MASSACHUSETTS LAWYERS WEEKLY
www.masslawyersweekly.com
March 21, 2011
THE DOLAN COMPANY

Estate Planning Special Feature

Advising clients in wake of new tax law

By Bryan S. MacCormack

The recent passage of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 has changed the playing field for estate planners.

For 2011 and 2012, the estate, gift and generation-skipping transfer tax exemptions are now unified, with a $5 million exemption and a top tax rate of 35 percent.

This article will address some of the provisions of the 2010 tax act, the planning opportunities that are now available, and some concerns that should be kept in mind.

One of the biggest changes of the new tax act is that, for the next two years, the gift tax exemption for individuals has increased from $1 million to $5 million. Married couples can now give away $10 million.

Unless Congress acts, in January 2013 the gift and estate tax exemptions will return to $1 million and the top tax rate will be 55 percent. The opportunity to give away $10 million of assets without having to pay a gift tax opens the door to many transfer opportunities that, with leveraging strategies, can move significant wealth from clients' estates.

The new federal law provides a unique window of opportunity that may last for only two years. One way to transfer assets is simply to make a gift.

Each year, anyone can transfer $13,000 (annual exclusion gifts) to as many people as he wants. In addition to annual exclusion gifts, one now can give away an additional $5 million.

You can leverage your gift by transferring it to an irrevocable grantor trust. A grantor trust is a trust that is disregarded for income tax purposes, which means the trust income would be reported on the grantor's personal income tax return.

Even though for income tax purposes the trust is disregarded, the trust would be respected for gift, estate and generation-skipping tax purposes. That means the grantor (the creator of the trust) would be taxed on the income generated from the trust assets, but the assets of the trust would not be included in his estate for estate tax purposes.

In addition to the asset protection you get by having the assets held in trust, the gift is leveraged because, by paying the taxes on the trust income, the grantor further reduces the value of his estate. The payment of taxes for the trust is essentially a tax-free gift for the trust beneficiaries.

For those clients who are concerned about making irrevocable gifts to trusts, the trust can be drafted to name a spouse as a discretionary beneficiary. The trust

ISTOCKPHOTO.COM

can also have an income tax reimbursement clause, giving the client the option of getting reimbursed for taxes paid on the income generated from trust assets.

For larger estates, clients should consider selling assets to grantor trusts. Using that option, the grantor establishes an irrevocable trust for the benefit of his children and grandchildren.

The trust can also be structured as a Dynasty Trust, which lasts for multiple generations. The grantor then sells the assets to the trust in exchange for a promissory note. The sale is legally recognized, but for income tax purposes the sale is not recognized.

That's because when you sell an asset to a grantor trust, the trust is disregarded and there are no income tax consequences

Bryan S. MacCormack has an L.L.M. in taxation. He practices in Boston and is of counsel to Rudolph Friedmann. He can be contacted at bryan@maccormacklaw.com.

when you sell to yourself. The result is that the grantor would not realize capital gain taxes on the sale of the assets to the trust, nor would the grantor recognize income from the interest payments on the promissory note.

By selling the assets to the trust, the effect is to freeze the value of the assets for estate tax purposes. To leverage your transfer, you can transfer limited partnership units, non-voting shares of stock, or non-voting membership units of an LLC. These non-voting interests can be discounted for lack of control and lack of marketability. For a closely held business entity, a discount of at least 50 percent is not unusual.

Clients owed money from children or trusts from previous sales of assets should consider reducing interest rates of promissory notes, if possible, or even forgiving the entire balance due on the note.

Another leveraging strategy is to make a gift of the note to an irrevocable grantor trust. The value of the gift can be significantly discounted. An appraisal of the note would be recommended.

The new tax act also provides planning opportunities for life insurance transfers. Because of the $5 million gift tax exemption (or $10 million for a couple), a high amount of life insurance coverage can be purchased by making a large gift to the trust to make future premium payments. If the insurance trust is structured properly, the life insurance proceeds can pass free of estate taxes to younger generations.

Another major change in the estate and gift tax rules is the "portability" of a taxpayer's deceased spouse's unused applicable exclusion amount. The new law is intended to prevent families from paying estate and gift taxes that would have been avoided if proper planning had been in place for the deceased spouse.

Portability enables a surviving spouse to utilize the unused estate tax applicable exclusion amount of a deceased spouse. Portability can be used by a surviving spouse for lifetime gifts or for transfers at death.

Typically, estate planners try to equalize assets of married persons to ensure full utilization of estate tax exemptions. But that may be difficult in certain instances, especially if one spouse has a large indivisible asset, such as an IRA.

In such a case, portability will ease post death planning by allowing any unused estate tax exemption to be reserved for future use by a surviving spouse. You will need to make a timely election on an estate tax return in order to transfer a portability allowance.

It's a perfect time to counsel clients about the current law, how it impacts their existing estate plans, and whether it makes sense to take advantage of the various exemption options available for the next two years.

So why do clients need trust planning now that there is portability of unused estate tax exemptions? There is no guarantee that portability will be available after 2012. The Massachusetts estate tax exemption is $1 million, but a deceased spouse's exemption is not portable. So it is still necessary to create a trust to preserve the Massachusetts exemption amount upon the death of the first spouse.

If there is no credit shelter trust, the appreciation of the assets left to a surviving spouse would be included in his gross estate. Credit-shelter trust assets can be protected from the claims of creditors and will help to ensure that children from a previous marriage are provided for. And more importantly, there is no portability of a deceased spouse's unused generation-skipping tax exemption.

But with a credit shelter trust, after the death of the first spouse, the allocation of such spouse's remaining GST exemption can be made to the trust.

So what happens if someone makes a lifetime gift of $5 million and dies when the estate tax exemption is $3 million? Presently there is no clear answer on what position the IRS will take. Prior gifts may be grandfathered, or the law may "clawback" any gifts that exceed the exemption amount in effect at the time of death. And there would be a possibility of additional estate taxes.

Even if there is a clawback, the combined estate/gift tax would not be greater if the gift had not been made in the first place. And by making the gift, you have removed from your estate the future appreciation and income from the gifted asset.

Why is now the time to act?

Unless Congress changes the laws, in January 2013 the gift and estate tax exemption will be reduced to $1 million, and the top tax rate will be 55 percent. Massachusetts taxes are not a concern because there is no gift tax, and Massachusetts does not base its estate tax calculation on prior gifts.

For larger estates, it is certainly possible that Congress will reduce or even eliminate valuation discounts. But for now, it's a perfect time to counsel clients about the current law, how it impacts their existing estate plans, and whether it makes sense to take advantage of the various exemption options available for the next two years.

MLW