the gift. It is also important to prioritize the allocation of GST exemption in the case of multiple GST gifts in case of an adjustment to values on audit.

6. Gift splitting

a. SLATs – If the spouse is a beneficiary of the donee trust, then gift splitting can be applied only as to the interests of the non-spouse beneficiaries. The beneficiary spouse's interest must be ascertainable and severable from the interest of the non-spouse beneficiaries. If the interest of the beneficiary spouse is not ascertainable or severable, such as when the spouse is a discretionary beneficiary, then no portion of the gift can be split.

b. Large gifts by one spouse – If the gift was made in 2012 with the idea that one spouse's $5.12 exemption would be used as a hedge against a decrease in the exemption in 2013, consider gift-splitting now that the $5+ million exemptions are "permanent".

c. Payment of gift tax – If one spouse is not as healthy as the other spouse, have the healthier spouse pay the entire gift tax. If a spouse who pays gift tax dies within 3 years of the gift tax payment, then Code § 2035(b) includes the gift tax paid in the deceased spouse's gross estate. However, if the surviving spouse paid the gift tax, no portion would be included.

7. Make sure you adequately disclose gifts and non-gift transfers in accordance with Code § 6501 and Treas. Reg. § 301.6501(c)-1(f) in order to get the 3 year statute of limitations started for the IRS to challenge the gift.

D. Improving 2012 gifts

1. In the rush to complete gifts in 2012, clients and advisors may not have had time to perform the due diligence needed to fully assess the consequences of their gifts or obtain values on the assets they truly wanted to gift.

2. Trusts can be judicially or non-judicially modified pursuant to Fla. Stat. §§ 736.04113 - 736.0416.

3. Trusts can be severed or merged pursuant to Fla. Stat. § 736.0417.

4. Trustees may be able to decant trust assets into a new trust with preferred terms if the trust contains a decanting power, subject to certain limitations. See Fla. Stat. § 736.04117.

   a. If there is not a decanting power in the trust (e.g., the trust only permits distributions pursuant to an ascertainable standard), consider whether the situs of the trust can be changed to a jurisdiction that authorizes decanting based on the existing terms of the trust.

5. If the trust contains a power of substitution, the donor can take back the gifted assets by substituting other assets of equivalent value.

6. If the trust does not contain a power of substitution, the donor can sell assets to the trust in exchange for the gifted assets. If the trust is a grantor trust, then the sale is disregarded for income tax purposes. Rev. Rul. 85-13.

7. If the donor effectively wants the assets back without giving up other assets, the donor could give an interest-only promissory note. The applicable federal rates (AFR) are still near historical lows. For example, the AFR for March 2013 for notes longer than 9 years is 2.66%.

8. For gifts made to QTIPable trusts, a QTIP or partial QTIP election can be made to limit the amount of exemption that the donor wants to use now that the increased exemptions are permanent.

9. Beneficiaries can disclaim gifts pursuant to Fla. Stat. Ch. 739.

V. Current Developments

A. *Morey v. Everbank and Air Craun, Inc.*, 93 So. 3d 482 (Fla. 1st DCA 2012) - The 1st District Court of Appeals affirmed the conclusion of the trial court that life insurance proceeds payable to the decedent's revocable trust were subject to creditors' claims, notwithstanding the specific exemption contained in Florida Statutes § 733.808. The decision of the District Court of Appeals was grounded in the specific language of the trust agreement directing the trustee to pay the decedent's death obligations and all enforceable debts. (see Tab 1).

B. 2013 Changes to Uniform Principal and Income Act (see Tab 2).

C. New Florida Revise Limited Liability Company Act (See Florida Senate Bill 1300; House Bill 1079).