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The Top 10 Estate and Tax Planning Ideas Before The End of 2010

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The number of days that remain until the calendar rings in 2011 is now dwindling to a precious few. With each passing day, the estate and tax planning opportunities that are unique to the calendar reading 2010, or which could be swiftly eliminated by Congressional action or other changes in circumstances, become more and more in focus. Accordingly, with apologies to David Letterman (and with the sequence below not intended to connote any particular internal ranking), I have compiled the following "Top 10 List" of estate and tax planning ideas before the end of 2010.

<u>Planning Idea # 10</u>: Qualified Disclaimer Planning to Take Advantage of the Temporary Repeal of the Federal Estate Tax during 2010

The author will spare the reader any stories of planned pilgrimages to Amsterdam during the waning days of 2010, which promises to be the last opportunity (barring any unforeseen retroactive legislation) for a U.S. person having very substantial wealth to die without being subject to Federal estate tax or generation-skipping transfer ("GST") tax.

But the cold hard truth is that if Congress fails to enact any estate tax legislation before the end of the year (and as of this writing, that does not seem likely), we will then face the new absurd reality of having the Federal estate tax (and the GST tax) laws that existed in 2001 return on January 1, 2011. That means a 55% top estate and GST tax rate, and only a scant \$1 million Federal estate tax exemption (and with a \$1 million GST tax exemption indexed for cost-of-living adjustments).

That brings us to the topic of qualified disclaimers. A qualified disclaimer is the quintessential tool for post-mortem 2010 estate planning because it can allow a person to shift wealth downstream by one or more generations free of any estate, gift or GST taxes – and this can generally be accomplished up to 9 months after the decedent's death. Thus, a surviving spouse can survey the circumstances and has up to 9 months to decide whether to disclaim property, and to what extent. Depending upon the terms of the disposing instrument (such as a Will, a trust, or a beneficiary designation) and its provisions governing alternate dispositions, it may be possible for the person who would inherit or otherwise acquire substantial property to be treated for transfer tax purposes as having predeceased the decedent or the donor, as the case may be.

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Take, for example, the case of a surviving spouse, who during the witching year of 2010 is the presumptive beneficiary of substantial wealth under the deceased spouse's estate planning documents. Assuming that the Federal estate tax is not retroactively reinstated, the estate tax marital deduction is completely superfluous and therefore unnecessary to shield wealth from the estate tax. Moreover, giving property outright to a surviving spouse can be an estate tax planning hindrance, because property that the surviving spouse inherits outright will be subject to Federal estate tax when he or she subsequently dies if death occurs after December 31, 2010. So how can wealth be shifted down a generation to pass without triggering any Federal estate tax at the parents' level?

Estate tax can be avoided at the parents' entire generational level if the surviving spouse executes a qualified disclaimer as to such property in compliance with Section 2518 of the Internal Revenue Code (the "IRC"). Moreover, in contrast to any other person, IRC § 2518 permits the surviving spouse to be a beneficiary of a trust in which the disclaimed property falls.[1] And so long as benefits are not accepted by the surviving spouse during this period, the surviving spouse has 9 months from the date of the death or other transfer to determine how to proceed. Depending upon when during 2010 death has occurred, this can provide a window to protect against the retroactive restoration of the Federal estate tax. Accordingly, through this technique, very substantial wealth can be shifted down a generation without any estate, gift or GST tax consequences – and notwithstanding that the surviving spouse may still be able to benefit from the disclaimed property.

<u>Planning Idea # 9</u>: Planning to Take Advantage of the Temporary Repeal of the Federal Generation-Skipping Transfer Tax during 2010

Why stop at one generational level in qualified disclaimer planning? Not only the Federal estate tax, but also the GST tax is repealed for 2010. So, subject to certain qualifications discussed below, wealth can be shifted down two (or more) generations during 2010 without triggering any GST tax.

In addition, if there are any assets in a "nonexempt trust" (that is to say, a trust that has not been shielded from GST tax in the future through the allocation of GST exemption), 2010 is the year to make a distribution, or to terminate some portion of the trust, in favor of a "skip person." To prevent GST tax from potentially being imposed at some point in the future, the distribution or termination of the nonexempt trust in favor of the skip person should be ***outright*** -- and not in further trust, or through arrangements that could be deemed to constitute a trust for GST tax purposes (such as a distribution to a Uniform Transfers to Minors Act account). If there are concerns regarding the beneficiary's ability to manage wealth (including spendthrift concerns), the property distributed to the skip person can be in the form of a non-managing membership interest in a limited liability company, or a limited partnership interest in a limited partnership.

<u>Planning Idea # 8</u>: Planning to Take Advantage of the 35% Gift Tax Rate during 2010

Although the Federal estate tax and the GST tax are not in effect in 2010, the gift tax is still in effect during 2010. A 35% tax rate applies to gifts during 2010, with donors continuing to have a $1 MLN lifetime exemption,[2] the $13,000 per donee annual exclusions, and the Section 2503(e) unlimited exemption for the direct payment of tuition and medical expenses.

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Accordingly, donors who are inclined to make gifts in excess of those thresholds should consider doing so in 2010 as a 35% gift tax rate applies, instead of the 45% rate that applied in 2009 and the 55% gift tax rate that is scheduled to apply to gifts made on or after January 1, 2011.

The ability to take advantage of the extremely low gift tax rate for 2010 is, of course, in addition to the traditional advantages of making lifetime gifts over death-time transfers. These traditional advantages of lifetime gifts over dispositions at death include

[A] the use of a tax-exclusive computation for gift tax purposes (instead of the tax-inclusive computation under the Federal estate tax regime that includes the estate tax in the tax base for computing the estate tax) and

[B] the availability of lack of marketability and minority interest discounts on transfers to donees for gift tax purposes[3] that, had the same transfer occurred at death, would have been subject to aggregation and therefore the loss of such discounts.

The major stumbling block to clients making taxable gifts during 2010 is, of course, the fear that if they were to die during 2010 after making the taxable gift, there would no Federal estate tax (or GST tax) imposed on such dispositions occurring at death. This risk can be addressed by making the gift effective as of December 31, 2010, or at some earlier date near the end of December if there is concern that lead time is needed in order for the gift to be fully executed (including to allow for funds to clear the banking system).

Planning Idea # 7: Using Grantor Retained Annuity Trusts ("GRATs") while the Window of Opportunity for 2 Year GRATs Is Still Open

In addition, those donors who are inclined to consider such leveraged gifting techniques as grantor retained annuity trusts ("GRATs")[4] should engage in such planning sooner rather than later. Indeed, there are several legislative proposals that, as a practical matter, would effectively extend the minimum survivorship term for a grantor to successfully utilize a GRAT from two years to ten years, as well as imposing certain other restrictions.[5] Moreover, the "Section 7520 rate" that is used for GRATs is at an all-time low of only 1.8% for December 2010.

Planning Idea # 6: Using Family Limited Partnerships ("FLPs") and Family Limited Liability Companies ("FLLCs") while Discounts are Still Available

Gifts or sales of FLP or FLLC interests should be considered while discounts for transfers to family-controlled entities are still available. There has been a fair amount of discussion this year (including the President's budget proposal) regarding the elimination of intra-family discounts. These valuation discounts reflect the relative lack of marketability and lack of control associated with such interests. So, all other things being equal now would appear to be the time to engage in gifts or sales of FLP or FLLC interests to lock in discounts for lack of control and lack of marketability.

There are certain caveats, however, to engaging in leveraged transfer planning with FLP or FLLC interests. Among other things, the ability of gifts of FLP or FLLC interests to qualify for the gift tax annual exclusion has been called into question by the recent case of *Price v. Comm'r*, T.C. Memo. 2010-2 (U.S. Tax Ct. 2010), in which the Tax Court determined that the gifts of FLP interests made by two parents to their children did

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not qualify for the gift tax annual exclusion under IRC Sec. 2503(b).[6] Similarly, in Fisher v. United States, No. 1:08-cv-00908, 2010 WL 935491 (S.D. Indiana March 11, 2010), gifts made by parents to their children of interests in a limited liability company were held not to qualify for the gift tax annual exclusion because the interests were considered "future interests" rather than "present interests" in property because of operating agreement restrictions on the children's rights relating to the property.

One way around the gift tax annual exclusion problem (and without sacrificing the magnitude of the discounts that should be available for transfers of interests under the entity's operating agreement) is for the donor to give the recipient a "put" right to sell the interest to the donor and get cash for a limited time. Presumably, that should satisfy IRS present interest requirements.[7]

Finally, the estate tax "end-game" needs to be carefully and thoroughly considered with FLPs or FLLCs, because discounts for gift tax purposes can be rendered meaningless in the final analysis if the value of the property transferred without any discounts (including subsequent appreciation thereon) is ultimately brought back into the transferor's gross estate for estate tax purposes following the transferor's death. Where the decedent (whether expressly, or by implied agreement as demonstrated through a course of dealings) has retained too much control over the FLP's or FLLC's operations (particularly with respect to the ability to direct entity distributions), or has retained the possession or enjoyment of, or the right to the income from, the entity's property, the property transferred to the FLP or FLLC may be subject to inclusion in the decedent's gross estate under IRC § 2036.

The Section 2036 risk analysis, however, can potentially extend far beyond the realm of mere opportunity cost. If Section 2036 applies (and further assuming that the bona fide sale for full and adequate consideration exception to Section 2036 is unable to be invoked due to the absence of a substantial nontax purpose[8] for the transfers of entity interests), planning with FLPs and FLLCs can severely backfire – and in some cases can accelerate estate tax to the first spouse's death even though the estate plan has been drafted with formula provisions that are intended to defer all estate taxes until the death of the surviving spouse. This horrific result of accelerating substantial estate taxes to the first spouse's death can occur because IRC § 2036 can create "phantom assets" that are included in the gross estate of the first spouse to die, but because they are not "real assets," are unable to pass to the surviving spouse to qualify for the federal estate tax marital deduction. This mismatch between gross estate values and marital deduction values could produce substantial estate taxes upon the "first death" -- in sharp contrast to the client's likely expectation that the marital deduction would shield the husband and wife from federal and state estate taxes until the death of the surviving spouse.[9]

There can also be adverse income tax consequences from using FLPs and FLLCs, including (come 2011) a loss of the step-up in basis of the transferred FLP interests that have not been brought back into the decedent's gross estate, and a substantial reduction (if not a complete loss) of the basic benefits available through the entity's Section 754 election.[10] Accordingly, a rush to obtain discounts should not blind the advisor to the need to exercise

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great care and analysis in the formation, funding and administration of the FLP or FLLC.[11]

Planning Idea # 5: Taking Capital Gains During 2010 While the 15% Long-Term Capital Gains Rate Still Applies

Clients may wish to consider selling assets in 2010 in order to recognize capital gains at the present 15% long-term capital gains tax rate. Capital gains tax rates are scheduled to rise to 20% in 2011 and 23.8% in 2013. It may be possible to defray some of this capital gains tax liability through charitable gifting, as further discussed below.

Nevertheless, there are exceptions to this principle. Where, for example, a client who has substantial appreciated property also has mortality concerns, a retention approach may provide the better capital gains tax strategy because the "step-up in basis" rules of IRC § 1014 will return on January 1, 2011 to eliminate such built-in capital gains upon the client's death.

Planning Idea # 4: Consider Charitable Contributions During 2010 While the 80% Phase-Out Rules for Itemized Deductions Do Not Apply for 2010

The itemized deduction phase-out rules contained in IRC § 68(a) do not apply in 2010,[12] but will return in 2011. The significance of this cannot be overstated for clients who are charitably predisposed. In the past, as a result of the 80% maximum phase-out of itemized deductions for certain taxpayers, the charitable deduction could potentially be reduced from 35 cents on each dollar to only 7 cents on each dollar.

In contrast, for charitable gifts in 2010, it is possible these same donors will only effectively pay 65 cents on each dollar, instead of 93 cents (100 less 7). It should be noted, however, that charitable gifts remain subject during 2010 to the applicable caps based on 50%, 30%, or 20% of adjusted gross income, as the case may be.

So what forms of charitable planning make the most sense today? It bears noting that, as a result of the current low interest rate environment, some forms of charitable planning work better now. One charitable planning technique that is particularly effective in low interest rate environments is the gift of a remainder interest in a residence or a farm. The valuation of the retained income interest goes down as interest rates go down, so the value of the remainder is higher when interest rates are low – as they are today.

Planning Idea # 3: Consider Making a Roth Conversion

The year 2010 is the first year that many wealthy taxpayers have had access to Roth IRAs because of the elimination of the income cap on converting a traditional IRA to a Roth IRA. Thus, the seemingly ubiquitous question these days is whether to convert one's traditional IRA to a Roth IRA. Doing so means that the taxpayer effectively prepays the deferred income tax liability upon the conversion – which, of course, requires the client to come up with the money to pay the tax. However, if the Roth conversion is done before the end of 2010, the taxpayer can elect to defer the income inclusion attributable to the 2010 Roth IRA conversion ratably into the years 2011 and 2012.[13]

Importantly, Roth IRA conversions provide the ultimate "escape hatch" (with this feature continuing beyond

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2010) --- namely, the ability to completely undo a Roth IRA conversion through a "recharacterization."[14] A recharacterization involves transferring the converted amount (plus allocable investment income) to a traditional IRA before the due date (including any applicable extensions) for filing one's federal income tax return. Thus, one can "wait and see" as late as the October 15, 2011 extended tax return filing deadline for 2010 returns to determine whether to undo a 2010 Roth IRA conversion. In addition to allowing one to subsequently evaluate his or her cash flow concerns, a recharacterization can prove very helpful if the investment value of the converted property has significantly declined.

Despite the ability to undo Roth IRA conversions through a recharacterization if the value of the converted assets decline or if the cash flow hit from accelerating the income tax liability is too severe, many clients are reluctant to proceed with a Roth IRA conversion. In the following five (5) circumstances, a Roth IRA conversion will generally be advisable (subject, of course, to the client's retained ability to undo it via a recharacterization) provided that the client has sufficient available cash to pay the tax on the conversion if it's not undone.

a. Where the client is likely to always be in the highest tax bracket. Such a person would not be pushed into a higher tax bracket as a result of the conversion. In this regard, the maximum 35% federal income tax rate in 2010 is relatively low by historical standards, and in any event is lower than the 39.6% and 43.4% top rates that are scheduled to occur in 2011 and 2013 respectively.

b. Where the client's estate will likely be subject to estate tax. Absent a Roth IRA conversion, such person's taxable estate would have been inflated by the deferred income taxes imposed on distributions from a traditional IRA account. Although beneficiaries are entitled to claim an itemized income tax deduction for the federal (but not state) estate taxes imposed on a traditional retirement account in the year in which they report the retirement plan distributions as taxable income,[15] the beneficiaries would have been better served if the traditional account had instead been converted into a Roth IRA so that no estate tax would have been levied on the deferred income tax.

c. Where the client is currently in a low income tax bracket but will likely be in a higher tax bracket at retirement.

d. Where the client has tax deduction carryforwards to offset the short-term tax hit attributable to the Roth IRA conversion.

e. Where the client wishes to take advantage of a Roth IRA's exemption from making lifetime required minimum distributions.[16]

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Planning Idea # 2: Consider Loan Transactions with Family Members and Trusts to Take Advantage of the Extraordinarily Low Applicable Federal Rates ("AFRs")

The applicable federal rates ("AFRs") for December 2010 continue to be extraordinarily low, with clients able to make short-term loans (*i.e.,* not over 3 years) at 0.32%, mid-term loans (*i.e.,* over 3 years but not over 9 years) at 1.53%, and long-term loans (*i.e.,* over 9 years) at 3.53%.[17] It is uncertain how long these low AFRs will continue. Accordingly, clients should act now to make loans to family members and trusts established for the benefit of family members to lock in these low interest rates.

Similarly, there is no time better than the present for clients to engage in installment sales with their grantor trusts[18] that are paid for in part by promissory notes that lock in these extraordinarily low interest rates. Under the 2009 Tax Court Memorandum decision of *Petter v. Commissioner*, T.C. Memo *2009-820* (U.S. Tax Ct. 2009), gift tax on any such sales can generally be avoided through the use of properly structured defined value formula clauses.

Planning Idea # 1: Make Loans to Irrevocable Life Insurance Trusts (or Use Policy Options) Instead of Making Gifts to ILITs

Finally, 2010 presents a challenge for donors making transfers to irrevocable life insurance trusts ("ILITs") that could ultimately benefit grandchildren or other "skip persons". This is so because GST tax exemption cannot be allocated for 2010. Although it is possible to make a late allocation of GST exemption in 2011 based upon the value of the property transferred at the time of the allocation, that strategy will fail miserably if the donor of the ILIT dies before GST exemption is allocated. So how does one manage the inability to allocate GST exemption (including for ILITs) during these waning days of 2010?

For ILITs, one solution is to pay premiums from the preexisting policy cash value (if available), or to use policy options (again, if available) to avoid paying premiums during 2010. If, however, neither alternative is feasible and the characterization of the annual funding of the ILIT has not yet been determined, then the donor should loan money to the ILIT trustee at the AFR to fund the premium payments. Once the calendar turns to 2011 and GST tax exemption can once again be allocated, the donor (acting in his or her discretion, of course) may determine whether to forgive these loans to the ILIT trustee within gift tax annual exclusion limits.

Endnotes

1 *See* IRC § 2518(b)(4)(A).

2 Due to computational mechanics resulting from differences in the application of tax rates to the unified credit, less than $1 million of lifetime gift tax exemption will be available for certain taxpayers who have previously made taxable gifts and used up some of their lifetime gift tax exemption. Accordingly, if lifetime gifts begin to approach the $1 million threshold, computations should be run to avoid any surprises when the 2010 gift tax returns are filed.

3 See Rev. Rul. 93-12.

4 The basic GRAT is essentially simple: the grantor transfers property into an irrevocable trust (the GRAT) for a specified number of years, retaining the right to receive an annuity (a fixed amount payable not less frequently than annually). Upon termination of the GRAT, the trust assets are paid to the remaindermen named by the grantor, typically his or her children, or to a trust of which the grantor's spouse and issue are beneficiaries. In essence, the grantor creates a GRAT to transfer its <u>remainder</u> at

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termination. This transfer is a taxable gift that is deemed to occur upon creation of the GRAT. The remainder is valued for tax purposes by subtracting the interest retained by the grantor—the annuity—from the value of the initial transfer into the GRAT. The Internal Revenue Service ("IRS") requires that the value of the retained annuity be calculated on an actuarial basis using an assumed interest rate published by the IRS that is in effect for the month that the GRAT is funded (the "Section 7520 rate").

The tax benefit of the GRAT therefore arises if the investments held in the GRAT outperform the assumed interest rate used in the gift tax calculations. In this event there is a tax free transfer to the extent of that extra performance from grantor to remaindermen because the actual value of the remainder at termination will be greater than the value that was calculated for gift tax purposes.

5 On June 15, 2010, the House of Representatives passed HR 5486, the "Small Business Jobs Relief Act of 2010". The bill contains the identical provisions regarding GRATs that were contained in an earlier bill (HR 4849, the "Small Business and Infrastructure Jobs Tax Act of 2010"), which the House passed on March 24, 2010. The House reiterated these provisions again on July 1st in an amendment to HR 4899, and these provisions have also been introduced in the Senate in S 3533 and S 3548.

Those provisions contain the following:

- A requirement that a GRAT have a minimum 10 year term;
- A requirement that the annuity payment not be reduced from one year to the next during the first 10 years of the GRAT term; and
- A requirement that the remainder interest at the time of the transfer have "a value greater than zero."

As in prior House bill, this bill contains no guidance regarding the parameters of the "greater than zero" requirement.

The proposed provisions regarding GRATs generally would only apply to transfers made *after* the law becomes effective. The one variation to this is S 3548, which provides that these GRAT provisions would apply to transfers made after December 31, 2010.

6 The court found the following aspects of the limited partnership agreement, and of the limited partnership's operations, to prevent qualifications as a present interest for purposes of the gift tax annual exclusions:

- The limited partnership agreement prohibited all assignments;
- The lack of any guarantee of distributors to a limited partners (for example, the limited partnership agreement did *not* require the general partner to make annual distributions of "Available Cash").

The limited partnership in *Price*, in fact, did not make distributions during two of the years at issue.

7 In addition, clients considering forming FLPs or FLLCs should bear in mind that forming FLPs or FLLCs too close in time to gifting or selling them opens the door for IRS attacks under the step transaction doctrine. When successful, the result is no valuation discounts, as the transfers are deemed made of the underlying assets.

8 There should always be a substantial nontax purpose for establishing the FLP. This can include any of the following:

- A joint investment vehicle for partners or members;
- The centralized and active management of assets;
- Asset protection;
- Facilitating an investment strategy that expressly permits the retention of portfolios that are heavily concentrated in particular assets or classes of assets;
- Facilitating the establishment of a voting block through the pooling of partners' or members' voting securities of a particular issuer;
- Facilitating the raising of capital from third parties; and
- Providing a mechanism to ensure the submission to arbitration of any intra-family disputes subject to strict confidentiality provisions.

9 *See* Kevin Matz, *Special Concerns in FLP Planning Where Both Spouses Are Living*, 34 Estate Planning 1, at 16 (Jan. 2007); *see also Estate of Black v. Comm'r*, 133 T.C. No. 15 (U.S. Tax Ct. 2009) (IRS asserts the marital deduction mismatch problem, but the case resolves on other

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grounds due to the application of the bona fide sale exception to IRC § 2036); *Estate of Bongard v. Comm'r*, 124 T.C. 95 (U.S. Tax Ct. 2005) (sustaining the IRS's application of IRC § 2036 to a family limited partnership, with a multi-million dollar estate tax deficiency resulting upon the death of the first spouse to die).

10 If an entity that is taxed as a partnership for federal income tax purposes makes a Section 754 election, the entity's basis in its assets (the "inside basis") will be adjusted, but only with respect to the transferee partner. Specifically, the entity will increase its inside basis by the excess of the transferee partner's "outside basis" (which has been stepped up under Section 1014) over his or her share of the entity's inside basis. Alternatively, if the transferee partner's outside basis has been stepped *down* under Section 1014, the entity making a Section 754 election (which, depending upon the circumstances, could potentially be mandated under amendments to Section 743(b) relating to "substantial built-in losses" that were added by the American Jobs Creation Act of 2004) will reduce its inside basis with respect to the transferee partner by the excess of the transferee partner's share of the inside basis over his or her outside basis. This adjustment to inside basis affects both the allocation of gains and losses to the transferee partner upon a disposition of an entity asset and the partner's share of inside basis for purposes of depreciation deductions and distributions. *See* Samuel A. Donaldson, *Income Tax Aspects of Family Limited Partnerships*, 39 Univ. of Miami Philip E. Heckerling Inst. on Est. Pl. ¶ 1402.4, at 14-14 (2005).

Significantly, if the estate tax value of the decedent's partnership interest has been discounted for lack of control lack of marketability, the disparity between the "inside basis" of the entity's assets and the "outside bases" (which will have been reduced by discounts) of the entity interest acquired from a decedent may be reduced, if not eliminated. *See id.* In this manner, the valuation discounts can produce an adverse income tax result.

11 *See* Kevin Matz, *Special Concerns in FLP Planning Where Both Spouses Are Living*, 34 Estate Planning 1, at 16 (Jan. 2007).

12 *See* IRC § 68(g).

13 *See* IRC § 408A(d)(3)(A)(iii).

14 *See* IRC § 408A(d)(6).

15 *See* IRC § 691(c).

16 *See* Christopher R. Hoyt, *Rethinking Roth IRA Conversions in 2010*, 24, Probate & Property 5 (Sept./Oct. 2010).

17 IRC § 1274(d).

18 Using grantor trusts will avoid any recognition of gain upon the sale of appreciated property by the grantor to the grantor trust, or the recognition of interest income to the grantor on the trustee's promissory note. *See* Rev. Rul 85-13. In addition, to the extent that the assets held by the grantor trust produce taxable income, such income will be taxable *to the grantor*. This has the same economic effect as a tax-free gift by the grantor to the trust, and if properly structured can be accomplished without rendering the property held in the grantor trust subject to estate tax inclusion in the grantor's estate. *See* Rev. Rul. 2004-64.

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