The Estate Planner

By Lewis J. Saret

Estate Tax Planning During 2012

Introduction

Generally

On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010[1] ("the Act").[2] The Act significantly changes the federal estate tax, which impacts estate planning for many individuals, and presents significant estate planning opportunities. Although the Act is now slightly more than one year old, because its provisions expire at the end of 2012, it is critical that planners understand the opportunities that the Act presents for their estate planning clients. This column summarizes the Act's key changes and provides observations about the Act's impact from an estate planning perspective. This column discusses some key planning strategies to take advantage of the increased $5.12 million gift tax exemption during 2012. Please note that there are several important changes made by the Act that this column does not summarize.

Summary of Key Estate and Gift Tax Provisions of the Act

Estate Tax

Before the Act, the federal estate tax was gradually reduced over several years and then eliminated for decedents dying in 2010. Prior law provided that the estate tax, with a maximum tax rate of 55 percent and a $1 million applicable exclusion amount, would be reinstated after 2010. Additional changes scheduled

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for years after 2010 affected the gift and generation-skipping transfer (GST) taxes.

The Act reinstates the estate tax for decedents dying during 2010, but at a significantly higher applicable exclusion amount of $5 million, which is indexed for inflation from 2012 beginning in 2012,[3] and a lower maximum tax rate of 35 percent, than under prior law. This estate tax regime continues for decedents dying in 2011 and 2012. Unfortunately, this new regime is itself temporary and will sunset on December 31, 2012, and the prior estate tax regime, with a 55-percent maximum estate tax rate and a $1 million applicable exclusion amount, is reinstated at that time.

Note. Because the new 35-percent top marginal estate tax rate applies to all estates above $500,000 in value and because the applicable exclusion amount is $5 million, the Act effectively creates a flat 35-percent estate tax rate above the estate tax exclusion amount.

Note. As discussed above, the $5 million applicable exclusion amount is adjusted for inflation beginning in 2012. The applicable exclusion amount for 2012 is $5.12 million.[4]

The Act also eliminates the modified carryover basis rules for 2010 and replaces them with the stepped-up basis rules that had applied before 2010. Property with a stepped-up basis generally receives a basis equal to the property's fair market value on the date of the decedent's death. Under the modified carryover basis rules that applied during 2010 before the Act, executors could increase the basis of estate property only by a total of $1.3 million (plus an additional $3 million for assets passing to a surviving spouse, for a total increase of $4.3 million), with other estate property taking a carryover basis equal to the lesser of the decedent's basis or the property's fair market value on the decedent's death.

The Act gave estates of decedents dying during 2010 the option to apply (1) the estate tax based on the new 35-percent top rate and $5 million applicable exclusion amount, with stepped-up basis, or (2) no estate tax and modified carryover basis rules under prior law.

The Act also provides for "portability" between spouses of the estate tax applicable exclusion amount for estates of decedents dying in 2011 and 2012 if both spouses die before 2013.[5] Generally, portability allows surviving spouses to elect to take advantage of the unused portion of the estate tax applicable exclusion amount (but not any unused GST tax exemption) of their predeceased spouses, thereby providing surviving spouses with a larger exclusion amount. Special limits apply to decedents with multiple predeceased spouses.

To preserve the first deceased spouse's unused applicable exclusion amount, the executor for such spouse must file an estate tax return and make an election on such return, even if such an estate tax return would otherwise not be required.

Note. The following represent key points planners should keep in mind about portability:

- Portability is accomplished by the Act providing that the estate tax applicable exclusion amount equals (1) the basic exclusion amount (*i.e.,* $5 million, indexed for inflation), plus (2) for surviving spouses, the "deceased spousal unused exclusion amount."
- The "deceased spousal unused exclusion amount" equals the lesser of (1) the basic exclusion amount, or (2) the basic exclusion amount of the surviving spouse's last deceased spouse over the combined amount of the deceased spouse's taxable estate plus adjusted taxable gifts.[6]
- The portability election must be made on a timely filed estate tax return for the first spouse to die, which must make an affirmative portability election. Note that this requires even small estates to, at a minimum, consider whether an estate tax return should be filed. Also note that the election is irrevocable.[7]
- The IRS may examine the predeceased spouse's estate tax return to adjust the amount of the deceased spousal unused exclusion amount at any time (*i.e.,* no statute of limitations applies for this purpose).[8]
- The portability provision does not increase the surviving spouse's GST exemption. This means that to take full advantage of both spouse's GST exemptions, the first spouse to die must create a nonmarital trust or a reverse QTIP to take advantage of that spouse's GST exemption.
- If a deceased spouse had more than one prior predeceased spouse, he/she may only use the most recent deceased spouse's unused exemption.[9]
- If the first spouse of a marriage to pass away (*e.g.,* Spouse #1) has a "deceased spousal unused

exclusion amount" from a prior marriage to a prior deceased spouse (*e.g.,* Spouse #0), then the surviving spouse (*e.g.,* Spouse #2) of the current deceased spouse (*i.e.,* Spouse #1) cannot use the "deceased spousal unused exclusion amount" that originated with the current deceased spouse's prior deceased spouse (*i.e.,* the "deceased spousal unused exclusion amount" that originated with Spouse #0).[10]

Gift Taxes

For gifts made in 2010, the maximum gift tax rate is 35 percent and the applicable exclusion amount is $1 million. For gifts made in 2011 and 2012, the Act limits the maximum gift tax rate to 35 percent and increases the applicable exclusion amount to $5 million, indexed for inflation. As discussed below, this change provides an opportunity to move significant amounts of wealth free of estate and gift taxes.

Donors continue to be able to use the annual gift tax exclusion before having to use any part of their applicable exclusion amount. For 2010 and 2011, the annual exclusion amount is $13,000 per donee (married couples may continue to "split" their gift and may make combined gifts of $26,000 to each donee).

GST Tax

The Act provides a $5 million GST exemption amount for 2010 (equal to the applicable exclusion amount for estate tax purposes) with a GST tax rate of zero percent for 2010. For transfers made after 2010, the GST tax rate would be equal to the highest estate and gift tax rate in effect for the year (35 percent for 2011 and 2012). The Act also extends certain technical provisions under prior law affecting the GST tax.

Observations Regarding the Act

Generally

Generally, the estate and gift tax provisions of the Act are very favorable to taxpayers because of the substantial increase in the applicable exclusion amount, to $5 million, indexed for inflation, and the lower maximum estate and gift tax rate of 35 percent. The Act also addresses several technical estate, gift and GST tax issues in a manner that is favorable to taxpayers (*e.g.,* the impact of the lapse of the estate tax, including the application of basis rules, on decedents passing away during 2010).

Temporary Fix

The Act is a temporary fix, which sunsets on December 31, 2012, immediately after the next election cycle. It is impossible to predict whether it will be extended in either its current or some modified form, especially given the fact that it is a hot button issue with both major political parties. If Congress fails to act, the Act will lapse and the estate tax will revert to what it would have been under prior law (*i.e.,* $1 million applicable exclusion amount and 55-percent maximum estate and gift tax rate).

Increased Gift Tax Applicable Exclusion Amount

From 2001–2010, the applicable exclusion amount for gift tax purposes has been $1 million. The Act increases this to $5 million, or $10 million per married couple. This change provides an unprecedented opportunity to move substantial amounts of wealth out of individuals' estates. There are several techniques that individuals can use to leverage this $5 million applicable exclusion amount, to move substantially more wealth out of their estates.

To illustrate, individuals can now make gifts of $5 million to trusts governed by the laws of certain states, such Delaware and Alaska, move all growth in such wealth out of their estates, provide a significant amount of asset protection for such assets, and the transferor may continue to be a discretionary beneficiary of such trusts, without any gift tax cost.

In addition, the increased gift tax applicable exclusion amount increases the amount of assets that individuals can transfer *via* an installment sale to a dynasty/grantor trust. Under this estate planning technique, individuals can now make an initial gift of as much as $5 million ($10 million per married couple) to a dynasty trust, and then transfer as much as $45 million ($90 million for a married couple) to such dynasty trust in exchange for an installment note. This technique works especially well for family businesses that are expected to grow significantly in value over time.

Given the fact that the Act will sunset without further Congressional action in 2012, the conventional wisdom among estate planners is that well advised clients should consider implementing estate planning techniques utilizing lifetime gifts before the December 31, 2012, sunset date.

State Estate Taxes

Many states have separate estate tax regimes with lower applicable exclusion amounts than the federal

applicable exclusion amount. These include the District of Columbia, Maryland, New Jersey and New York, among others. It is critical that the estate plans of individuals living in or owning property located in such states address such estate tax exposure.

Portability

One of the more notable provisions contained within the Act is the "portability" provision, which provides in general terms that if one spouse does not fully utilize his/her entire $5 million applicable exclusion amount, the unused portion can be used by the surviving spouse's estate. This provision is intended to avoid the need for credit shelter trusts in estate planning documents. Unfortunately, both spouses must die before 2013 in order to benefit from the portability provision.

In addition, credit shelter trusts continue to provide significant additional benefits beyond just the use of each spouse's applicable exclusion amounts. These include the following:

- Ensuring that assets contained in the credit shelter trust pass to children of the couple and not to any new spouse of the surviving spouse
- Ensuring that appreciation on the assets contained within the credit shelter trust, which may exceed the applicable exclusion amount at the surviving spouse's death, are not subject to estate tax at that time
- Protection of assets in the credit shelter trust from creditors of the surviving spouse, including any marital claims of future spouses
- In some cases, elimination of the need to file an estate tax return for the first spouse to die, which would otherwise be required to make the portability election

Given the fact that the portability provision will sunset in 2012, as well as for the reasons stated above, well-advised clients will continue to use estate plans that incorporate credit shelter trusts.

Things Not in the Act

There are two key provisions that many commentators feared would be in the Act, but that were not included. Specifically, there have been several proposals to place limits on Grantor Retained Annuity Trusts (GRATs), which allow individuals to transfer wealth out of their estates with as little as a zero estate or gift tax cost that would have made GRATs less valuable from an estate planning perspective. There have also been several proposals to limit valuation discounts in connection with certain estate planning techniques such as family limited partnerships. There were no such provisions included in the Act. Therefore, these techniques continue to be available to move wealth to lower generations.

Temporary Relief Does Not Extend to Non-U.S. Citizens Who Are Not Resident for Estate Tax Purposes

The Act reinstates federal estate taxes on U.S.-situs property of non-U.S. citizens who are not residents. The increased applicable exclusion amount to $5 million per person does not apply to non-U.S. citizens who are not residents. U.S. situs property exceeding $60,000 in value is again currently subject to U.S. estate taxes beginning at graduated marginal rates beginning at 18 percent. Accordingly, particular vigilance needs to be exercised in structuring the acquisition of U.S. assets such as real property, so as to avoid imposition of U.S. estate taxes at pre-2010 levels.

Predictions for Future

The predictions for the future, while scattered all across the board, seem to coalesce around four key scenarios, which are as follows:

- The rules set forth in the Act are extended either permanently or, once again, for a temporary period of time. This view results primarily from human nature tending to predict that the future will be very similar to the present.
- The 2009 estate and gift tax rules will be reinstated. These are the provisions contained within the Obama Administration's budget proposals.
- Complete repeal of the federal estate tax. There are continuing lobbying efforts to permanently repeal the estate tax, which has some momentum.
- Reversion to the estate and gift tax provisions that existed prior to the enactment of the Economic Growth and Tax Reconciliation Act of 2001, which would result in a $1 million estate and gift tax applicable exclusion amount and a 55-percent top marginal estate tax rate. Although nobody is proposing this as a legislative proposal, if Congress deadlocks and no legislation is enacted to extend the Act, the Act's provisions will terminate due to the sunset provision and this scenario could result. Therefore, it remains a significant possibility due to legislative gridlock over the past several years.

Estate and Gift Planning for 2012

Generally

The Act presents significant estate tax planning opportunities for 2012. In particular, by reunifying the estate and gift tax systems and increasing the applicable exclusion amount for gift taxes from $1 million to $5 million for 2011–2012, the Act significantly increases the ability of affluent individuals to make large gifts to remove significant amounts of assets and appreciation on such assets from their estates.

Planning Pointer. Although making lifetime gifts is one of the most effective techniques to reduce overall estate and gift taxes, planners must bear in mind key nontax factors, which are critically important to their clients. These include the following:

- Impact of a large gift on the beneficiary
- Impact of a large gift on the donor's ability to maintain his/her desired standard of living
- Level of complexity and inflexibility associated with a large irrevocable gift

Analysis Planners Should Follow

The initial step in the analysis is whether the client should make a gift at all, and if so, the amount of such gift. This is a very personal decision for each client, and typically a decision where nontax factors are critically important. Such factors include the following:

- How will a large gift impact a beneficiary? This in turn hinges heavily on the personality and character traits of the beneficiary. Traits that should be considered include, among others, the beneficiary's financial situation and sophistication, marital/family situation, self-reliance, age and maturity, any physical or mental disability, and any history of dependence on drugs.
- How will a large gift impact the clients' ability to maintain their standard of living and attain their retirement goals? This analysis will typically involve financial modeling, which in turn is best accomplished when the clients' advisors work together as a team.

Of course, one key factor in deciding whether to make a gift is the estimated tax benefits of such a contemplated gift, although as noted above, the tax considerations alone should not be the deciding factor. Here, planners should keep the following key tax points in mind.

First, donors can make gifts totaling up to the full applicable exclusion amount (*i.e.,* $5.12 million in 2012) before having to pay any gift tax. However, making gifts does not generally remove such gifts from the estate tax base, which is used to calculate estate tax. This results because on the estate tax return all gifts above the annual exclusion amount and exceeding certain educational and medical gifts are added back to a decedent's taxable estate for purposes of calculating the estate tax. Therefore, the primary benefit of making a gift, from a transfer tax standpoint is to remove the appreciation of gifted assets out of the donor's estate, along with any income earned on such assets after the date of the gift. These benefits may be leveraged by using valuation discounts to reduce the value of the gift, and to have the donor pay income taxes on income earned by the gifted assets by using a grantor trust, even though such income actually accrues to the benefit of the beneficiaries of such grantor trust.

Example 1. David Dad founds Noodle, an Internet search engine that replaces Google as search engine of choice, in the process making David a billionaire. In 2012, in Noodle's early days, David gifts Noodle stock to his son, Sam, worth $5 million and files a gift tax return reflecting this gift. In 2020, David dies. The stock gifted to Sam is now worth $2 billion. However, only $5 million is added back to David's estate for estate tax purposes. Therefore, $1,995,000,000 of value has escaped estate and gift taxation.

Caution. There has been a significant amount of debate among estate lawyers as to whether, if the applicable exclusion amount drops to an amount less than $5 million in the future, the full $5 million would be required to be added back to a donor's estate for estate tax purposes, which has generally been referred to as a "clawback." The bottom line is that nobody knows what will happen in the future. If there is no clawback of the difference between the $5 million applicable exclusion amount and any future lower applicable exclusion amount, then the client will have further benefitted his/her estate by permanently removing from his/

her estate tax base the amount of the gift up to the amount of the difference between the current applicable exclusion amount and any future lower applicable exclusion amount. At a minimum, the donor will have removed any appreciation on assets gifted. Therefore, gifting almost always will be beneficial from an estate and gift tax standpoint. However, because a clawback is possible and if it does occur it would generate estate taxes with respect to assets gifted during the donor's lifetime and which, therefore, would not be available as part of the donor's estate to pay any such estate taxes, planners should consider either (1) having a net gift agreement with the donee to assure that the donee agrees to pay any estate taxes attributable to any clawback, or (2) expressly providing in the donor's Will that any such taxes would be apportioned to the donee.

Example 2. Same facts as Example 1 except that in 2020 the applicable exclusion amount is $3.5 million and there is no clawback. Here, only $3.5 million is added back to David's estate, and the difference (*i.e.,* $5 million less $3.5 million) permanently escapes estate taxation.

Second, by transferring an asset by gift rather than as part of the donor's estate, a donor gives up the step up in basis associated with transfers at death. Specifically, property acquired from a decedent generally takes a basis equal to fair market value at date of death,[11] whereas property acquired by gift generally takes a carryover basis equal to the donor's basis, except that if the fair market value of the gifted property at date of death is less than the donor's basis then the recipient's basis is the lesser amount for purposes of calculating a loss.[12]

The second step in the analysis, after having decided to make a gift and determining the amount of such gift, is to determine the specific assets to gift. Here, planners should consider gifts that will clean up any prior estate planning issues. Specifically, planners should look at prior estate planning and gifting where a donor may have, over time, inadvertently favored one or more children over others (*e.g.,* by making gifts to assist with the purchase of one child's home but another child has never had occasion to purchase a home, *etc.*). Also, if there is any concern about audit risk associated with prior estate planning techniques or a desire to unwind prior estate planning techniques that are no longer effective, gifting might be available as a way to accomplish these goals. To illustrate, some parents may want to use gifting to transfer remaining interests in family limited partnerships.

Finally, planners should consider various strategies to accomplish gifting during 2012 to determine which techniques, if any, are appropriate for their clients. The following are some examples of techniques that are often popular with clients.

Lifetime Credit Shelter Trust

Lifetime credit shelter trusts are essentially credit shelter trusts funded during lifetime. The trust corpus would be excluded from the estates of both the donor and the spouse, and would be for the benefit of the donor's spouse and or the donor's spouse and children, and the spouse could be named as trustee. The spouse could be given a limited power of appointment over the trust and the power of appointment could even potentially be broad enough to appoint the assets back to the donor if necessary, although this should generally be avoided because this increases the risk that the trust corpus could be exposed to the grantor's creditors.

This type of trust would not only be beneficial for estate tax planning purposes but also generally protect the assets in the trust from the claims of both spouses' creditors, depending in part on the terms of the trust.

The key benefit of this type of trust is that it takes advantage of the increased gift tax applicable exclusion amount but still makes the assets available to the family to ensure that the family is not left impoverished if the donor's remaining assets decline substantially in value.

Nonreciprocal Credit Shelter Trusts for Each Spouse

This approach would essentially involve having each spouse create a spendthrift trust for the other spouse. However, it is important that, if this approach is used, that the trusts not be mirror images of each other, which could trigger the reciprocal trust doctrine.

Under the reciprocal trust doctrine, interrelated transfers can be "uncrossed" and each grantor will be treated for tax purposes as the grantor of the trust for his/her own benefit.[13] This would destroy the tax benefit of using a credit shelter trust so it is critical that, if this strategy is used, the trusts be

sufficiently different to avoid application of the reciprocal trust doctrine.

Delaware/Alaska–Type Self-Settled Spendthrift Trusts

The laws of certain states, most notably Alaska and Delaware, but including several others, have enacted laws that provide for self-settled spendthrift trusts, which under certain circumstances allow the grantor to be a discretionary beneficiary of the trust, and protect the trust corpus from the settlor's creditors. For purposes of this column, a key benefit is that the IRS will treat transfers to such trusts as completed gifts for estate and gift tax purposes.[14] Therefore, using such a trust, clients can move assets out of their taxable estates, remain a beneficiary of such trusts, and the assets will achieve some degree of asset protection.

Other Techniques

Other techniques that planners could use include the following:

- Dynasty trusts
- Installment sales to intentionally defective grantor dynasty trusts
- Qualified personal residence trusts
- Life insurance transfers
- Forgiveness of outstanding loans to children

Summary

To summarize, the Act makes significant estate and gift tax changes. The key points discussed above include the following:

- The estate tax exclusion amount increases to $5 million per person for 2010 through 2012.
- The maximum estate and gift tax rate is reduced from the 55-percent maximum rate under prior law to a maximum estate and gift tax rate of 35 percent for 2011 and 2012.
- A "portability" provision is included, which allows surviving spouses to use any applicable exclusion amount that is not used by the first spouse to pass away.
- The GST exemption amount is increased to $5 million for 2010 through 2012.
- The Act sunsets at the end of 2012, thus making the foregoing changes temporary in nature.

As always, planners should recommend that clients review their estate plans periodically and/or whenever a significant life event occurs (*e.g.,* birth of a child, death of a spouse, purchase of new home, *etc.*).

For clients with substantial amounts of wealth and with closely held businesses, planners should highly recommend that such clients consider using lifetime gifts to take advantage of the current $5 million lifetime gift tax applicable exclusion amount, which will expire absent further Congressional action at the end of 2012.

Endnotes

1 Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (P.L. 111-312), December 17, 2010.

2 This column interrupts our ongoing series of columns, which address retirement benefits in the estate planning context. The reason for this interruption is that the estate planning provisions of the Act are time sensitive and generally only apply, under current law, to estates of decedents passing away during 2011–2012, or gifts made during 2011–2012. We anticipate that the series of columns focusing on retirement benefits in the estate planning context will resume in the May 2012 issue.

3 Act Sec. 302(a).

4 Rev. Proc. 2011-52, IRB 2011-45, 701.

5 Act Sec. 303.

6 Code Sec. 2010(c)(2), as amended by Act Sec. 303(a).

7 Code Sec. 2010(c)(5)(A), as amended by Act Sec. 303(a).

8 Code Sec. 2010(c)(5)(B), as amended by Act Sec. 303(a).

9 Code Sec. 2010(c)(4)(B)(i), as amended by Act Sec. 303(a).

10 *Id.*

11 Code Sec. 1014.

12 Code Sec. 1015.

13 *See J.P. Grace Est.,* SCt, 69-2 USTC ¶12,609, 395 US 316 (1969); *B. Bischoff Est.,* 69 TC 32, Dec. 34,702 (1977).

14 LTR 200944002 (July 15, 2009).