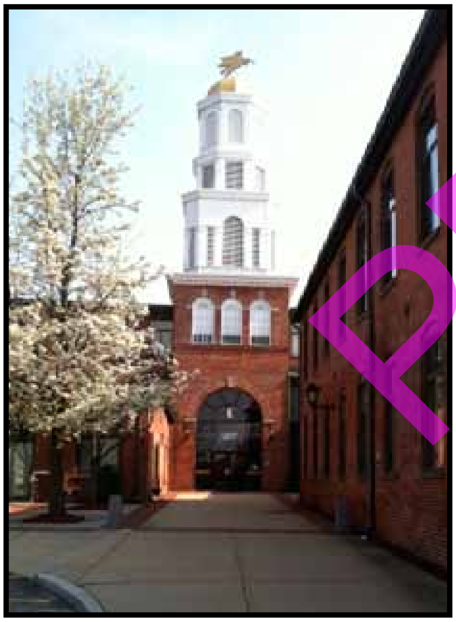
Lahti, Lahti & O'Neill, LLC
ESTATE PLANNING & ELDER LAW

Comprehensive Estate Planning & Elder Law Services

White Paper

Planning for Large Estates Through 2012



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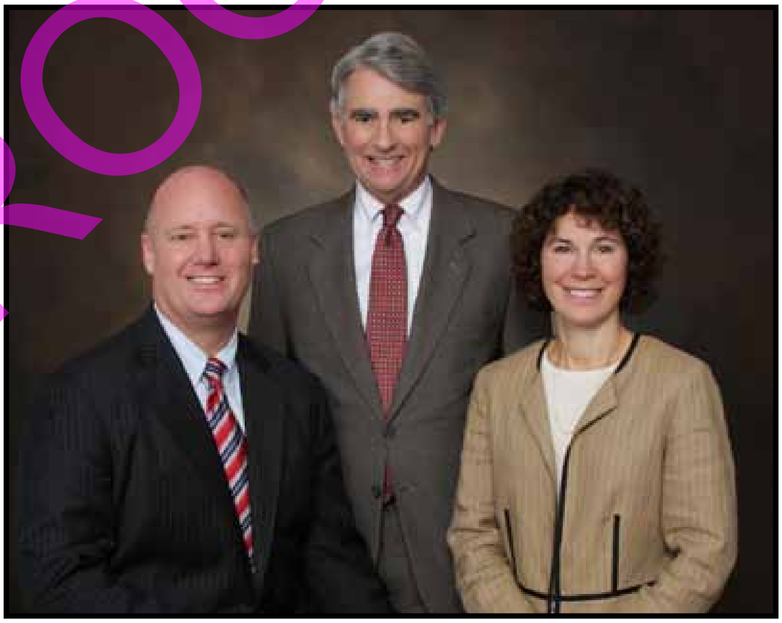

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This white paper should not be construed as legal advice but rather as general guidance on matters as to which you may wish to consult with a qualified professional advisor.

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1 By "large estates" we mean individuals with estates near or in excess of $5 million, and married couples with estates near or in excess of $10 million

Executive Summary

For 2011 and 2012 the federal gift, estate and generation-skipping transfer tax exemptions have all been increased to $5 million and the tax rate reduced to 35%. These changes present significant opportunities for those with estates of $5 million or more to make lifetime gifts in order to greatly reduce the impact of federal and state wealth transfer taxes on future generations. In this paper, various pertinent lifetime wealth transfer tax savings techniques are explored and the benefits of implementing such transfer techniques are illustrated, with due regard to the likelihood and effects of possible "recapture" of the resulting tax benefits due to uncertainties in the new law.

In addition, the newly introduced concept of "portability" of the $5 million exemption between spouses for federal gift tax and estate tax purposes is discussed, and then summarily dismissed because of the numerous adverse consequences of relying upon it.

Gift, Estate and Generation-Skipping Transfer Tax Exemptions and Rates

As a result of federal tax law changes introduced by the 2010 Tax Act, through December 31, 2012 the gift, estate and generation-skipping transfer tax exemptions are each $5 million and the flat tax rate is 35%. However, unless Congress acts by the end of 2012, in 2013 these exemptions will be reduced to $1 million and the top tax rate will be 55%.

The 2010 Tax Act, also known as the Tax Relief, Unemployment Insurance Reauthorization and Jobs Creation Act of 2010 or "TRUIRJCA 2010," also introduced portability of the gift and estate tax exemptions (but not of the generation-skipping transfer tax exemption) between spouses who both die in 2011 or 2012.

Planning Pointer: Caution is called for in 2011 and 2012 when deciding how to plan for insurance needs and disclaimers, and in allocating amounts to the "bypass" or "family" trusts, bearing in mind that depending on year of death the exemption might be $5 million or might be some lower amount (e.g. $1 million).

Income Tax Provisions of the New Law

We also have lower income tax rates during 2011 and 2012. Unless there are changes by the end of 2012, in 2013 the long-term capital gains tax rate will go back to 20%, the maximum tax on qualified dividends will go back to 39.6%, and the additional 3.8% surtax will be introduced.

Tax Planning Opportunities Through 2012

With the gift tax exemption at $5 million per person, through the end of 2012 we can expect large transfers of wealth by individuals with estates near or in excess of $5 million, and by married couples with estates near or in excess of $10 million. Those who have already used their $1 million federal gift tax exemption will now have an additional $4 million of exemption available until the end of 2012. Let's look at some of the planning opportunities that will immediately maximize the benefits of these transfers.

Gifting to Spousal Access Trusts

This is a fancy lawyer name for a “bypass” or “family” trust which, instead of being created upon the death of the first spouse, is created by gift while both spouses are still alive. Just like the typical post-death “bypass” or “family” trust, it can provide benefits for spouse, children and other descendants and can even name the spouse and/or descendants as trustees. Each spouse may gift up to $5 million to such a trust for the benefit of the other spouse and descendants.

The benefits of a Spousal Access Trust include creditor protection, estate tax protection, direct descendant protection (property stays within the bloodlines) and income shifting.

Planning Pointer: If both spouses intend to create Spousal Access Trusts, care must be taken to avoid the “reciprocal trust doctrine” enunciated by the U.S. Supreme Court. If the trusts are found to be reciprocal, the IRS and/or the courts will include the value of each trustmaker's trust in his or her gross estate. With careful planning, the effects of this doctrine can be avoided.

Planning Pointer: If a Spousal Access Trust is created, be sure to file a gift tax return and allocate the trustmaker's generation-skipping transfer tax exemption if desirable, i.e. do not rely on the automatic generation-skipping transfer tax exemption allocation rules.

Gifting to Irrevocable Life Insurance Trusts (“ILITs”)

Life insurance can be used to provide income for surviving loved ones, to pay estate taxes, and to shelter income from taxes. If structured properly so that the trustmaker does not have any “incidents of ownership,” none of the assets (policy proceeds plus any other assets which may have been gifted to the trust during the trustmaker's lifetime) of the ILIT will be included in the trustmaker's taxable estate, making the assets free of both income taxes and estate taxes at the trustmaker's death. Also, ILITs are likely to become more popular should income tax rates increase in 2013, as scheduled, from the current 35% rate to 39.6% or even to 43.4% for taxpayers subject to the 3.8% surcharge.

The general concept of an ILIT is that it is both owner and beneficiary of insurance on the trustmaker's life. The trustmaker makes gifts to the trust to cover the insurance premiums, and the trustee makes the premium payments. At the trustmaker's death, the insurance proceeds would be payable to the trustee, who may use the funds to purchase assets from the deceased trustmaker's estate and thereby provide liquidity for estate taxes and other expenses. The trust would typically be designed so that following the trustmaker's death it operates like a “bypass” or “family” trust, benefiting the trustmaker's spouse, children and other descendants. Like a bypass or family or spousal access trust, it can produce the additional benefits of creditor protection, estate tax protection, direct descendant protection and income shifting.

Planning Pointer: Considering that the amount to be applied against the trustmaker's gift tax exemption and annual gift tax exclusions is not the full face value of the life insurance but rather only the amounts gifted to the ILIT to pay the premiums on the life insurance, you can see how much leverage this technique can provide, for example with a single premium or two-premium life insurance policy.

Planning Pointer: Those with large estates who have insurance in place to provide liquidity to pay estate taxes should be cautious about canceling such insurance policies now. Better to wait until closer to 2013 when we'll hopefully have an idea of what the 2013 wealth transfer tax exemptions will be.

Gifting to Dynasty Trusts

"Dynasty Trust" is another fancy lawyer name for a "generation-skipping trust[2]" which benefits multiple generations, ideally with none of the trust assets being included in the trustmaker's taxable estate and even more ideally with none of the trust assets being included in the taxable estates of any of the succeeding multiple generations of beneficiaries. Avoidance of wealth transfer tax (historically at 45-55% rates) by multiple generations through a dynasty trusts obviously can preserve a much greater portion of family wealth than through a non-dynasty trust.

Long before we had a $5 million wealth transfer tax exemption, generation-skipping trusts were being used to generate tremendous potential wealth transfer tax savings for younger generations – even when created by trustmakers with relatively modest estates[3]. But before 2011 the maximum lifetime amount an individual could transfer to generation-skipping trusts without paying a gift tax was $1 million. For 2011 and 2012 the gift tax exemption and the generation-skipping transfer tax exemption, and accordingly the wealth transfer tax savings potential, have been increased five-fold.

Rhode Island has abolished its "common law rule against perpetual trusts" and thus a "dynasty trust" established under **Rhode Island** law can theoretically go on forever (or as a practical matter until you run out of descendants), with the trustee having the power to make distributions for the lifetime of each beneficiary in each generation. **Massachusetts** has not abolished its rule against perpetual trusts, and therefore the wealth transfer tax avoidance benefits of Massachusetts generation-skipping trusts can only continue for 21 years beyond the lives of those beneficiaries who are living at the time the trust becomes irrevocable. In Florida, the other jurisdiction in which LLO's attorneys practice, a trust may continue for 360 years after it becomes irrevocable.

2 By "large estates" we mean individuals with estates near or in excess of $5 million, and married couples with estates near or in excess of $10 million. Actually the term "generation-skipping trust" can be a misleading one. Properly designed, a generation-skipping trust doesn't truly skip a generation but rather skips imposition of wealth transfer taxes on one or more younger generations while benefiting all younger generations.

3 Take the example of an individual or couple with a million or so of assets and one or more children who are highly financially successful. Which sounds better: (i) leaving a child's inheritance outright where it will be taxed in his or her estate at the highest marginal rate and be exposed to creditors, or (ii) leaving the inheritance in a generation-skipping trust whose full amount, including appreciation during the child's lifetime, will be excluded from taxation in the child's estate, not to mention (with proper drafting) being unreachable by the child's creditors?

In addition to the wealth transfer tax savings afforded by generation-skipping or dynasty trusts, other advantages are creditor protection, divorce protection, direct descendant protection, and spendthrift protection.

Planning Pointer: Again, be sure to file a gift tax return for any lifetime generation-skipping or dynasty trust that is created. If the trustmaker is able to allocate enough generation-skipping transfer tax exemption to cover the entire gift to the trust, it is possible that neither the gift to the trust nor any increase in value in the trust nor any distribution from the trust will ever be subject to wealth transfer taxes.

Planning Pointer: Also be aware of the President's proposal to limit the wealth transfer tax benefits of generation-skipping or dynasty trusts to 90 years regardless of whether a given jurisdiction may have fully or partially repealed the rule against perpetual trusts.

Gifting to Income-Shifting Trusts

The concept here is to shift income to younger family members in order to reduce income taxes. Parents can move up to $10 million ($5 million per parent) in income-producing assets gift tax-free to their children who can use the income to purchase insurance and/or other investments.

Benefits include creditor protection on the assets; estate tax savings because future growth in the assets is transferred to the children and out of the parents' estates; and income tax savings because the children will likely pay income taxes at a lower rate than their parents.

Gifting to Grantor Retained Annuity Trusts (GRATs)

The maker of a GRAT transfers assets to the GRAT and gets an annuity payout for a fixed term. At the end of the annuity term, any residual assets remaining in the trust pass to the remainder beneficiaries, such as the trustmaker's children. The retained annuity is structured so that its value is nearly equal to the full initial value of the trust, producing little or no taxable gift.
GRATs are treated for tax purposes so that if their assets grow at exactly the Internal Revenue Code Section 7520 interest rate in effect for the month the GRAT is created, the net wealth transfer over the GRAT term is zero. Thus if the GRAT outperforms the 7520 rate, there will effectively have been a tax-free gift of the excess earnings to the remainder beneficiaries.

Planning Alert: For December 2011, IRS has set the 7520 rate at a near-historic low of 1.6%. This makes GRATS, at least for now, extremely attractive.

Gifting to Intentionally Defective Grantor Trusts (IDGTs)

An IDGT is a trust that is considered owned by the trustmaker (i.e. a "defective" transfer) for income tax purposes, but a completed transfer for gift, estate, and GST tax purposes. IDGTs are an especially attractive wealth transfer tax device right now because of the combination of the $5 million gift and generation skipping transfer tax exemptions and historically low interest rates.

Using an IDGT, a single individual can currently gift up to $5 million (or a married couple up to $10 million) of (hopefully) highly appreciating assets to an intentionally defective grantor trust or trusts for the benefit of younger generation beneficiaries, and then sell additional interests in the same assets to the IDGT in exchange for an installment note. If these transactions are all structured correctly, valuation discounts on both the gifted and sold assets will be available, thus increasing the amount of transfer tax exemption leverage. Assuming the growth rate on the assets sold to the IDGT is higher than the interest rate on the installment note, the difference would be passed on to the trust beneficiaries free of any gift, estate and/or GST tax. And of course the trustmaker winds up with an installment note which will not appreciate in value and which has a relatively low interest rate, thus effectively freezing the value of the transferred assets for wealth transfer tax purposes. It is even possible that the note itself could later be purchased by the IDGT at a valuation discount, generating additional tax savings.

Also, because the IDGT is a grantor trust (i.e. a "defective" trust for income tax purposes), the sale is effectively a sale by the trustmaker to himself or herself, such that no capital gains tax is due on the installment sale, the interest income on the installment note is not taxable to the grantor, and all income earned by the trust is taxed to the grantor, effectively allowing for a further, tax-free gift to the trust's beneficiaries equal to the tax burden borne by the trustmaker. The IDGT can be designed so that discretionary distributions of income and principal may be made to the trust beneficiaries during their lifetimes, and (by utilizing the trustmaker's available generation skipping transfer tax exemptions), so that all assets in the IDGT remain outside of the beneficiaries' taxable estates.

Gifting to a Qualified Personal Residence Trust ("QPRT")

A QPRT is a legislatively created gifting technique that allows you to get the value of one or more of your personal residences out of your taxable estate at a discount. It involves gifting a residence to an Internal-Revenue-Code-qualified "personal residence trust" under which you retain the right to occupy the house rent-free for a term of years (the "initial term"), after which time the house transfers either outright to, or in further trust for the benefit of, your spouse and/or descendants. If you survive the initial term, the house will at that time no longer be includable in your taxable estate. Thus you should select an initial term which you are likely to survive.

> **Example:** assume you are 70 years of age and have a house worth $1 million. You transfer it to a QPRT under which you reserve the right to use the house for an initial term of 10 years, after which term your right to occupy the house ceases but the house remains in trust for the benefit of your spouse (and with proper trust design is not included in your spouse's taxable estate). You also reserve the right through the trust to rent the house from the trust at its fair rental value so that if

your spouse should predecease you, can still occupy the house until your death. Following the death of both you and your spouse the house would transfer to or in trust for the next generation.

All of the above is specifically permitted by the Internal Revenue Code and by IRS regulations and rulings. And because the gift to the trust is a gift not of a present interest but rather of a future interest (in our example, 10 years in the future), under IRS-published tables, the value of the gift is discounted down to its present value.

In our **Example**, the discounted present value of the gift is not $1 million but rather $591,000. Assuming the residence appreciated at 4% annually over the 10 year initial term, and assuming a 50% marginal estate tax rate, the projected estate tax savings at the end of the term would be $444,000. And the longer you lived after the end of the term, the greater the transfer tax savings. Plus if you wound up renting the house from the trust, you would be getting more assets out of your estate in the form of rent.

The Internal Revenue Code allows you to transfer both a primary residence and a vacation residence to a QPRT. Thus a married couple may transfer a total of three residences to QPRTs.

Other Gifting Techniques

Other traditional advanced gifting techniques, including other leveraged techniques such as gifting interests in family limited liability companies and family limited partnerships, continue to be effective strategies. In fact they have the potential to be five times as effective for gifts made through the end of 2012 due to the five-fold increase in the federal gift tax exemption.

Although simple outright gifts of course result in surrendering control of the gifted property and will not produce any wealth transfer tax savings for future generations, they should nonetheless be considered. Annual exclusion gifts of up to $13,000 per "donee" get the property along with future income and growth on the property permanently out of your taxable estate and do not require the filing of a federal gift tax return. Thus married couples can annually transfer up to $26,000 to any number of beneficiaries annually.

Enhanced State Death Tax Benefits of Gifting

For residents of states like **Rhode Island** and **Massachusetts** which have no gift tax and have "decoupled" their wealth transfer tax system from the federal wealth transfer tax system, any amounts transferred out of the estate for federal gift tax purposes are not only removed from the estate for state death tax purposes but there is no corresponding loss of state death tax exemption. This is to be distinguished from the situation which occurs for federal transfer tax purposes, where the present value of any gifts in excess of the (current) $13,000-per-donee annual exclusion causes a corresponding loss in the federal death tax exemption.

Caution: Lifetime gifts of appreciated assets will cause the transferees to take over the transferor's income tax basis, whereas retaining such assets until death will give the transferees a "stepped-up" basis equal to the value of the assets at the transferor's death.

Caution: "Recapture" of Benefits of Gifts Made Under the Enhanced Exemption?
As strange as it may seem, under what we hope will turn out to be an unintended confluence of current federal tax laws, making a gift under the protection of the enhanced ($5 million) gift tax exemption may cause a most undesirable "recapture" of the benefits of such a gift if the donor later either (1) makes another taxable gift while the gift tax exemption is smaller than $5 million or (2) dies while the estate tax exemption is smaller than the gift tax exemption which was used during lifetime. In other words, the benefits of the now higher exemption might later be "recaptured" -- although even if this should turn out to be the case, the growth and income earned on the gift should escape recapture. The Treasury Department has unofficially stated that whether the current law would require later recapture is at present uncertain. Recapture (also sometimes referred to as "clawback") would appear to be a possibility only if (1) the exemption amount goes down in the future, (2) the law is ultimately interpreted to require recapture and (3) Congress does not act to avert what would seem to be an inherently unfair result.

Portability of Deceased Spouse's Unused Exclusion Amount (DSUEA)

For those dying in 2011 and 2012, the executor of the estate may transfer any unused federal estate tax exemption to the surviving spouse. It must be done on a timely filed Form 706 Estate Tax Return. Only the most recent deceased spouse's unused exemption may be used by the surviving spouse so a remarriage jeopardizes the original DSUEA. The DSUEA can also be used to exempt gifts by the surviving spouse.

Example, Part 1: John and Mary are married and neither has made any taxable gifts. John dies in 2011 and leaves his entire $3 million estate to a bypass trust. His executor elects to permit Mary to use John's unused exclusion amount. Mary now has an applicable exclusion amount of $7 million (her $5 million basic exclusion amount plus $2 million DSUEA from her deceased husband, John).

Example, Part 2: After John died, Mary married Harry. Harry died in 2012, and left his entire $4 million estate to his children. The $2 million DSUEA Mary previously received from John is wiped out by Harry's subsequent death. If Harry's executor makes the election to permit Mary to use Harry's DSUEA, her applicable exclusion amount is $6 million ($1 million less than she had prior to Harry dying). If Harry's executor does not make such an election Mary's applicable exclusion amount is just her own $5 million ($2 million less than she had prior to Harry dying).

Alternate Part 2: Assume the same Part 1, but as for Part 2, assume Mary dies in 2012 rather than Harry. Mary leaves her entire $3 million estate to a bypass trust; therefore her DSUEA is $4 million (Mary's $7 million applicable exclusion amount minus the $3 million she leaves to the bypass trust). If Mary's executor makes the election, Harry can use Mary's unused exclusion amount, so his applicable exclusion amount will be $9 million (Harry's basic exclusion amount of $5 million plus Mary's $4 million DSUEA).

Planning for Use of the Deceased Spouse Unused Exemption Amount

If a DSUEA happens to fall in your lap, of course you should use it. But should married couples rely on portability of the federal estate tax exemption in their planning? No. Having the first spouse to die leave all of his or her assets to the surviving spouse, as opposed to the pre-2011 approach of sheltering his or her exemption in a trust or trusts for benefit of the surviving spouse, means at a minimum:

- You lose the opportunity to exclude growth in the first spouse's exemption amount between the first and second death from being taxed in the surviving spouse's estate

- Because there is no portability for state death tax purposes, you never get to shelter the first spouse's exemption (plus growth on the exemption amount occurring between the first and second death) from state death taxes

- Because there is no portability for federal generation-skipping transfer tax purposes, you lose the opportunity to "double up" on your generation-skipping transfer tax exemptions

- You forfeit the creditor protection which can be afforded by an exemption-sheltering trust

- The assets are not protected in the event of the surviving spouse's remarriage

- You forfeit the potential for shifting income to lower-bracket beneficiaries which can be provided through an exemption-sheltering trust

- Both spouses lose the certainty of knowing that if they are the first to die they will have the desired control over how their share of the assets will be managed and distributed

In summary, we recommend planning as if the DSUEA did not exist.

Conclusion

High net worth individuals have an exceptional window for transfer opportunities in 2011 and 2012 with the $5 million estate, gift, and GST tax exemptions; lower income and estate tax rates; and still-depressed property values.

To comply with U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax advisor based on the taxpayer's particular circumstances.

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