Estate Planning Council of Cleveland

MUSINGS FROM MOROCCO:

USING 2012'S BEST ESTATE PLANNING TECHNIQUES BEFORE THE BALL DROPS

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The City Club

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ARTICLE REPRINTS

Planning Opportunities and Pitfalls Arising from the 2010 Tax Act (Cleveland Bar Journal, December 2011)

A Charitable Giving Toolbox (Cleveland Bar Journal, June 2012)

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About the Speaker

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His ability to design creative and comprehensive plans – and make them practical and understandable – has garnered him a practice that is national in scope, including clientele drawn from the ranks of Forbes 400, business owners, families and nonprofit organizations. He is often called upon to resolve the difficult issues that arise in the dynamic relationships among business owners and family members. He also assists executors and trustees in the often complex role of estate and trust administration.

In 2011 Steve became the first recipient of **Best Lawyers in America "The Lawyer of the Year" for Cleveland Trusts and Estates**. In 2009 he received the **Estate Planning Council of Cleveland's Distinguished Estate Planner Award**. He is named in **Ohio Super Lawyers** for Estate Planning and Probate and received the **Award of Merit** from the Ohio Legal Center Institute.

For the **Estate Planning Council of Cleveland**, Steve has served as President, Program Chair, and Developments Reporter at its monthly meetings for four years. For the **Cleveland Metropolitan Bar Association**, he has served on its Continuing Legal Education Committee and chaired its Annual Estate Planning Institute. He is an **OSBA Board Certified Specialist in Estate Planning, Trust and Probate Law**; a software consultant for **BNA Estate and Gift Tax Planner**; a Fellow of the **American College of Trust and Estate Counsel**; a frequent speaker on a wide range of estate planning topics for numerous Estate Planning Councils, Bar Associations, professional associations, financial institutions, and nonprofit organizations; and an author and editor of several national and state publications.

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MUSINGS FROM MOROCCO:

USING OUR BEST ESTATE PLANNING TECHNIQUES BEFORE THE BALL DROPS

I. THE ROAD TO MOROCCO

Year	Estate Exemption	GST Exemption	Gift Exemption	Top Tax Rate	Step-Up
2001	$675,000	$1,060,000	$675,000	55-60%	Full
2002-2003	1,000,000	1,100,000+	1,000,000	50-49%	Full
2004-2005	1,500,000	1,500,000	1,000,000	48-47%	Full
2006-2008	2,000,000	2,000,000	1,000,000	46-45%	Full
2009	3,500,000	3,500,000	1,000,000	45%	Full
2010	5,000,000	5,000,000	1,000,000	35%[1]	Full
-OR-					
2010	TAX REPEALED	TAX REPEALED	1,000,000	35%	Limited
2011	5,000,000	5,000,000	5,000,000	35%	Full
2012	5,120,000[2]	5,120,000[2]	5,120,000[2]	35%	Full
2013	1,000,000 or ?	1,390,000[3] or ?	1,000,000 or ?	55-60%[4] or ?	Full

[1] Except 0% GST rate.
[2] Includes inflation adjustment.
[3] Estimated.
[4] 5% surtax imposed on estates between $10,000,000 and $17,184,000.

II. WHY THIS TOPIC IMPACTS ESTATES OF ALL SIZES

A. Outdated Tax Formula Clauses in Wills and Trusts.

B. Portability of Estate Exemptions between Spouses.

C. Estate Exemption Scheduled to Revert to $1 Million in 2013.

D. Window of Opportunity to "Use or Lose" Up to $5 Million of Gift and GST Exemptions.

E. Ways to Make a Gift without "Giving It All Away."

F. Proposals to Curtail GRATs, Discounts and Grantor Trusts.

III. PLANNING PITFALLS ARISING FROM THE 2010 TAX ACT

A. Outdated Formula Clauses. Beneficiaries may be disinherited or receive different amounts than intended, as a result of tax-driven distribution formulas.

B. Specter of "Clawback." If an individual uses the $5 million gift exemption and later the estate exemption drops below $5 million, will the tax benefit of having earlier used the larger gift exemption be recaptured in the individual's estate?

C. Mistaken Reliance on "Portability." When the first spouse dies, the executor may elect to transfer any unused portion of the decedent's $5 million estate exemption to the surviving spouse. Expires December 31, 2012.

D. Lost Opportunities on Doing Nothing.

1. The $5 million gift, estate and generation-skipping exemptions drop to $1 million on January 1, 2013 with a 55-60% top rate.

2. Risk of Future Legislation: Obama's 2013 Revenue Proposals.

a. Reduce the gift exemption to $1 million and the estate and generation-skipping exemptions to $3.5 million; increase the top rate to 45%.

b. Eliminate valuation discounts on interests in family controlled entities.

c. Terminate the generation-skipping exemption of a trust on the 90th anniversary of the creation of the trust, thereby subjecting distributions after that time to a 45% GST tax.

d. For GRATs, a 10-year minimum term (thereby increasing the mortality risk of the grantor predeceasing the term).

e. A grantor trust (treated as owned by an individual for income tax purposes) would be included in that individual's gross estate for estate tax purposes; transfers from a grantor trust would be treated as gifts; and conversion to non-grantor status would be treated as a gift.

3. Lost opportunities to leverage the $5 million gift and generation-skipping exemptions.

a. Post-gift appreciation.

b. Post-gift income.

c. Valuation discounts for lack of marketability and lack of control.

d. Payment of income tax by donor following gift to a grantor trust.

e. Loans or installments sales to gift trusts, thereby leveraging the gift and GST exemptions by a factor of 9 to 1, or even higher with loan guarantees.

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C. The timing to make gifts.

1. A convergence of favorable factors.

a. Low asset values.

b. Low interest rates.

c. High gift exemption.

d. High generation-skipping exemption.

2. A short window of opportunity before proposals curtailing the use of the valuation discounts, GRATs, grantor trusts, and generation-skipping trusts are enacted?

D. The desire to make gifts.

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C. Equalization of Past Gifts.

D. Review Past Transactions.

E. Gift to Dynasty Trust for Children.

F. Gift to Dynasty Trust for Grandchildren.

G. Gift to Grantor Dynasty Trust Leveraged with Later Loan.

H. Gift to Grantor Dynasty Trust Leveraged with Later Installment Sale.

I. Qualified Personal Residence Trust (QPRT).

J. Grantor Retained Annuity Trust (GRAT).

1. Because the taxable gift of the remainder interest can be virtually zeroed-out, a GRAT is useful for:

   a. A donor who does not want to "give it all away."

   b. A donor who has used all or nearly all of the gift exemption.

   c. Assets that are volatile in value, because:

      (i) If the asset value increases, much of the appreciation can be passed along to the beneficiaries free of gift tax.

      (ii) If the asset value decreases, there will have been little or no waste of gift exemption.

   d. Assets that are difficult to value.

2. The remainder beneficiary can be a trust for the spouse or the children.

3. For a GRAT to be successful, its growth must exceed the Section 7520 rate. This hurdle rate is now at an historic low of 1.0%.

4. The grantor must outlive the term of the GRAT; otherwise the GRAT is included in the grantor's estate, but the gift exemption used is "restored" (except that in the case of a split gift, the gift exemption used by the consenting, non-donor spouse is not restored).

5. Obama's Fiscal Year 2013 Revenue Proposals would require a 10-year minimum term, effective for GRATs created after the date of enactment, thereby increasing the mortality risk of predeceasing the term.

K. Gift to Trust for Donor's Spouse (Spousal Access Trust).

L. Gifts by Spouses to Complementary Trusts for Each Other.

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feature

Planning Opportunities and Pitfalls Arising from the 2010 Tax Act

by Stephen H. Gariepy

The 5-5-5 Plan

What gets the most press in the estate planning realm about the 2010 Tax Act? The 5-5-5 tax plan. It provides an unprecedented $5 million gift exemption, $5 million generation-skipping exemption and $5 million estate exemption.

No Estate Left Behind

The Act, however, is more than a tax break for the wealthy. It impacts the planning of estates of all sizes—from the modest to the largest. It might well have been called "The No Estate Left Behind Act." Why?

- It distorts the standard tax formula clauses we use for marital deduction trusts, credit shelter trusts and generation-skipping, potentially disinheriting beneficiaries or skewing the amounts they receive.
- It creates "portability" of the estate exemption between spouses, something Congress thought would simplify planning for all married couples, but presenting traps for the unwary.
- It lets the estate exemption drop to $1 million after 2012—of concern to those who, the past few years, thought the higher exemptions meant they had nothing to worry about.
- It creates a two-year window of opportunity to use up to $5 million of gift and GST exemptions ($10 million for a married couple), and because there are ways to make a large gift without "giving it all away," more clients can take advantage of this than we might expect.
- For all, whether below $1 million or above $10 million, it presents an opportunity to refocus our time and creativity not only on tax-driven goals, but on values-driven goals, i.e., developing meaningful provisions for children, grandchildren, business succession and legacies to non-profit organizations.

Use Them Before You Lose Them

Our mantra for 2011 and 2012 should be "use the exemptions before you lose them." The $5 million exemptions will automatically drop to $1 million in 2013 (with an inflation adjustment for the GST exemption), unless Congress and the President agree on new legislation. There are proposals that would reduce the exemptions even sooner, to a $1 million gift exemption and $3.5 million GST and estate exemptions, effective January 1, 2012.

Exemptions ($ millions)

	Gift	GST	Estate
2011	5	5	5
2012	5	5	5
2013	1	1.39*	1

*Estimate

If the gift exemption were to drop back to $1 million, it is not just the super rich who would be impacted by the loss of the $4 million worth of extra exemption, but also the modestly wealthy who might have lost the opportunity to use something less—perhaps an extra $1 million, $2 million or $3 million. The loss would not just be of the gift exemption, but also the GST exemption, and all of the post-gift appreciation and other tax benefits of lifetime gifts.

A Popular Misconception

There is a misconception about how the $5 million gift exemption works. If you make a gift of $1 million, which $1 million do you use first? Is it $1 million of the new extra $4 million, so that if the exemption does drop back to $1 million, you still have the original $1 million left? Or the original $1 million exemption, so you would have zero left? It's the latter. Because the gift exemption is likely to remain at least $1 million, a client has to make a gift of more than $1 million in order to lock in any advantage of the increased exemption.

The Specter of Clawback

If an individual uses any of the $5 million gift exemption in 2011 or 2012, and Congress later reduces the estate exemption below the amount used, will the IRS claw back the tax benefit of having used the larger exemption when the client dies? If we were to follow the instructions to the federal estate tax return, that would be the surprising result. However, sources indicate that Congress did not intend clawback and that clawback would not be imposed.

Portability: The Bridge to Nowhere

A centerpiece of the 2010 Tax Act is its introduction of "portability." Heralded as a panacea for the estate planning of married couples, it allows a spouse who dies to "port" his or her unused estate exemption to the surviving spouse. At first impression, it would appear to eliminate the need for spouses to rebalance their estates by having the wealthier spouse transfer assets to the less-wealthy spouse to take advantage of both their exemptions; simplify an estate plan by eliminating the need to create a credit shelter trust in order to make use of the estate exemption of whichever spouse dies first;

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and facilitate bequeathing assets outright to the surviving spouse, rather than to a credit shelter trust, for a second step-up in basis when the surviving spouse dies.

Tempting as it may be, forgoing use of a credit shelter trust and instead relying on portability to make use of both spouses' exemptions may be mistaken reliance. For it to apply, both spouses must die before 2013 when portability expires. Moreover, portability does not shelter post-death appreciation from tax in the surviving spouse's estate, cannot assure that assets will remain in the family bloodline and not diverted (for example, on remarriage to a second spouse), and does not provide creditor protection, all of which a credit shelter trust can. Easy to overlook, portability does not apply to the GST exemption.

Further, portability is not automatic. On the death of the first spouse, the executor must file a full-blown federal estate tax return in order to elect portability, even if the estate is less than the federal exemption and a return would not otherwise be required. Even once elected, portability is not permanent. It only applies to the unused exemption of the most recently deceased spouse. If a surviving spouse remarries and the second spouse predeceases, the unused exemption of the first spouse is lost.

$5 Million Gift Exemption Checklist

- ✓ Outright gifts
- ✓ Forgiveness of loans
- ✓ Equalization of past gifts
- ✓ Gift to Dynasty Trust
- ✓ Sale to Dynasty Trust
- ✓ Qualified Personal Residence Trusts
- ✓ Grantor Retained Annuity Trusts
- ✓ Lifetime Credit Shelter Trusts
- ✓ Self-Settled Trusts
- ✓ Irrevocable Life Insurance Trusts

Strategic Opportunities for Using the $5 Million Gift and GST Exemptions

There are a number of ways the increased gift and GST exemptions can be put to good use in 2011 and 2012.

Outright gifts to family members—Simple, but for larger gifts, a trust can provide creditor protection and other benefits.

Forgiveness of loans—For a child's purchase of a home; promissory notes owed to clients on installment sales they made to Grantor Dynasty Trusts; or loans made to Irrevocable Life Insurance Trusts when premiums on the policies exceeded the available annual gift exclusions.

Equalization of past gifts—One child's family with more children may have received more annual exclusion gifts than another child's family; or the child involved in the family business may have received stock in the business while the other children received other gifts of lesser value.

Gift to a Dynasty Trust—This can not only make use of the increased gift exemption, but also remove the post-gift appreciation and income from the donor's estate, make use of fractional interest discounts, make use of the increased GST exemption, take advantage of grantor trust status so that the donor pays the income tax on the trust's income, and provide creditor protection for the beneficiaries.

Sale to a Dynasty Trust—Of particular advantage to business owners, the gift and GST exemptions can be leveraged with an installment sale to the trust. If leveraged by a factor of 9 to 1, this can facilitate the transfer of up to $50 million in value, or $100 million for a married couple. The sale can be a tax-free transaction, and the installment note can include a self-canceling feature, providing that the note will be canceled in the event of the grantor's death before it is paid off (if the grantor meets the test of more than likely to live at least one year).

Qualified Personal Residence Trusts—The donor retains the right to occupy a home for a specified term of years, thereby reducing the upfront gift of the remainder interest. A relatively small amount of gift exemption can cover the transfer of a principal residence and one secondary residence.

Grantor Retained Annuity Trusts—The grantor reserves a fixed annuity for a set number of years in an amount that can virtually zero-out the value of the upfront gift of the remainder interest that passes to the beneficiaries when the trust terminates. A GRAT can be useful for those clients who do not want to "give it all away" because they get back the original value of what they put in, plus a return equal to the Section 7520 rate (currently 1.6%). In effect, all appreciation and income exceeding this hurdle rate passes to the beneficiaries gift tax-free.

Lifetime Credit Shelter Trusts—One spouse can make a large gift now to an irrevocable trust for the benefit of the other spouse. The beneficiary-spouse can be the Trustee. The beneficiary-spouse can even be given a limited power of appointment, including the power to appoint back to, or in trust for, the donor-spouse. Of course, there must not be any upfront agreement that the beneficiary-spouse will exercise the power in favor of the donor-spouse. This trust can serve as a reserve fund for clients who would otherwise be reluctant to take advantage of the increased gift exemption before it may expire. Spouses cannot, however, create trusts for one another that are substantially identical or related as to economic interests or powers without running afoul of the reciprocal trust doctrine.

Self-Settled Trusts—Some clients will ask, "Why can't I make a gift to an irrevocable trust of which I myself am a beneficiary?" The trust would still be included in the donor's gross estate, at least if the trust were created in Ohio or most other jurisdictions. There are a handful of states, however, that protect a self-settled trust from the settlor's creditors, which is a requirement for exclusion of the trust from the settlor's estate.

Irrevocable Life Insurance Trusts—In light of the increased estate exemption, clients are asking if they should re-evaluate their life insurance coverage needs. Although it is true that we now have a high $5 million estate exemption, that exemption is scheduled to drop to only $1 million in 2013, subject, of course, to any future legislation Congress and the President may agree upon. For policies having premiums that exceed the available annual gift exclusions, a large gift to prefund premiums should be considered.

A Once-in-a-Lifetime Opportunity

For all these reasons, the 2010 Tax Act presents what may well be a once-in-a-lifetime opportunity for estate planning for individuals and business owners, along with a number of pitfalls to be avoided.

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A Charitable Giving Toolbox

BY STEPHEN H. GARIEPY

A low-interest rate environment and increased market volatility need not deter donors from considering planned charitable giving. Low rates and high volatility actually enhance the benefits of several planned giving tools.

Charitable Gift Annuities

Charitable Gift Annuities (CGAs) are particularly useful for donors unsettled by sharply reduced income from their CDs, money market accounts and Treasuries. They also appeal to donors unnerved by the volatility of the stock market. These donors want to be able to count on a stable income, unaffected by future fluctuations in interest rates or stock values, and want the security of payments they cannot outlive.

A CGA provides all this in a simple contract. A charity, in exchange for a gift of cash or marketable securities, agrees to pay an annuity of a fixed amount of money to one or two annuitants for life. Usually the annuitant is the donor, or donor and spouse, but can be any person the donor selects, such as an elderly parent or long-time, valued employee.

Most charities offer the rates suggested by the American Council on Gift Annuities. The rates vary depending on the number of annuitants (one or two) and their ages. Higher rates are paid to older annuitants on account of their shorter life expectancy. The single-life rates currently available for donors ages 50 to 90 range from 3.7% to 9.0% (and even higher for deferred annuities).

These rates compare favorably to the returns on CDs, money market accounts, Treasuries and mutual funds. For example, the 1% paid on a $100,000 CD can be quintupled to 5.1% on a Charitable Gift Annuity for a 70-year old annuitant. Moreover, if the annuity is funded with cash, a significant portion of each payment will be a tax-free return of principal (77% tax-free for a 70-year old annuitant, thereby boosting the effective payout rate to 8.3% for an annuitant in the top income tax bracket). If the annuity is funded with appreciated stock or real estate, the capital gain is spread over the annuitant's lifetime, and each payment is part ordinary income, part capital gain and part tax-free return of basis. (Any payments past life expectancy are taxed as ordinary income.)

Further, donors can claim an income tax deduction in the year of the gift for the amount of the contribution, less the present value of the life payments to be made to the annuitant (a deduction of $36,912 in the above example). To the extent not fully used in the year of the gift, the deduction can be carried forward for up to five years.

The favorable rates (partly tax-free), secure fixed income, income tax deduction, and donors' freedom from investment responsibility, all make CGAs an attractive alternative in the current economic climate. Charities can generally expect to benefit by a residual of 50% of the initial gift amount.

Single-Life Gift Annuities

Age	Rate
50	3.7%
60	4.4%
70	5.1%
80	6.8%
90	9.0%

Charitable Remainder Unitrusts

Charitable Remainder Unitrusts (CRUTs) provide another way for donors to increase their income stream in a low-interest environment. Let's take the example of a retired couple, both age 75. They would like to increase their retirement income, reduce their income taxes and estate taxes, and make a gift to their favorite charitable organization. Let's say they have $1 million of publicly-traded stock with a low cost basis, and it yields only 2% in annual dividends. If they sell the stock, they pay a capital gains tax, leaving less to reinvest.

Instead, they can transfer their stock to a CRUT, and the trust then sells the stock with no tax and reinvests the gross proceeds. The net result is that their retirement income over their lifetimes may increase because the trust has the full $1 million working for them, rather than what they would have been left with after paying capital gains tax. If the donors set the CRUT payout at even the minimum allowed rate of 5% of the trust as revalued annually, they may increase their income stream substantially over the 2% stock dividends they were receiving.

The CRUT donors also get an upfront income tax deduction for the present value of the remainder interest that will pass to charity when the second of them dies (a deduction of $490,470 in the above example). If they cannot make full use of the deduction in the year of the gift, they may carry it forward for up to five years. The increased income stream, in combination with the upfront charitable deduction, work to maximize the economic return to the donor.

To top it off, by transferring $1 million to a CRUT, the donors' estates are reduced by $1 million for estate tax purposes.

CRUTs are also a tax-efficient tool to "unlock" the value of illiquid assets, such as collectibles (the proverbial Stradivarius violin), or transition a concentrated position in a low-basis stockholding (including a closely-held business) to a diversified investment portfolio.

A donor may name more than one charity as the remainder beneficiary and reserve the right to change the charitable beneficiaries.

Personal Residence Remainder Gifts

Experiencing the downturn in the real estate market, many seniors are more inclined to remain in their homes rather than selling at a reduced price. Others, irrespective of the market, like where they live and remodel their homes to make accommodations for their physical needs, such as a master bedroom and bath on the main floor. With more seniors continuing in their homes, Personal Residence Remainder Gifts deserve increased consideration.

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A donor may make a gift to a charity of a remainder interest in a personal residence taking effect at death, while retaining a life estate. The tax benefit is that the donor may claim an income tax deduction for the remainder in the year of the gift. In a low-interest rate environment, the calculation of the present value of the future remainder interest produces a larger income tax deduction. For example, a 75-year old with a $500,000 residence is currently entitled to an upfront deduction of $439,255. This large deduction, if not fully used in the current year, may be carried forward to shelter income for up to five years. The resulting tax savings can be helpful to donors who have seen declines in their investment values and income.

If the donor should later vacate the residence before the life estate expires, the donor has several early exit options. The donor may lease the home and collect the rent for the remainder of the life estate. The donor and charity may agree to a joint sale of their interests to a third party and split the sale proceeds actuarially. The donor may make a gift of the remaining life estate to the charity and take an additional income tax deduction. The donor may transfer the remaining life estate to the charity in exchange for a Charitable Gift Annuity, or to a Charitable Remainder Trust, and receive an income stream for life and an income tax deduction.

Charitable Lead Annuity Trusts

Charitable Lead Annuity Trusts (CLATs) pay out a fixed annuity amount to a designated charity for a set number of years. When the trust ends, all remaining assets are distributed to (or continue in trust for) designated family members.

The goal of every CLAT is to generate income and appreciation that exceeds the rate projected by the IRS, currently only 1.2%. If successful, the excess passes to family members free of gift tax and estate tax. Highly appreciating assets that can beat the IRS hurdle rate are the ideal choice for funding a CLAT. For example, a 15-year CLAT funded with $10 million that grows at 7.4% (interest, dividends and appreciation) and pays out 7.4% to charity, will at the end of the term distribute $10,000,000 to family.

Superlative results are possible for CLATS when there is a confluence of low interest rates and low asset values. Low interest rates reduce the amount and/or shorten the term of the payout to charity necessary to zero out the IRS projected value of the remainder gift. Contributing de-valued assets expected to rebound in the coming years can further boost the odds of a CLAT producing a significant transfer to family.

Taking a CLAT to the next level involves first transferring assets into a Family Limited Liability Company (FLLC) and then transferring nonvoting units in the FLLC to the CLAT at a discounted value. The valuation discount allows the upfront valuation of the remainder to be zeroed out with smaller payouts and/or shorter terms.

In 2012 a donor may apply the $5 million gift exemption to a CLAT. In the above example, this can shorten the term to 7 years or reduce the payout to 3.7%. The $5 million exemption is scheduled to revert to $1 million on January 1, 2013.

Whether a CLAT is funded with $100,000 or $100 million, the remainder, in whatever amount it actually grows to be at the end of the term, can be transferred to family with zero gift tax and estate tax.

Advisors' Role in Initiating Discussion of Charitable Giving Benefits

There's more to charitable giving than just the financial and tax advantages. Donors also derive the personal satisfaction that comes from supporting the mission of a favorite organization, building relationships with the organization's staff and other donors, involving family members in philanthropy, and receiving recognition of their generosity from the organization and community.

It's for all these reasons — financial, tax, philanthropic and social — that we, as professional advisors, have a role to play and responsibility to embrace in initiating a conversation about charitable giving with our clients, and providing counsel to them in accomplishing these goals. There is much to be gained by charities and donors alike — in the best or most challenging of economic times.

Every day we are presented with an opportunity to refocus our time and creativity not only on tax-driven goals, but on values-driven goals, i.e., developing meaningful provisions for children, grandchildren, business succession and legacies to non-profit organizations.

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A Charitable Giving Toolbox

Charitable Gift Annuity – a low-yield CD, stock or bond can be converted to a 5.1% – 9.0% lifetime annuity.

Charitable Remainder Unitrust – a low-basis or low-yield stock or collectible can be converted to a diversified portfolio with a payout of 5% or higher.

Personal Residence Remainder Gift – a residence can generate an immediate deduction of 63% – 93% of value, even though the donor retains the right to live there for life.

Charitable Lead Annuity Trust – whether funded with $100,000 or $100 million, the remainder can pass to family with zero gift tax and estate tax.

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