BRYAN CAVE

Estate Planning in 2012

ESTATE PLANNING IN 2012

Overview and Goals of Estate Planning in 2012

Generally, there are three basic goals of estate, generation skipping transfer, and gift tax planning: (1) the reduction of estate and gift taxes upon transfer; (2) the deferral of the estate, generation skipping transfer, and gift tax burden; and (3) ensuring for the necessary liquidity to pay the taxes when they come due.

We are in the midst of very volatile times which, at least for a foreseeable future, although no one knows for how long, can provide opportunities to achieve these goals in particularly beneficial and tax-efficient ways. This is the result of the present low interest rates and the drop in value of most types of assets, which allows clients to engage in some estate planning that may not be available when interest rates rise and values are driven higher.

In addition, we don't know what Congress is considering, or how they will act with respect to the current transfer tax system, since we do not know what the political make-up of Congress will be by the end of 2012.

This is particularly important in 2012 because Congress increased the estate, gift and generation skipping transfer tax exemption to $5 million and lowered the estate, gift and generation skipping transfer tax rates beginning in 2011, but these increased exemptions and lower rates disappear at the end of 2012. In 2013, unless Congress acts, we will have much lower transfer tax exemptions and much higher transfer tax rates.

Therefore we are faced with the necessity of urging clients to make some transfers, perhaps before they are prepared to do so, in order to take advantage of these opportunities in 2012, while we are sure we have them. These opportunities include low interest rates, low values, low transfer tax rates and high exemptions.

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The Estate, Gift and Generation Skipping Transfer Tax ("GST") System in 2012

Rates are historically low:

In 2012, the estate, gift and GST tax rate is 35%.

In 2013, unless Congress acts, the rates will revert to a graduated rate system, the highest rate being 55%.

Exemptions are historically high.

In 2012, the estate, gift and GST tax exemption is $5,120,000 (minus the amount of the exemption used in prior years).

In 2013, unless Congress acts, the estate, gift and GST tax exemption will be reduced to $1 million.

Don't forget the annual exclusions.

In 2012, you have a $13,000 per donee annual exclusion ($26,000 per donee between a married couple), and an unlimited exclusion for tuition payments and certain medical expense payments that are not reimbursed by insurance.

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State Estate Tax Considerations

Many states have enacted their own estate or inheritance tax, or a combination of both, including a separate exemption from the state estate tax. The state-level exemptions are often not as generous as the Federal estate tax exemptions. As a result, an estate may not have any Federal estate tax due, but may have a state estate tax due upon the decedent's death.

For example, in Maryland and the District of Columbia, the exemption from state estate tax is currently $1,000,000. Therefore, for a resident of Maryland who passes away in 2012, if their total estate is $5,120,000 or less, there will be no Federal estate tax on the estate, but there will be a Maryland estate tax on the excess over the Maryland estate tax exemption amount ($1,000,000). The Maryland estate tax on the $5,120,000 in this example is approximately $100,000.

Other states, such as Virginia, have eliminated their estate tax entirely.

State estate tax is imposed on all property of a resident-decedent other than real property located in another state. State estate tax is imposed on nonresident-decedents who own real property located in the subject state. As a result of this change in the state-level estate tax systems, the residence or domicile of the decedent, for estate tax purposes, and the existence and location of real property has become very important.

Illustratively, assume a decedent from Virginia (which currently has no estate tax) owned real property located in Maryland at the time of his death. Although there is no Virginia estate tax, if the real property located in Maryland exceeds $1,000,000 in value (the Maryland exemption amount), there will be a State estate tax payable to Maryland.

Although many states are moving to enact an estate tax, not many are considering a gift tax. Can we achieve savings by making a gift rather than a bequest at death, due to the lack of any state gift tax?

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Tax-Cost Basis Rules

Where property is acquired by purchase, the basis for such property is its cost.

Property which is acquired by gift generally has, under Section 1015(a), a basis in the hands of the donee equal to that of the donor.

However, if the basis of the property at the time of the gift was higher than its fair market value (so there would be a loss if the property was sold) and the property is later sold by the donee, the basis for determining loss will be the fair market value at the time of the gift and the basis for determining gain will be the basis in the hands of the donor.

Generally, the basis of gifted property is increased by the amount of gift tax paid with respect to the gift.

The basis of property acquired by inheritance generally will, under Section 1014, be its fair market value at the date of death.

It is sometimes possible to use the fair market value of the property determined six months after the date of death to establish basis. This is called "alternative valuation".

Certain types of property do not have their basis adjusted to fair market value either as of the date of death or the "alternative valuation" date. These types of property generally include retirement benefits, promissory notes and property that, for all intents and purposes, was sold at the time of the decedent's death, but the title was still in the decedent's name.

When appreciated property is gifted to a decedent within one year of his or her death, and upon the decedent's death such property passes to the person who originally transferred it to the decedent, then, under Section 1014(e), the basis of such property will not be adjusted.

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GIFTING TECHNIQUES:

General Rules:

Gift assets that have appreciation potential.

Gift to a trust, rather than outright.

Provides creditor protection for beneficiaries.

A trust can include spouse as a trustee and/or beneficiary without inclusion in spouse's estate.

A trust can be characterized as a "grantor trust" in which the income tax on the trust income continues to be paid by the donor. This allows the trust assets to further appreciate, due to the lack of any income tax consequences. The donor's estate is further reduced due to paying income tax on funds he or she does not receive.

Once the gift is made, the trust can purchase additional assets from the donor, utilizing a promissory note.

Consider a 'dynasty" trust.

A dynasty trust is a trust that is held for future generations. A dynasty trust is designed to avoid or minimize estate tax inclusion of trust assets in the donor's children's and/or grandchildren's estates.

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Reduction in Value of a Gift Using Retained Interests

General Rules

If an asset is placed into a trust for the benefit of one or more persons and the transferor does not retain any interest in the trust, the value of the gift will be the value of the property (or entity interest) passing to the Trust.

However, if the donor is a trust beneficiary who retains the right to the income of the trust for a term of years, if planned for correctly, then the value of the gift will be the value of the property minus the value of the retained right.

In order for such a gift to succeed, the donor has to survive the retained term interest.

GRATS AND GRUTS

A Grantor Retained Annuity Trust ("GRAT") and a Grantor Retained Unitrust ("GRUT") are types of irrevocable trusts.

Both of these types of trusts are established for a fixed term of years and the donor/grantor retains an income right. The income right in a GRAT or a GRUT is a stated amount paid to the donor/grantor each year during the term of the trust. Upon the termination of such trust, the trust fund, which would include any income earned during the trust term that exceeded the stated amount payable to the donor/grantor, is payable to the remainderman (or remaindermen).

In a GRAT, the income interest is a fixed sum of dollars determined at the outset of the trust, which is payable each year.

In a GRUT, the donor/grantor receives an amount equal to a fixed percentage of the fair market value of the trust. The percentage is fixed at the time the GRUT is created; however, the fair market value of the GRUT, on which the percentage is based, is determined each year.

Choosing a higher annuity will increase the present value of the donor/grantor's income interest to a point that the remainder interest (and hence the gift) is worth nothing.

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Example of How a GRAT Works

60 year old Donor and the Section 7520 rate is 3.6%. Value of asset is $1,000,000

	GRAT Annuity Amount	Value of Gift
10 year GRAT:	$50,000	$586,260
10 year GRAT:	$90,000	$255,268
10 year GRAT:	$120,848	$ - 0 -
8 year GRAT	$50,000	$657,730
8 year GRAT	$90,000	$383,914
8 year GRAT	$146,083	$ - 0 -
2 year GRAT	$527,148	$ -0-

In a 2-year Cascading GRAT, the donor takes the annuity and creates a new 2-year GRAT funded with the annuity amount. The annuity amount for the new GRAT is determined in light of current interest rates but is designed to "zero out" the new GRAT (which means the GRAT produces no taxable gift). Only negligible remainder interests are created with these Cascading types of GRATs but after several of the GRATs have terminated, the remainder interests that end up in the family's hands can be substantial and the donor's risk of dying during the term is reduced since the GRATs only last for 2 years.

Charitable Lead Annuity Trusts

A Charitable Lead Annuity Trust is similar to a GRAT, except that rather than the donor receiving the annuity during the term of years, a charity receives the annuity. The remainder interest that exists at the end of the term still passes to the donor's family at a reduced gift tax value determined at the outset of the trust.

The donor receives a charitable income tax and gift tax deduction for the annuity interest in most cases.

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Qualified Personal Residence Trusts

There is a gifting technique that can be utilized to transfer a house (usually a vacation home, but it can also be the primary residence) to the donor's children at a discounted value. These are referred to as Qualified Personal Residence Trusts ("QPRTs").

Similar to a GRAT, a QPRT is an irrevocable trust, to which the house is transferred and the donor reserved the right to live in the house for a term of years. At the end of the term, the house is distributed either to the children or to a trust for the benefit of the children. If the donor wishes to retain the use of the house, the donor rents the house from the children or the trust.

The QPRT (and the successor trust that receives the house at the end of the term) are "grantor trusts," so the donor continues to receive the benefit of the deductions for the costs involved that are deductible, such as real estate taxes and if the donor pays rent to the successor trust, the rent is not taxable income.

A QPRT is prohibited from holding any assets other than the personal residence, improvements thereupon, policies of insurance on the residence and certain cash additions for specific purposes, such as for expenses and improvements, and sale proceeds, for a limited time, if the house is sold.

If the house is sold, the QPRT can be converted to a GRAT so that the value of the technique is not lost even though there is no residence. This means that a QPRT will work even for the older client who plans to one day sell a residence in order to move to an assisted living arrangement.

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Example of How a QPRT Works

A donor places a residence worth $1,000,000 into a Personal Residence Trust at a time when the Section 7520 rate is 3.6%:

Terms of the Trust	Value of Gift
A. If the donor is 75 years old and retains the right to use the residence for 3 years:	$784,110
B. If the donor is 75 years old and retains the right to use the residence for 5 years:	$652,660
C. If the 75 year old donor is married to a 65 year old spouse and the residence is divided in half, with each spouse owning one-half:	
1. 75 year old donor transfers his one-half interest in the house to the trust at a value of $450,000 ($500,000 discounted for estimated cost of partition [10%]) and retains the right to use his half for 5 years:	$293,696
2. 65 year old donor transfers her one-half interest in the house to the trust at a value of $450,000 ($500,000 discounted for estimated cost of partition [10%]) and retains the right to use her half for 15 years:	$156,752

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Family Limited Partnerships and LLCs

Individuals use entities such as Limited Partnerships or Family Limited Partnerships ("FLPs") and Limited Liability Companies ("LLCs") and corporations in their estate planning for several reasons.

Creditor Protection Provided by these Entities and the Creditor Remedies against Entity Owners

A creditor of the owner of a FLP or LLC interest is normally prohibited from reaching the assets held by the entity to repay the creditor's claim against the owner. Instead the creditor is usually limited to a "charging order" which allows the creditor to reach only what is distributed to that owner from the entity.

Most FLP and LLC agreements (as well as state law) also prohibit the owner from selling his interest in order to raise funds to pay the creditor's claims. This protects the owner from being forced by the creditor to sell the entity interest.

For the same reason, most FLP and LLC agreements (as well as state laws) prohibit an owner from withdrawing from the entity by demanding to be bought out of the entity, and prohibit the owner from being able to demand distributions be made to the owner from the entity.

Ease of Management of the Assets

A family can pool together its individual holdings. Once pooled together in a common ownership, the development and management of the various assets become much easier and more cost-efficient.

Entity arrangements allow families to negotiate with each other to determine a means of managing the property without intra-family litigation. If the family members are beyond negotiation, then the entity agreement allows the parents' older generation a means of imposing a system of management on future generations of owners.

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Discounts and Premium Adjustments to Valuation in a FLP or LLC

There are many discounts and possible premiums that can be imposed when valuing an asset (or an interest in an asset), when it is held in a FLP or LLC.

Minority Interest Discount

This discount reflects the minority owner's lack of control in the entity. As a result of the lack of control or voting power, the owner has no ability to influence the entity's future (i.e., the management of the entity or the liquidation or merger of the entity) or the future of the owner's investment (i.e., control the payment of dividends or make cash distributions).

Lack of Marketability Discount

This discount reflects the inability or limited ability of the owner to liquidate his or her investment, either because of timing restrictions or because the resultant liquidation value will not be fair market value. This discount would apply to any FLP or LLC interest that is restricted in this manner.

Control Premium

Instead of discounting the value of the gift (or the interest in the estate), it is possible that the interest in the entity will be valued at a premium to reflect the control the entity owner has over the entity. This type of premium will generally be imposed on the value of a partner's general partner interest or the value of a majority shareholder's stock in a closely held corporation.

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Using a Grantor Trust for your Technique

We referred to a "grantor trust" earlier in this memo as the type of trust we recommend that should be utilized in the gift plan. A grantor trust is a type of trust that is irrevocable when used in a gift technique, and is ignored for income tax purposes but not for gift, estate or GST purposes. Therefore, the property is still treated, for income tax purposes as if it were owned by the donor or "grantor". For estate, gift and GST purposes, it is treated as having been transferred out of the donor or grantor's ownership.

Example of How a Grantor Trust Works

$1,000,000 asset with net return of 6% is transferred into LLC by Grantor. Grantor sells a 40% LLC interest to Grantor Trust.

Sale price: $280,000
($400,000 (40%) minus an assumed 30% discount)

Gift to Grantor Trust: $28,000

Many practitioners believe a Grantor Trust should not be unfunded when entering into a purchase and 10% of the sale price is generally considered a safe amount.

Grantor Trust owns 40% of LLC and a 20 year promissory note payable to Grantor at 8% with a face amount of $280,000.

Year One:

LLC pays Grantor Trust $24,000. (This is 40% of 6% return from the asset).

Grantor Trust pays Grantor $36,400 (note payments: principal $14,000, interest $22,400). Trust must use some of its gift to meet payment, and in less than three years the gift amount will be completely used up.

Grantor pays income tax on $24,000, which is $9,504 (at 39.6% rate) on the LLC distribution to the trust. Grantor pays no income tax on the promissory note payment.

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Conclusion

In this memo, we have provided examples of gifting techniques that clients should consider if they want to take advantage of the transfer tax system that currently exists in 2012.

There are many other techniques, such as sales of assets to the family or a trust that work particularly well in a low-interest environment where assets values are also low. These opportunities will continue as long as the economy remains somewhat stagnant, unlike high transfer tax exemptions and low transfer tax rates, both of which will end at the close of 2012 unless Congress acts. For this reason we emphasized gifting techniques here.

There are also much simpler gifting techniques a client could consider, which may or may not utilize the entire $5,120,000 exemption from gift tax that is available in 2012, but could utilize at least some of it. Some of these techniques include the following:

-- If any family member has borrowed money, consider forgiving the loan

-- If a family member is living in a house or apartment owned by a client, consider gifting the residence to the family member

-- If a family member is planning to start a business, consider giving him or her the start up money, rather than loaning it to them.

-- If the client is planning to start a new business that will be owned by family members (or trusts for their benefit), rather than retaining an interest in the new entity so that the client can make a contribution to the business, or loaning money to the business, transfer the funds to the business, which, if planned for correctly, will be a gift to the owners of the new enterprise.

Any technique discussed in this memo requires careful planning and we urge you to contact us if you would like to discuss taking advantage of our suggestions.

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