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WILL 2011 AND 2012 BE THE END OF THE GOLDEN AGE FOR ESTATE PLANNING?

By: Steven G. Siegel © 2011

A. Major Estate Tax Changes Enacted in the 2010 Tax Relief Act

1. Reinstatement of the Tax. The 2010 Tax Relief Act has reinstated the estate tax and the generation-skipping transfer tax effective for decedents dying and transfers made after December 31, 2009. The estate tax applicable exclusion is \$5 million. That number is indexed for inflation for decedents dying in calendar years after 2011. The maximum estate tax rate is 35%.

2. Election for 2010 Deaths. For 2010 deaths, the 2010 Tax Relief Act provides estates of decedents dying after December 31, 2009 and before January 1, 2011 an option to elect not to come under the reinstated estate tax. The law provides the choice to elect to apply the estate tax based on the restored \$5 million exemption and 35% tax rate and be allowed to use stepped-up basis rules - or follow the original 2010 rules of no estate tax and modified carryover basis rules as provided under EGGTRA. [Note: the IRS has yet to issue the Form(s) to make this election]. The Code does say that any election, once made, will be revocable only with the consent of the IRS. The new law indicates that the "default" provision is an election to have the estate tax apply - unless there is an affirmative election mad to have the estate tax not apply.

3. Extension of Time to File and Report the Decision. When must the decision be made with respect to whether the 2010 Tax Relief Act will be applicable to the decedent's estate? The law provides a nine month time period from the date of enactment of the legislation (it was signed into law December 17, 2010) within which to file the tax return and make any payment due. This is regardless of the exact date of the decedent's death that occurred prior to December 17,

2010. This special nine-month extension also applies to disclaimers. A person may disclaim an interest in property passing to him or her within nine months of the date of enactment of the new law - not the traditional nine month from date of death period for a qualified disclaimer under Code Section 2518. Caution: The rules referring to no qualified disclaimer has occurred if the disclaiming party has accepted a benefit of the property now sought to be disclaimed have not been relaxed for purposes of this rule. Careful also if applicable state laws prevent a valid disclaimer from occurring.

4. **Provisions Are Temporary**. These changes to the estate tax allowing an increased exemption amount and a tax rate reduced to 35% are available only for decedent's dying before January 1, 2013. Thereafter, the law reverts back to the rules providing for a \$1 million exemption and a 55% maximum tax rate, etc.

B. Major Gift Tax Changes Enacted in the 2010 Tax Relief Act

1. **2010 Rules**. For gifts made in 2010, the gift tax annual exclusion was \$1 million and the top gift tax rate was 35%. The 2010 Tax Relief Act did not change this rule.

2. **Post 2010 Rules**. For gifts made after December 31, 2010, the gift tax has been reunified with the estate tax, so that the applicable exclusion amount for lifetime gifts is \$5 million per donor, with the top gift tax rate set at 35%.

3. **Annual Exclusion, Gift-Splitting Unchanged**. The annual exclusion for gifts of present interests was \$13,000 for 2010 and will be \$13,000 for 2011 as well. This was not affected by the 2010 Tax Relief Act, and remains subject to annual cost of living adjustments, requiring adjustments in increments of \$1000. (Code Section 2503). Spouses may continue to split gifts as under prior law (Code Section 2513).

4. **Provisions are Temporary**. These changes to the gift tax allowing for a \$5 million lifetime exclusion and a 35% tax rate are available only for gifts made prior to January 1, 2013. Thereafter, the law reverts back to the post-EGGTRA rules described in Section I B. above, i.e. rules providing for a \$1 million lifetime exemption and a top tax rate of 55%.

C. Major Generation-Skipping Transfer Tax Changes Enacted in the 2010 Tax Relief Act

1. **2010 Rules**. The generation-skipping transfer tax is restored for decedents dying or transfers made after December 31, 2009. The exemption is equal to the applicable exclusion amount for estate tax purposes, i.e. \$5 million. However, although the GST tax is applicable in 2010, the tax rate for transfers made in 2010 is zero. Accordingly, despite the applicability of the rules, there will not be and GST tax liability due with respect to generation-skipping transfers made in 2010. This provision made direct skip gifts to either skip persons or to trusts for the benefit of skip persons extremely advantageous in 2010.

2. **GST Rules for 2011 and 2012**. For 2011 and 2012, the GST is applicable, with a \$5 million exemption and a 35% tax rate. Planning techniques such as the reverse QTIP Trust remain available.

3. **GST Reporting Issues**. Any transfer made to a skip person in 2010 (or 2011 or 2012) should be reported on the appropriate tax return. For gifts made in 2011 and 2012, the tax rate is 35%, so in all cases of GST transfers, appropriate use of the \$5 million GST exemption should be made.

4. **Provisions are Temporary**. These changes to the generation-skipping transfer tax allowing for a \$5 million lifetime exclusion and a 35% tax rate are available only for decedents dying and gifts made prior to January 1, 2013. Thereafter, the law reverts back to the post-EGGTRA rules described in Section I B. above, i.e. rules providing for a \$1 million lifetime exemption, indexed for inflation since 1997, and a top tax rate of 55%.

D. Portability of the Estate Tax Exemption

1. **What is Portability?** Portability is a new concept enacted as part of the 2010 Tax Relief Act. It provides that a surviving spouse can use the unused portion of the deceased spouse's applicable exclusion amount for federal estate tax purposes. This new rule is effective for the unused exclusion amount of the deceased spouse (called the "deceased spousal unused exclusion amount") who dies after December 31, 2010. This amount is available to the surviving spouse in addition to the surviving spouse's own applicable exclusion amount.

The deceased spousal unused exemption amount is not indexed for inflation.

The unused generation-skipping transfer tax exemption of a predeceased spouse is not portable.

2. Portability Applies Only to the Unused Exclusion of the Last Deceased Spouse. In a situation where a surviving spouse is predeceased by more than one spouse, the amount of the unused exclusion that is available to be used by the surviving spouse is limited to the lesser of \$5 million or the unused exclusion of the last deceased spouse. If the last deceased spouse has no unused exclusion available, the surviving spouse gets no benefit from portability - the unused exclusion of an earlier deceased spouse cannot be used in such a case. A surviving spouse may use the predeceased spousal carryover amount in addition to such surviving spouse's own \$5 million exclusion for taxable transfers made either during lifetime or at death.

3. Election is Required for Portability to Apply. In order for a surviving spouse to be allowed to use the unused exclusion amount of a predeceased spouse, an election must be made on a timely filed federal estate tax return (including extensions) filed for the estate of the predeceased spouse on which the amount of the unused exclusion is computed, regardless of whether the estate of the predeceased spouse is otherwise required to file an estate tax return. The IRS is given an unlimited statute of limitations to examine the return of the predeceased spouse in order to determine the deceased spousal unused exclusion amount available for use by the surviving spouse.

4. Provisions are Temporary. The portability election will sunset on January 1, 2013, unless extended by subsequent legislation.

E. Concerns in 2011 with Formula Clauses in Wills and Trusts - The Potential Problem with Formula Clauses.

Given the significant increase in the applicable exclusion, what is the effect of a formula clause in a client's will or trust? For example, if a document says, "I leave the amount of the federal applicable exclusion to my children and the balance of my estate to my spouse". How much has this person left to children? If death occurs in 2011 or 2012, that would be \$5 million. What, if anything is left for the spouse? The spouse may be forced to make an election against the decedent's will in such a case. If

death occurs in 2013 or later, the amount for children would possibly be \$1 million. If this is a blended family where the children are not the children of the surviving spouse, what is the intent of the decedent to "balance" assets between the spouse and the children?

Wills and trusts written before 2011 were signed when the federal estate tax exemption was significantly less than \$5 million. All wills and trusts with formula clauses should be reviewed and a determination made as to what the testator/grantor intended when the will or trust was written.

If it does become necessary to discern the intent of a decedent, where will this action take place? In the first instance, it will take place in a state court. Perhaps it will be litigated in an adversarial proceeding, or perhaps it will be handled in a friendly manner with all family members consenting. In either event, will the litigation to interpret the decedent's documents go beyond the local court? If not, the federal courts and the Internal Revenue Service are not bound by any interpretation or action that occurs in the state courts, unless the case proceeds in an adversarial litigation to the highest court of the particular state. Commissioner v. Bosch, 387 US 456 (1967). Obviously, these types of issues will cause either great uncertainty or substantial expense (or both) in cases of persons with significant estates where interpretation of formulas becomes a controversial matter.

F. General Planning Opportunities Suggested by the 2010 Tax Relief Act.

1. Planning for Gifting Issues.

The federal gift tax remains in effect for 2011 and 2012. It is likely to continue beyond 2012 as well. The gift tax rate is 35% for 2011 and 2012 and scheduled to increase to 55% for 2013. The exemption is \$5 million for 2011 and 2012 and scheduled to decrease to \$1 million in 2013. Planning might suggest making significant gifts in 2011 and 2012. For most clients, especially those that are married, an available exclusion of \$10 million will cover all the gifts they wish to make. For clients at higher levels of wealth, larger gifts may be considered, with the gift tax paid at the "advantageous" 35% rate. This could accomplish several objectives. First, if the client dies more than three years after making the gift, there is no "gross up" of any gift tax paid. Second, the payment of gift tax will

avoid paying gift or estate tax at a significantly higher rate on the same assets if they are held until death. Note that the gift tax is "tax exclusive", while the estate tax is "tax inclusive". A simple example of this point is that if the donor gives the donee 100 units of property while alive, the donee receives 100 units and the government receives 35 units of tax in 2011 or 2012. If the donor makes no gift, and dies with 100 units of property in 2013, the donee will receive 45 units and the government will receive 55 units.

2. Planning for States with Independent Death Taxes.

States that have decoupled from the federal estate tax system must be taken into account in planning, particularly with the higher applicable exclusion available under federal law. What planning is appropriate in circumstances where there may still be a state death tax regardless of the fact that there may not be a federal estate tax as a result of the estate falling short of the federal exemption, but exceeding the state exemption?

Be careful of planning that directs an entire estate to pass to a credit shelter trust. While this may be a good idea under the federal system with the enhanced federal exemption, it may result in a very substantial state estate tax. When the federal exclusion was \$3.5 million, and a credit shelter trust of that amount was funded, the state estate tax liability in most of the decoupled states was \$229,200. Where the federal applicable exclusion is \$5 million, and a credit shelter trust of that amount is funded, the state estate tax liability in most decoupled states will be approximately \$400,000.

G. Consider Planning For a Reduced Federal Estate Tax Exclusion

1. Dividing and Allocating Assets to Utilize the Federal Estate Tax Exclusion

a. Before portability, in the ideal planning situation, each spouse of a married couple had at least the amount of the applicable exclusion in separate names or in their individually created and controlled revocable trusts. If the couple resides in a community property state the community property assets are allocated equally between them. Where this "ideal" situation exists, there is no need to move assets between the spouses, and drafting can be easily done to take full advantage of the federal estate tax

exemption. The first to die spouse will have sufficient assets available to fund a bypass trust at the first death, and utilize the available applicable exclusion in full.

b. With portability, this planning becomes unnecessary, as the exemption will not be "wasted" if it is not used at the first death, assuming appropriate elections, etc. are made to take advantage of portability. As the law presently stands, portability is available only in 2011 and 2012. Planners should not eliminate focusing on how assets are owned, at least until there is a "permanent" decision made as to portability and the size of the applicable exclusion.

c. That said, adhering to this planning has become increasingly difficult. Issues concerning the desirability of holding property in joint names with right of survivorship, fears between the spouses of separate property control, disproportionately-owned retirement plan accounts, large life insurance policies payable to a spouse, business assets the ownership of which cannot be split between spouses, etc. makes simple asset division impractical, if not impossible for some families.

2. A Flexible Planning Suggestion - The Disclaimer Trust Solution

a. A popular solution to the problem of how to divide an estate to assure full use of the applicable exclusion over two deaths is the use of a qualified disclaimer. Code Section 2518. This has been a popular planning choice since the 2001 Act. Should its use be continued in light of the Tax Relief Act of 2010?

b. The "disclaimer plan" suggests that each spouse leave all or substantially all of his or her assets to the other spouse, with a "disclaimer path" leading to a properly drawn bypass trust. If the planning is successful, when one spouse dies, the survivor will disclaim the optimal amount of property necessary to exactly fund the bypass trust created by the first decedent's estate plan. The amount disclaimed will be equal to the maximum applicable exclusion available in the year of the first spouse's death. The balance of the first decedent's property will be retained by the surviving spouse, to qualify for the marital deduction. When the survivor dies, the property in the bypass trust will not be part of the survivor's estate, and the balance of the survivor's property will be sheltered in whole or in part by the applicable exclusion available in the year of the survivor's death. The goal of allowing the maximum

amount of property to pass through two estates with the least tax being imposed will be attained.

c. A spouse may be a beneficiary of a disclaimer trust under an exception to Code Section 2518's general qualified disclaimer rules that otherwise prohibit a disclaimant from accepting the benefits of the disclaimed property. Code Section 2518(b)(4)(A). This rule makes the spouse much more willing to "balance" tax-saving for the family and self-interest where neither has to be sacrificed.

d. A "typical" disclaimer trust may contain provisions granting the surviving spouse generous benefits in the bypass trust to be funded by the disclaimer. The survivor may be entitled to the income of the trust as well as principal in the discretion of the trustee, albeit limited by an "ascertainable standard" addressing support, health, maintenance and education. The survivor may also be given a "5 and 5 power", to withdraw from the trust the greater of 5% of the trust principal or \$5,000, on an annual, non-cumulative basis. The survivor should not, however, be given any special (limited) power of appointment over the trust property (unless the power is limited by an ascertainable standard) since possession of such a power would be viewed as giving the surviving spouse the right to direct the beneficial enjoyment of the disclaimed property, which is inconsistent with the definition of a qualified disclaimer. Reg. 25.2518-2(e)(2).

e. The advantage of continuing the use of this planning is to "hedge" against a reduced applicable exclusion in years beyond 2012. If the exclusion is not reduced, the likelihood is that fewer surviving spouses will exercise the disclaimer option. That may or may not be a positive outcome - depending on the impact of all of the non-tax advantages of trusts (asset protection, etc.) noted above.

f. The disclaimer planning option will not work in every case. Forces of fear, greed, grief, etc. may work against a disclaimer decision. The disclaimer must be accomplished within nine months of the decedent's date of death. There may be multiple marriages or blended families involved to complicate selecting the disclaimer technique. Where the disclaimer is unlikely or inadvisable, what alternative planning is available?

3. Another Flexible Planning Suggestion: The Contingent QTIP Trust Solution

a. Where the spouses lack confidence that the survivor will follow through with the disclaimer planning, or where there is concern that the survivor may accept the benefits of the estate before a disclaimer can be filed, another planning solution is the contingent or "Clayton" QTIP trust.

b. Here, each spouse leaves his or her assets to a trust designed to qualify as a QTIP trust. The executor of the first decedent's estate (not the spouse) decides how much property to qualify for QTIP treatment. This designation removes the post-mortem qualification decision from the surviving spouse and places it within the control of a presumably more objective party. The property not elected to qualify as QTIP property typically passes into a credit shelter trust, often for the lifetime benefit of the surviving spouse. Regs. 20.2056(b)-7(d)(3) and 20.2056(b)-7(h), Ex. 6; Estate of Clayton v. Commissioner, 976 F.2d 1486 (5th Cir. 1992).

H. Planning Techniques to Reduce the Size of an Estate

1. Beyond Basic Gifting

For most families, the combination of annual exclusion gifts to children and grandchildren and the use of the \$5 million per spouse lifetime gift tax exclusion may be enough to bring the family's assets under the \$10 million federal estate tax exemption. Where this is the case, and assuming the increased exclusion amount and portability remain the law, no further planning techniques may be necessary. Where, however, despite the client's best efforts to utilize the available gifting techniques, the estate is still of a size likely to generate federal estate tax liability, other planning techniques should be considered.

2. Planning in the "Perfect Storm" - Low Values, Low Interest Rates, Change Coming

a. Loans to Family Members

With interest rates at or near record lows, an excellent estate reduction technique involves making loans to one's children or grandchildren. Extending credit to a family member is not a gift if the lender receives in return a note that bears interest at the appropriate Applicable Federal Rate (AFR). May 2011 rates are: AFR 3.0%; Short-term loans (up to three years): 0.56%; Mid-term (4 to 9

years) 2.44%; Long-term (10 years or more) 4.19%.

b. Consider a Variety of Estate Freezing Transactions

An estate "freezing" transaction involves a transfer of a client's asset (typically to a family member or to a trust for the benefit of a family member) for fair market value consideration, and serves to "freeze" the value of the client's asset at its date of transfer value (typically through the use of a promissory note or annuity payable to the client reflecting the value of the transferred property as of the date of transfer).

c. Estate Freezing Transactions: Installment Sales

i. Use an installment sale to accomplish this "freeze" result. An asset is sold to a junior family member (based on an independent appraisal and for fair market value to eliminate gift tax issues) in exchange for a note which bears a market rate of interest at the applicable federal rate. Code Section 7520. The future appreciation of the transferred asset inures to the benefit of its new owner. If the transferor dies before the note is paid in full, the balance due on the note is an asset of the decedent-transferor's estate. The seller retains cash flow from the transferred asset, no gift has been made, and the death tax value of the transferred property is "frozen" at the amount of the balance due on the note. All appreciation in excess of the Section 7520 rate is removed from the seller's estate.

ii. The seller may forgive the installment payments as they come due, utilizing the seller's available gift tax exclusions. The issue may then become: Was forgiveness of the debt the seller's intention from the outset of the transaction, in which case the IRS may attempt to recharacterize the transaction as a "disguised" gift from inception, and require reporting the entire value of the transferred property as a gift. Rev. Rul 77-299, 1977-2 CB 343. To avoid this result, avoid a commitment to forgive the debt at the outset of the transaction, and avoid a regular, predictable pattern of annual debt forgiveness.

d. Estate Freezing Transactions: The Self-Canceling Installment Note (SCIN).

i. The SCIN transaction takes the installment sale freeze a step further. The SCIN involves the sale of property in exchange for an installment note calling for payments at a specified interest rate over a set period of

time, which note payments terminate upon the death of the seller. The term of the note should not extend beyond the seller's actuarial life expectancy. Since death terminates the seller's right to receive payments, there is nothing of value to include in the seller-decedent's estate. The potential gift tax issue is avoided by reflecting the self-canceling feature as part of the bargained-for consideration for the sale, by either placing a premium on the price to be paid for the property or by stating an interest rate substantially above the market rate.

ii. Since the note, by its terms, is canceled by the noteholder's death, the value of the note is excluded from the decedent's estate. Estate of Moss v. Commissioner, 74 TC 1239 (1980); acq. 1981-1 CB 2. Estate of Costanza, 320 F. 3d 595 (6th Cir. 2003). There must be an expectation of full repayment and the intent to enforce the collection of the indebtedness. The note may be secured.

iii. The SCIN works best if the seller dies soon after the property is transferred, i.e. the less the buyer must pay, the greater the estate tax benefit realized. Accordingly, SCIN transactions are most often used for persons whose actual life expectancy is expected to fall short of their actuarial life expectancy. However, where the seller dies within a short time of entering into the SCIN transaction, the IRS is allowed to disregard the actuarial tables in such circumstances. The actuarial tables must be used to determine the seller's life expectancy provided it can be shown that the seller has at least a 50% probability of surviving for more than one year from the date of the sale (Reg. 20.7520-3(b)).

e. Estate Freezing Transactions: Sale to an Intentionally Defective Grantor Trust.

i. This technique combines favorable estate tax planning with advantageous income and gift tax planning. The grantor creates a trust for the benefit of family members, and sells assets to the trust in exchange for a long-term installment note. The sale is made for fair market value per appraisals, etc., (including valuation discounts) so that the sale by the grantor to the trust is not treated as a gift to the trust beneficiaries.

ii. The trust is drafted to treat the grantor as the owner of the trust for income tax purposes, but not for estate tax purposes. This is accomplished by including certain grantor-retained administrative powers in the trust (such as the power to substitute trust assets of equivalent

value in a non-fiduciary capacity as approved by Rev. Rul. 2008-22) which cause the grantor to be treated and taxed for income tax purposes as the trust owner (Code Sections 671-678) but not to be treated as the trust owner for estate tax purposes (the retained powers fall short of the powers required for inclusion in the grantor's estate - Code Sections 2036-2038). The trust is thus "defective" for leaving the grantor subject to income tax, but "intentionally" so, since this was done by design.

iii. With the trust so prepared, the sale of assets by the grantor to the trust avoids capital gain taxes, and the note interest (at required IRS interest rates) payable to the grantor from the trust is not subject to income tax. The transaction is treated as a sale by the grantor to him or herself. Rev. Rul. 85-13, 1985-1 CB 484; PLR 9535026. Appreciation on the assets sold by the grantor to the trust grows outside the grantor's estate. Hence the "freeze" works. If the grantor dies before the note is paid in full, only the unpaid balance of the note is included in the grantor's estate. In appropriate cases, a SCIN may be considered for use in these circumstances to avoid any estate tax inclusion.

iv. The only gift tax element of this transaction arises from the requirement that the trust must be capitalized ("seeded") with sufficient equity assets (other than the assets acquired from the grantor in exchange for the note) to establish the independence of the trust from the assets sold by the grantor to the trust. The capitalization is generally 10% of the value of the installment note to create a debt to equity ratio within the trust of 10:1. Other equity in the trust may arise by having the beneficiaries personally guarantee the installment note repayment to the grantor. With the increased gift tax exclusion, at least for 2011 and 2012, the amount of a seed money gift available to support an installment sale to a defective trust has increased dramatically. This suggests an aggressive use of this technique while the gift tax exclusion remains high, and the IDGT technique remains available. Where the grantor's gift tax exclusion had already been used, and guarantees were installed to achieve the desired equity, those guarantees can now be withdrawn, it that is an appropriate step in light of all of the trust's circumstances.

v. Significantly, the trust grantor may pay the income tax on the trust's income from the grantor's own funds without having such payment be characterized as a gift to the trust beneficiaries. This allows the grantor to

further reduce his/her estate by making the income tax payments with no transfer tax consequences. (This is sometimes referred to as the "tax burn"). If the trust requires reimbursement to the grantor of income taxes paid, it will be viewed as a "retained interest" and all of the property contained in the trust will be included in the grantor's estate. Rev. Rul. 2004-64, 2004-2 CB 7.

f. Transferring Wealth with No Gift Tax Cost: Using the GRAT

i. The GRAT is an irrevocable trust to which the trust grantor transfers property (securities, real estate, a family business, S corporation shares, etc. - discounted where appropriate) while retaining the right to receive an annuity interest, i.e. a fixed percentage return from the transferred property for a fixed term of years (a "qualified interest" within Code Section 2702). When the term of years expires, the property passes to the designated remainder beneficiaries of the trust (presumably the children of the grantor).

ii. The advantage of GRATs is the ability of the grantor to transfer property to the remainder beneficiaries at a significantly reduced gift tax cost, since the actuarial value of the grantor's retained interest is subtracted from the fair market value of the trust property to determine the gift tax value of the transfer. The larger the retained interest (based on the grantor's age, duration of the trust, prevailing interest rates, and the selected fixed percentage retained payment) the smaller the taxable gift of the remainder interest.

iii. The case of Walton v. Commissioner, 115 TC 589 (2000), acq. Notice 2003-72, 2003-44 IRB 964 approved a "zeroed out GRAT" (i.e. a GRAT which provides a combination of a retained interest term and/or a substantial payout to the grantor or the grantor's estate so as to result in no gift to the remainder beneficiaries). The IRS has issued Regulations approving the Walton GRAT. Reg. 25.2702-3(e), Examples 5 and 6.

iv. Transferring property to a Walton GRAT allows the funding of the GRAT with no gift tax requirement. Since the annuity value of the GRAT is equal to the entire value of the transfers to the trust, the goal for planning success is appreciation. If the value of the trust property appreciates at a rate greater than the Code Section 7520 rate used to calculate the annuity interest on the date of funding of the trust, the Walton GRAT will be a success -

provided the grantor survives until the end of the trust term. If the grantor fails to survive the term, the grantor has retained an interest in the trust property at death, and an amount of the trust property valued as of the grantor's date of death needed to provide the required annuity is included in the grantor's estate. Reg. 20.2036-1.

v. In evaluating the desirability of a Walton GRAT, planners should consider the "upside" of possibly moving appreciation out of a client's estate at no transfer tax cost. If the GRAT "fails", the grantor is exactly where he or she began - with the exception of the payment of professional and appraisal fees for creating the arrangement.

vi.. Walton GRATs are generally designed to be of short duration (generally two years) with high annual payouts. As rates increase, GRATs created in subsequent years under higher Section 7520 rates will demand greater annuity payments to the grantor, requiring more appreciation to provide a benefit to the trust beneficiaries. When rates are low, the temptation is to lock in to a longer-term GRAT.

NOTE: The 2010 Tax Relief Act did NOT address or limit GRATs. The House passed The Small Business and Infrastructure Jobs Tax Act (HR 4849) (3/24/10) that required GRATs to meet the following requirements:

1. A minimum 10-year term.
2. A remainder interest that is greater than zero (how much greater is not specified; commentators have suggested 10% is the likely target).
3. No declining annuity during the first 10 years of the GRAT's term.

The fact that these rules were not enacted leaves the GRAT "in play", at least until the next round of tax law changes. This certainly suggests urging clients to lock in their GRAT planning in the 2011-2012 "window of opportunity"

vii. In designing a GRAT, use several single property GRATs rather than diversified property GRATs, since the single property GRATs that "succeed" by appreciating will be beneficial, while the single property GRATs that "fail" to appreciate will not be harmful. A diversified GRAT that nets no gain or loss will not be beneficial.

viii. If the grantor survives the end of the trust

term, the property has been removed from the grantor's estate at a reduced transfer tax cost (note that a transfer to a GRAT is the gift of a future interest, ineligible for the present interest annual gift tax exclusion), and all of the post-date of gift appreciation inures to the benefit of the trust beneficiaries (note that if a GRAT "works" the grantor's tax basis carries over to the beneficiaries, while if the GRAT is unsuccessful, and the property is included in the grantor's taxable estate, the beneficiaries receive a date of death value). Code Sections 1014, 1015.

g. Leveraging the Transfer of a Personal Residence by Using a Qualified Personal Residence Trust.

i. The transfer of a property used as a personal residence (it need not be the grantor's principal residence) to a trust in which the grantor retains the right to use and occupy such residence for a fixed number of years, with the remainder interest passing to children or other beneficiaries, offers significant transfer tax planning opportunities.

ii. Where the grantor satisfies the criteria for the creation of a qualified personal residence trust (a "QPRT") as set forth in Reg. 25.2702-5(c), the grantor is able to transfer the residence to a trust for the benefit of family members, only bearing a transfer tax cost equal to the present value of the remainder interest in the trust. The grantor maintains control, use and enjoyment of the residence during the trust term. If the grantor outlives the trust term, the residence is removed from the grantor's estate, and all post-transfer appreciation inures to the benefit of the remainder beneficiaries. If the grantor dies before the end of the trust term, the residence is included in the grantor's estate at its fair market value at death.

iii. The QPRT gift calculation results in a heavy weighting of the client's retained interest and a generally favorable gift tax result. For clients with lifetime gift tax exemption available, the QPRT is a worthwhile use of that exemption. With the dramatic increase in the exemption for 2011 and 2012, the QPRT should be a popular planning technique. The QPRT is particularly popular where the family enjoys a grantor-owned vacation home.

iv. Married persons owning a residence jointly should first transfer the residence to themselves as tenants in common, each with an undivided 50% interest in the property, then have each spouse create his or her own QPRT. This will enable each of the spouses to claim a valuation

discount (20%? 25%?) before making the QPRT calculation, thereby lowering the valuation of the property and decreasing the taxable gift.

I. New Laws Enacted as Part of the Health Care Reform - Effect on Future Tax and Estate Planning

a. Increased Medicare Tax on High Income Earners

Currently, wages are subject to a 2.9% Medicare payroll tax. Workers and employers each pay $\frac{1}{2}$, or 1.45%. Self-employed persons pay it all but get an above-the-line income tax write-off for $\frac{1}{2}$. This Medicare tax is assessed on all earnings or wages without a cap. Starting in 2013 an additional .9% Medicare tax will be imposed on wages and self-employment income over \$200,000 for singles and \$250,000 for married couples. IRC Sec. 3101(b)(2). That makes the marginal tax rate 2.35% for employees. Self-employed persons will face a 3.8% rate on earnings over the above amounts.

b. Expansion of Medicare Tax to Net Investment Income

i. Introduction

Currently, only wages and earnings are subject to the Medicare tax above, but starting in 2013 a new 3.8% Medicare tax will apply to net investment income if adjusted gross income (AGI) is over the \$200,000 (single) or \$250,000 (joint) threshold amounts. IRC Sec. 1411. More specifically, the greater of net investment income or the excess of modified adjusted gross income (MAGI) over the threshold, will be subject to this new tax.

These amounts are **not** to be indexed, so inflation will erode these thresholds over time. Failure to inflation adjust these amounts is a significant departure from many prior tax law changes. Over time the tax will shift from applying to the wealthiest group of taxpayers to a broader range of taxpayers, just like the AMT expanded over time.

Net investment income includes interest, dividends, royalties, rents, gross income from a passive business, and net gain from property sales. Income from a trade or business will not be included in definition of net investment income. IRC Sec. 1411(c). It does not include distributions from a traditional IRA or a Roth IRA.

ii. Application of Medicare Tax on Investment Income of Trusts and Estates

This new tax will apply to the unearned income of individuals, as well as to the investment income received by estates and trusts. IRC Sec. 1411(a)(2). An estate or trust will pay the Medicare tax on investment income based on the lesser of the estate or trust's undistributed net investment income, or the excess of the estate or trusts net investment income over the threshold at which the estate or trust is taxed at the highest marginal tax rate. In 2010 that figure is \$11,200. However, unlike the thresholds for applying the increased Medicare taxes for individuals, this figure for estates and trusts is inflation indexed.

Will it become advantageous to distribute money from a larger estate or trust to the beneficiary quicker to avoid the surcharge? If an estate or trust earns \$25,000 of investment income, for example, it will face the additional Medicare tax. However, a beneficiary who is entitled to a distribution from the estate, or who holds an interest in the trust, may not have, even with the full distribution of his or her share of the estate or trust income, enough income above the individual's threshold to trigger the Medicare investment tax.

Will the fiduciary face a different analysis in determining whether or not to hold assets in the estate or trust if doing so will increase the tax cost? Perhaps an executor is favoring delaying distributions to a later calendar year pending receipt of a tax clearance letter, or confirmation of the exact amount of a liability. Those decisions should be documented if the delay may trigger the additional tax. Instead, the fiduciary could perhaps distribute the funds prior to year end, reducing the fiduciary income to a level below the threshold at which the Medicare investment tax will apply, and have the beneficiaries sign receipts, releases and refunding bonds agreeing to refund the distribution to the estate if the funds are needed for the uncertain liability. This puts the fiduciary between the proverbial rock and the hard place. If the fiduciary distributes funds needed for covering expenses the fiduciary might face personal liability. However, if the fiduciary does not make the distribution the funds will be potentially taxed at a higher rate and the fiduciary could face claims from the beneficiaries.

Some trusts will be exempt from the Medicare investment tax. These include charitable trusts exempt from tax under Code

Section 501 and charitable remainder trusts (CRTs) exempt from tax under Code Section 664. Grantor trusts, and simple trusts that distribute all income (or a complex trust that distributes all income) will not face the tax. But that is of little solace as the grantor or other beneficiaries may face the Medicare tax on their individual investment income.