<u>The 2010 Tax Act changes in the Estate, Gift and Generation Skipping Transfer tax.</u>

<u>Summary:</u>

1. **All estate planning documents should be changed to either a one big QTIP Trust (if all benefits should go a surviving spouse) or a *Clayton* QTIP Trust (if beneficiaries other than the surviving spouse are included) with an independent co trustee and personal representative who has the power to make QYIP elections and broad fiduciary distribution powers.**
2. **All clients who can afford to should lock in the $5 million exclusion as soon as possible, and should consider unraveling existing discounting techniques, such as Family Limited Partnerships, before they become ineffective.**
3. **Alternative gifting using tangible personal property should be explored.**

<u>Generally:</u> The 2010 Tax Act makes significant changes in the tax law, but does so only on a temporary basis. The law applies only for estates with dates of death between January 1, 2010 through December 31, 2012 (unless an election is made for estates of those dying between 1/1/2010 and 12/17/2010 to apply the 2001 law repealing the estate tax) and gifts made between 12/17/2010 and 12/31/2012. This memo is broken out into two sections, one deals with the drafting of estate planning documents for this time period, the second is on current gifts and other transfers during this time period, to take advantage of the tax savings, where possible.

Drafting Estate Documents: Since Congress did not complete the reform to the estate tax laws, and has every intention to make changes to the law by 12/31/2012 (if not sooner) all existing estate plans must be revised to increase flexibility, including an ability for the fiduciary of an estate plan (either the personal representative or trustee) to respond to changes in the new applicable exclusion amount (now $5 million, which may be lowered to $3.5 million) for both estate and GST taxes, the possible extension or permanence of portability of the exclusion by surviving spouses, the possible reunification of the gift and estate taxes, the repeal of the GST tax and so on. All Existing estate planning documents should be revised.

1. Who does this apply to? Because the new law does not index the portable exemption of a pre deceased spouse for inflation, and because there may be a "claw back" of this exemption amount if the exclusion is lowered after 2012, these recommended changes apply to clients who have:
    a. A personal estate of $3.5 million or more, or a combined estate with a living spouse of $7 million or more, and
    b. Any estate where assets are likely to appreciate more rapidly than the inflation index rate (i.e. closely held businesses, real estate, art and other collectibles, and so forth).
2. **What should be done?** Existing or new estate planning documents should be revised to increase their flexibility, this includes providing for:
    a. **Broad Fiduciary Powers of Distribution**: The best way is to give the fiduciary of both marital and non-marital trusts broad powers to distribute income and principal to and among the beneficiaries. This allows the fiduciary to shift assets to take full advantage of the

changing applicable exclusion amounts. There are some issues with this approach, including:

i. **Trustee powers and Trustee selection.** A broad power to distribute given to a Trustee that is, or is controlled by, a beneficiary that has an interest in either income or remainder of the trust will be considered a general power to appoint the trust in their favor, and so the entire assets of the trust will be included in that trustee's estate. This can be cured by selecting a "disinterested" independent co-trustee to exercise the broad powers of distribution, and limit the "interested" family trustee to only limited powers of distribution.

ii. **Income Tax Considerations.** When naming a trustee with broad powers to distribute, remember that under IRC section 678, a person who holds such a broad power will be considered the Trustee to be considered owner of some or all of the trust assets if the trustee could make a distribution to a beneficiary in discharge of the trustee's obligation to support that beneficiary, even if that distribution never, in fact, takes place. An example is a family trustee making a distribution from the trust to themselves, their child or their spouse. Again this can be cured by an independent disinterested co-trustee.

iii. **Terminations of Trusts.** Further changes in the tax law (such as a repeal of the estate tax) may make the trust superfluous so it would be helpful if the Trustee was able to terminate the trust by distribution of some or all of the trust principal explicitly stated in the trust. Obviously, if the trust is in place for non-tax reasons, such as to protect and control the assets from the

mismanagement and creditors of a beneficiary, then the trust should also be allowed to remain in place.

b. **Disclaimer Based Estate Planning:** One way of adding flexibility is to leave assets outright to a spouse and providing that they can disclaim the assets and have them pass into a non-marital trust. There are a number of disadvantages to this type of planning, since the beneficiaries of the trust may not be the same as the beneficiaries of the surviving spouse, at the time of death, the surviving spouse may be unwilling or unable to make such a disclaimer, and the disclaimer is only valid for estate and gift tax purposes if it is made in writing within nine months of the date of death of the first spouse and the surviving spouse has not received any benefit(either income or principal) from the assets to be disclaimed.

c. **One Divisible Trust, one United Family:** A preferred way of increasing the flexibility of the estate plan is to leave all of the assets to a trust that qualifies as a Qualified Terminable Interest Property (QTIP) trust, and direct the Trustee to divide the trust after the grantor's death as needed to take the best advantage of the estate and GST tax exclusions and the marital deduction (for both state and federal taxes) as possible. This is most useful when you want the entire estate to benefit the surviving spouse during his or her lifetime, since to qualify for a QTIP election, the surviving spouse can be the only income and principal beneficiary of the trust. It is better than using a disclaimer, since the surviving spouse is not given the opportunity to disqualify the estate planning by inadvertent acceptance of the benefit from the assets.

d. **A *Clayton* QTIP Trust:** A variation on the one big QTIP trust, the estate passes to a Marital QTIP trust only those assets that the Personal Representative elects to deduct on the estate tax return; the balance of the assets will go into a different trust, with different terms, than the QTIP Marital Trust. This has the advantages of a QTIP, and allows some of the estate to go to beneficiaries other than the surviving spouse, but the one big QTIP trust may produce greater tax savings than the *Clayton* QTIP Trust and it presents some problems with certain states elective share laws.

   i. **The serving spouse should not be the personal representative on a *Clayton* Trust:** The IRS may treat the surviving spouse as having made a taxable gift for those assets that he or she does not elect to deduct on the estate tax return.

   ii. **No beneficiary should be the personal representative on the *Clayton* Trust:** As that beneficiary will be considered to have made a taxable gift to the extent that they do not deduct the estates assets on the estate tax return.

Planning for Lifetime Transfers in 2011 and 2012: The 2001 tax law generally discouraged clients from making lifetime transfers of wealth because

1) The gift tax exclusion amount was fixed at $1 million

2) The gift tax rate was lowered the longer the client held the assets and

3) There was the promise of a complete repeal of the estate, gift and GST taxes after 2009.

The 2010 Tax Act makes it plain that the estate, gift and GST taxes will not be repealed now or after 2012, but it does encourage clients to make lifetime transfers in 2011 and 2012. This is because

1) The gift, estate and GST tax exclusion is reunified at $5 million,

2) The gift tax rate is reduced to 35%,

3) the 2010 Tax Act did not include the ban on discounts from the use of Family Limited Partnerships that had been proposed, and is likely to be included in any post 2012 law and

4) The 2010 Tax Act does not limit the use of short term Grantor Retained Annuity Trusts (GRATs) again that will be limited by the likely law after 2012.

The 2010 law may sunset on 12/31/2012, but the Congress may make changes before then, with the terms of the changes being enforceable to the date the changes are proposed, rather than the date of enactment. It is important to lock in the advantageous tax situation immediately by:

1. **Lock In the $5 million Lifetime Gift Tax Exemption and the 35% Top Tax Rate:** This can be done in several ways, including:
    a. **Gifts Outright** By making gifts either outright or in trust that qualify as completed gifts, you can 1) shift all post gift realized capital gains and income effect for income tax to the donee and 2) all of the appreciation and income from the assets from the date of the gift to the date of death will go to the beneficiary without being included in the donor's estate.
        i. The disadvantage of outright lifetime gifts is that the donor's cannot retain any interest in the gifted property (such as a right

to the income or to distributions of principal) and the assets are subject to the ability of the donee to manage the property, and to the creditors of the donee.

b. **Gifts in Trust** For clients who are unwilling or unable to afford making an outright gift currently, specialized trusts can be used for lock in the $5 million exclusion and the 35% top tax rate. These include:

   i. **A Retained Interest Discretionary Interest Trust**: In some states (including Wyoming) a person can create an irrevocable trust where they keep a right to receive income and principal, based on the discretionary power of an independent Trustee. The advantage of a "self-settled" trust is that the Donor keeps access to the income and principal of the trust. The disadvantage is that the Donor cannot force the trustee to give him or her income or principal. This sort of trust is relatively new, and has not yet been tested in state or federal courts for gift tax purposes.

   ii. **The Reciprocal Spousal Benefit Trust:** Where a couple have a stable marriage and general agreement on the remainder beneficiaries of their estates, each spouse creates a trust for the benefit of the other spouse and appropriate family members other than themselves. This trust resembles the non-marital trusts, in that:

      1. The other spouse could be entitled to all of the income, or the income could be sprayed among the other spouse and the other family members,

2. The other spouse and other family members can be entitled to distributions of principal, so long as those distributions are made for their health, education, maintenance and support (a HEMS ascertainable standard) , and
3. The other spouse the non-cumulative right to demand a withdrawal of not more than the greater of 5% or $5,000 annually from the trust. Also, the other spouse could hold a special power to appoint the trust assets in their estate among a designated class of other family members.
4. Care has to be taken that the trust is drafted so that the trusts do not fall afoul of the Reciprocal Trust Doctrine, which can be done by granting different rights of testamentary appointment of the trust assets for each of the trusts, making the rights not "substantially the same".
5. A disadvantage of this technique is that the surviving spouse will lose the financial support of the trust they set up for the now deceased spouse when that spouse dies.

iii. **Annual exclusion amount gifts in trust** Currently, up to $13,000 per person per year can be gifted using the annual gift tax exclusion. This exclusion only applies to gifts that the beneficiary receives a current interest in, which is generally achieved by giving the beneficiaries a time-limited right to withdraw the gift from a trust, a so-called Crummy Power. The problems of Crummy powers is that they become quite complicated to administer annually, and they can often lead to ugly family situations if the beneficiaries exercise their right to

withdraw even though the donor prefers that they do not. The 2010 Tax Act relieves some of this first by raising the lifetime gift tax exclusion from $1 million to $5 million, so making even taxable gifts tax-free in effect. Additionally, where the client wishes to provide exclusively to cover the direct medical and educational cost of the beneficiaries and unlimited amount can be made to a specialized Health and Education Endowment Trust (HEET).

iv. **Grantor Trusts:** Grantor trusts are structured so that the gift to the trust is a completed gift for estate and gift tax purposes, but which is still income taxable to the grantor of the trust for income tax purposes. This is, in effect, giving the beneficiaries a tax-free gift of the amount of income tax that they, or the trust, would otherwise have paid on the income generated by the trust. This could have even greater effect if the planned top marginal income tax rate is raised from the current 35% to 39.6% (with a combined state and federal tax rate reaching a top marginal rate of 45% to 50% in some states) and the gift or estate tax rate remaining at 35%.

2. **Review Valuation Discount Planning:** The budget proposals for 2010 and 2011 would have severely restricted, or eliminated, taking any discount for family limited partnerships, family limited liability companies and other related entities, especially where those entities hold passive investments. Although none of these proposals passed Congress, it is unlikely that they will not be renewed, and it raises the likelihood that a person making a transfer to such an entity, or dying holding an interest in such an entity, after such a law is proposed, will find that they cannot use the discount for tax

purposes. **This means that all current discounting plans should be reevaluated in light of the threat to this technique, the rise of the gift tax exclusion to $5 million and the lower estate, gift and GST rates in 2011 and 2012.** This will lead to the unraveling of many of the existing discounting plans.

3. **Use Tangible Property in Future Discount Planning:** Even if the budget proposals pass Congress and discounting for FLPs and FLLCs is eliminated in whole or in part, discount planning involving tangible personal property and real estate will remain, since those discounts are not based on the legal restrictions on control over liquid passive investments, but rather on the unique attributes the transfer, inability to physically divide the property and costs of liquidation of the property for a cash division involve. These include:
    a. **Blockage Discount Concept:** In valuing a large number of works by the same artist, the "blockage" theory reduces their value to reflect the fact that unloading a large number of works will generally depress the selling price below what a smaller sale would bring. The blockage theory was used in valuing a large number of art objects left in an estate. Sculptor David Smith left 425 pieces of his work when he died. In arriving at an estate tax valuation for these sculptures, his executors first valued each piece at the price it would have brought if sold individually at the time of his death. This produced a total value of $4,284,000. The executors then cut this amount by 75% to reflect the theory that on Smith's death these pieces could only have been sold in bulk for resale. They next cut this resulting figure by $^1/_3$ to cover commissions that would have to be paid on sale of these pieces. This brought the estate tax valuation down to $714,000. IRS agreed with

the initial $4,284,000 valuation set by the executors. But it rejected any discount from that amount. It claimed that the "simultaneous availability would have no adverse impact...." The Tax Court disagreed. It said that "each willing buyer in the retail art market would take into account, in determining the price he would be willing to pay for any given item, the fact that 424 other items were being offered for sale at the same time." Under these circumstances, "... the amount which an en bloc purchaser for resale would pay and the aggregate of the separate "one-at-a-time" values to be obtained by a variety of dispositions in the "retail market" would be the same." The court arbitrarily placed this value at $2,700,000. It rejected any discount for anticipated sales commissions. IRS has agreed to follow this case.

b. **Use of an Expert Opinion in Valuation:** Unlike the discount valuation opinion for FLPs and FLLCs (which are usually done by specialist firms or CPAs) the valuation of tangible personal property and real estate is dependent on the opinion of experts in the field of buying and selling that particular asset in that particular market. This means that the expert needs to be selected with great care, and such factors as the likely cost of sale (such as buyers and sellers commissions), moving, storage and the like may also be deducted from the fair market value of the asset. Additionally, in some case involving artwork and other collectables, the client can obtain the opinion of the IRS Art Advisory Board as to the value, which is binding on the Service (though it is not binding on the Client or the Courts).

<u>Recap:</u>

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