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Estate Planning in 2012, 2013 and the  
Future

Philip M. Lindquist  
Collin County Bar Association  
Estate Planning and Probate Section  
Plano, Texas  
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www.klgates.com

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**The Estate & Gift Tax - Where we have been**

Some practitioners today remember when the top rate was 77%

Tax Reform Act of 1976

Economic Recovery Tax Act 1981

- Top rate phased-in to drop from 70% to 50%
- Exemption equivalent raised to \$600,000
- Unlimited marital deduction

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**The Estate & Gift Tax - Where we have been**

1993 – Top rate got stuck at 55% with 5% clawback

Taxpayer Relief Act of 1997 - phased in exemption equivalent increase from \$600,000 to \$1 million

Economic Growth and Tax Relief Reconciliation Act of 2001

- Exemption increased and rates were phased down from 55% to 45%

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**The Estate & Gift Tax - Where we have been**

Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")

Exemption increased

2002 & 2003	\$1 million (gift tax held at \$1 million)
2004 & 2005	\$1.5 million
2006 – 2008	\$2 million
2009	\$3.5 million

State death tax credit replaced with deduction

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**The Estate & Gift Tax - Where we have been**

EGTRRA – 2010 before TRA 2010 (the Tax Relief, Unemployment Insurance Authorization and Job Creation Act of 2010)

Estate tax repealed with carryover basis after adjustments

GST tax repealed

Gift tax imposed at 35% for lifetime gifts over \$1 million

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**2010 after TRA 2010**

As a practical matter, 2010 law stood, unless you opted to pay estate tax and avoid carry-over basis in a large estate

Portability added

Mechanics of gift tax computation were changed

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**Where we are – 2011 & 2012**

\$5 million exemption for estate and gift tax purposes

\$5 million exemption for GST tax purposes

Exemptions are inflation adjusted, so \$5,120,000 in 2012

35% rate

EGTRRA provisions generally extended for two years

**Where we are going – 2013 and beyond**

Exemption

Rates

“Clawback”?

**Where we are going – 2013 and beyond**

Portability

- Will it be there after 2012?
- Does not work for GSTT planning
- More of a fallback than a planning tool?

Other changes in the estate, gift and GST tax law that were enacted with the Bush tax cuts

**Estate Planning in 2012, 2013 and the Foreseeable Future**

Estate, gift and GST taxes will not be as important to many people

- Will there be less gifting that is motivated by the desire to get the estate below the exemption amounts? (What do you think will happen after the election?)
- Many plans will be less tax driven

**Estate Planning in 2012, 2013 and the Foreseeable Future**

Estate, gift and GST taxes will not be as important to many people

- More “all to my spouse” with option of disclaiming into a bypass trust
- Simple gifts
- GST exempt gifts

**Estate Planning in 2012, 2013 and the Foreseeable Future**

Estate, gift and GST taxes will not be as important to many people

- Non-married couple planning
- Self-settled asset protection trusts

**Estate Planning in 2012, 2013 and the Foreseeable Future**

Some things will be more complicated

- Additional gifts in 2012 after client exhausted 2011 gift tax credit
- Trade-offs between transfer tax savings at the price of higher income taxes will be closer calls – e.g., discounting of entity interests v. new basis at death

**Estate Planning in 2012, 2013 and the Foreseeable Future**

Some things will be more complicated

- Planning for assets subject to state death taxes will be more difficult
  - State tax was relatively large compared to estate tax
  - After-estate tax deduction impact of state tax is now larger
  - Authority to others to make gifts for client?

**Estate Planning in 2012, 2013 and the Foreseeable Future**

Some things will be more complicated

- File estate tax returns to preserve deceased spouse's exemption?
- And we still are living with a lot of uncertainty (compare to 2010)

**Estate Planning in 2012, 2013 and the Foreseeable Future**

What's This Mean for the Future of the Estate Planning Practice?

- Jonathan Blattmachr
  - He was in Dallas to speak for Catholic Foundation morning after the announcement of the agreement for the TRA 2010
  - "What's the future of the practice?"
- Future bleak for estate planners at Jones Day since about 1985

**Estate Planning in 2012, 2013 and the Foreseeable Future**

What's This Mean for the Future of the Estate Planning Practice?

- It is less likely that the government will be paying any of your fees, and even when they do they will be paying 35%, rather than as much as 60%
- Continued shift of lawyers from big firms to boutique and solo practices

**Estate Planning in 2012, 2013 and the Foreseeable Future**

What's This Mean for the Future of the Estate Planning Practice?

- Continue to see strong practitioners move into expert advisor roles for corporate trustees
- Much less of the practice will be tax driven and will be more driven by the need for asset management and protection – my Plano experience

### Estate Planning in 2012, 2013 and the Foreseeable Future

What's This Mean for the Future of the Estate Planning Practice?

- Harder for clients to recognize value without tax savings
- If portability is here to stay, even fewer tax driven wills

### Estate Planning in 2012, 2013 and the Foreseeable Future

What's This Mean for the Future of the Estate Planning Practice?

- Sophistication of practitioners will probably be less
- More trust reformation practice?

### Estate Planning in 2012, 2013 and the Foreseeable Future

In the meantime, for clients who still have estate tax concerns, any estate freeze (*i.e.*, gifting) is better than none

- Gift taxes are less than estate taxes

### Estate Planning in 2012, 2013 and the Foreseeable Future

At a 45% rate and assuming no available exemption, \$1 million will incur \$450,000 in estate tax ( $\$1 \text{ million} * 45\%$ ), leaving \$550,000

At a 45% rate and assuming no available exemption, a gift of \$689,655 will incur a gift tax of \$310,345 ( $\$689,655 * 45\%$ ), for a total outlay of the gift and the gift tax of \$1 million

The beneficiaries get over 25% more with a lifetime gift rather than waiting until death.

### Estate Planning in 2012, 2013 and the Foreseeable Future

At a 35% rate and assuming no available exemption, \$1 million will incur \$350,000 in estate tax ( $\$1 \text{ million} * 35\%$ ), leaving \$650,000

At a 35% rate and assuming no available exemption, a gift of \$740,741 will incur a gift tax of \$259,259 ( $\$740,741 * 35\%$ ), for a total outlay of the gift and the gift tax of \$1 million

The beneficiaries get almost 14% more with a lifetime gift rather than waiting until death

### Estate Planning in 2012, 2013 and the Foreseeable Future

Taking a new basis at death may offset some of the advantage, but probably not all of it

- But using the 35% rate example, if the \$740,741 is a gift of zero-basis property which is then sold, the capital gains tax at 15%, \$111,111, will be more than the savings from paying gift tax rather than the estate tax, which is only \$90,741

The difference in estate and gift tax is recaptured if the donor fails to survive for three years after the gift is made

### Estate Planning in 2012, 2013 and the Foreseeable Future

In the meantime, for clients who still have estate tax concerns, any estate freeze (i.e., gifting) is better than none

- Asset values tend to rise over time
  - As assets appreciate, the available exemptions will shield less of the assets from tax
  - Even if a donor does not survive a gift by three years, the gift tax value is fixed as of the date of the gift

### Estate Planning in 2012, 2013 and the Foreseeable Future

In the meantime, for clients who still have estate tax concerns, any estate freeze (i.e., gifting) is better than none

- Estate freezes work with assets that are discounted and that are not discounted
- Use of a grantor trust (leveraged and unleveraged) can *substantially* increase the benefits of the gift
- It is important to quantify a client's ability to afford a particular gifting program

### Types of Estate Freezes

#### Outright gifts

- Advantages
  - Maximum benefit to beneficiaries
  - Certainty regarding the transfer of property
  - Relatively simple
- Disadvantages
  - Paying gift tax, which is a purely voluntary tax
  - Risk of assets going down in value post-gift
  - Possible repeal of the estate tax

### Types of Estate Freezes

#### Outright gifts

- First priority for the client willing to make a gift – use up gift tax exemption equivalent
  - Get the advantages of an outright gift
  - No gift tax has to be paid
  - This can be combined with other techniques, such as making the gift to a grantor trust and even going a step further to sell assets to the grantor trust for an installment note (as discussed below)

### Types of Estate Freezes

Life insurance trusts

Gift to grantor trust (\$10 million)

Installment sale to intentionally defective grantor trust – low interest rates mean that less interest has to be paid back to the grantor (\$90 million)

And another sale to the grantor trust after the assets appreciate (say 10%, so sell another \$90 million)

### Types of Estate Freezes

Grantor Retained Annuity Trusts ("GRATs")

- Value of an annuity payment will be valued higher if interest rates are low, making the remainder worth less
- For a "zeroed out" or near "zeroed out" GRAT, smaller annuity payments will "zero out" the GRAT if interest rates are low

### Types of Estate Freezes

QPRTs and other personal residence trusts

- Low interest rates make the value of the retained "income" interest lower and the value of the remainder interest higher
- Remainder interest is what is subject to gift tax
- Low real estate values may still make this an interesting freeze technique

Private annuities & SCINs

### GRATs

History

Since 1990, expressly permitted by § 2702 of the Internal Revenue Code and the Treasury Regulations thereunder

GRATs are fragile in that the required terms must be strictly complied with or very severe adverse tax consequences may result

### GRATs

Value of retained interest is determined under § 7520 of the Internal Revenue Code

- Section 7520 provides for the valuation of annuities, interests for life or a term of years, and remainder or reversionary interests
- Section 7520 provides for discounting payments at a rate that is 120% of the mid-term AFR for the month (rounded to the nearest 2/10ths of a percent)
- The § 7520 rate for August 2012 is 1.0%

### GRATs

Other requirements:

Retained payments must be *fixed amounts* (i.e., annuity interests)

- Section 2702 permits using a fixed percentages of the fair market value of the trust property (i.e., unitrust interests)
- GRUTs are almost never used because they do not shift appreciating assets as effectively

### GRATs

Other requirements:

Retained payments can only increase 20% above the prior year's payment

Retained payments must be payable at least annually

### GRATs

Other requirements:

Retained payments must be for a term of years specified at inception

- This term should be short enough that there is a high degree of confidence that the grantor will survive the term of the trust
- If grantor dies during the term of the trust, the GRAT's assets will be included in the grantor's taxable estate for estate tax purposes and the GRAT generally will have accomplished nothing for estate and gift tax purposes

**GRATs**

Other requirements:

But consider very long-term GRATs as an alternative

Retained payments must actually be made with trust assets, not with IOUs, notes, etc.

The Internal Revenue Service has taken the position that a GRAT fails to so qualify retroactively if the annuity payments are not made timely

**GRATs**

At the end of the GRAT term, after all the retained annuity payments have been made, any assets remaining in the GRAT will pass to the specified remainder beneficiary or beneficiaries

- Can be an individual(s)
- Can be trust(s) established under the same document as the GRAT
- Can be trust(s) established under a different document than the GRAT before the GRAT is established

**GRATs**

GRATs are typically structured to provide that the value of the retained payments are almost equal to the value of the property contributed to the GRAT, resulting in minimal gift tax

**GRATs**

GRATs might be compared to a son investing the money in his mother's savings account in the stock market

- If the returns in the stock market outperform what mother would have gotten from the savings account, son gets to keep the extra money he "made"
- If the returns in the stock market underperform what mother would have gotten from the savings account, mother bears the loss

**GRATs**

Short-term "rolling" GRATs allow the remainder beneficiaries to get more of the gains without suffering the losses

- This can currently be done with minimal gift tax
- Risk of changes in laws regarding GRATs?

**Installment Sale to Intentionally Defective Grantor Trust Structure**

An intentionally defective grantor trust ("IDGT") is established

- The trust is generally like other irrevocable trusts established for purposes of gifting
- Trust can be GST exempt (unlike a GRAT)
- It is important that the trust be a grantor trust for income tax purposes

**Installment Sale to Intentionally Defective Grantor Trust Structure**

A gift is made to the IDGT as necessary so that it has a net worth equal to approximately 10% of the total transaction

- There is no specific requirement in tax law about the size but the concern is that the sale be respected for tax purposes
- The gift will often give rise to gift tax liability

**Installment Sale to Intentionally Defective Grantor Trust Structure**

Assets are sold to the trust by the trusts grantor for a note

- Because the trust is a grantor trust, the sale will not be recognized for income tax purposes (*i.e.*, income tax law treats it as a sale from the grantor to the grantor)
- The sale is recognized for estate and gift tax purposes

**Installment Sale to Intentionally Defective Grantor Trust Structure**

The note can be structured with whatever terms are suitable, reasonable and do not undercut the sale being bona fide

- The note will typically be secured (because of the debtor trust's limited ability to pay apart from the assets sold)
- Payments can be regular as to interest and even principal, or payments may be fully or partially deferred
- Payment terms are subject to periodic renegotiation and adjustment

**Installment Sale to Intentionally Defective Grantor Trust Structure**

Interest should be paid at least at the applicable federal rate ("AFR") to avoid having the sale characterized as a partial gift. The AFRs for August 2012 are:

- Short-term (not over 3 years) – 0.25%
- Mid-term (over 3 years but not over 9 years) – 1.07%
- Long term (over 9 years) – 3.01%

**Installment Sale to Intentionally Defective Grantor Trust Structure**

Tax consequences at grantor's death

Note can be prepaid

Valuation risk – part gift/part sale?

- Accept the risk?
- Sell amount determined by formula, with gift of excess to charity, GRAT, etc.
- Just use a simple formula

**GRATs v. IDGTs - Structural Considerations**

Differences in interest rate

The path of the return will have a huge impact on the success of a GRAT but not so much on a sale to an IDGT

- Most assets do not yield a steady rate of return
- High early returns can weather negative late returns
- Negative early returns can dwarf high late returns