2010 CPAmerica International Tax Conference

Estate, Gift, and Fiduciary Taxes – Recent Developments

Part I – Recent Developments

Part II – Joint Trusts

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2010 CPAmerica International Tax Conference

Estate, Gift, and Fiduciary Taxes – Recent Developments Part I

9:50AM – 11:55AM

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Planning in the Twilight Zone

Year	Mass. Exemption	Federal Exemption
2003	$700,000	$1 million
2004	$850,000	$1.5 million
2005	$950,000	$1.5 million
2006	$1 million	$2 million
2007	$1 million	$2 million
2008	$1 million	$2 million
2009	$1 million	$3.5 million
2010	$1 million	**No Federal Estate Tax**
2011	$1 million	$1 million

Comment: A portable exemption does not eliminate a need for planning.

2001 Act – Modified Carryover Basis

Once the estate tax is repealed in 2010, a modified carryover basis structure will be established. Under this structure, recipients of property transferred at death generally will acquire a basis in the property equal to the lesser of the:

- Decedent's basis in the property immediately before death, or
- Date-of-death value of the property.

The so-called modified carry-over basis rules, which allow a basis increase, applies to “property acquired from a decedent” by bequest, devise, or inheritance, or by the decedent’s estate from the decedent and any property passing from the decedent to the extent such property passed without consideration. New Code 1022 (e)

Types of Property to which the modified carryover basis rules apply

The modified carryover basis rules apply to property "acquired from the decedent." Property acquired from the decedent is:

(1) property acquired by bequest, devise, or inheritance, New Code § 1022(e)(1)

(2) property acquired by the decedent's estate from the decedent, New Code § 1022(e)(1)

(3) property transferred by the decedent during his or her lifetime to a qualified revocable trust as defined in IRC § 645(b)(1), New Code § 1022(e)(2)(A)

(4) property transferred by the decedent during his lifetime in trust with the right reserved to the decedent at all times before his death to make any change to the enjoyment thereof through the exercise of a power to alter, amend or terminate the trust. New Code § 1022(e)(2)(B),

(5) any other property acquired from a decedent by reason of the decedent's death to the extent such property passed without consideration (e.g., property held as joint tenants with right of survivorship or as tenants by the entireties), and New Code § 1022(e)(3)

(6) the surviving spouse's one-half share of certain community property owned by the decedent and the surviving spouse as community property

Planning Note:

- The decedent will not be treated as owning any property by reason of holding a general power of appointment. New Code § 1022 (d)
- It is questionable whether a reserved life estate is eligible for a step-up in basis

Aggregate Increase in Basis

Under the 2001 ACT, the basis of such property shall be increased by a so-called “basis increase“. In the case of any estate, the aggregate basis increase is $1,300,000. New Code § 1022 (b) (2) (B). Additionally, basis may be further increased by any unused capital losses, net operating losses, and certain built-in losses of the decedent.

An additional $3 million of basis increase is available for property transferred to a surviving spouse for a total of $4,300,000.

The executor chooses the property that will receive these basis increases. However, in no event can the basis of property be adjusted above its date-of-death value.

Non-residents who are not U.S. citizens will be allowed to increase the basis of property by up to $60,000. The $60,000, $1,300,000 and $3,000,000 amounts are to be adjusted for inflation occurring after 2010, but not less that $5,000 in the case of $60,000, not less than $100,000 in the case of $1,300,000, and not less than $250,000 in the case of $3,000,000.

Property acquired by Surviving Spouse

The special $3,000,000 spousal property basis increase applies to so-called "qualified spousal property." The term "qualified spousal property" means (A) an outright transfer of property, and (B) qualified terminable interest property. New Code § 1022(c)(1)(2) and New Code § 1022(c)(1)(3).

<u>Quality Terminable Interest Property</u> – New Code § 1022(c)(1)(3)

1. All income must be payable for life to the spouse at least annually; and

2. No person has any power to appoint property to any person other than the surviving spouse.

Planning Note: Federal and Massachusetts QTIP election can differ. Same as IRC 2056(b)(7)

Planning Note: Great care will be needed in drafting and funding marital and by-pass trusts to maximize the benefit of the new basis rules.

Special Rule Relating to Grantor Trusts

Any transfer of property in trust will be treated as a taxable gift under IRC § 2503 unless the trust is treated as <u>wholly owned</u> by the donor or the donor's spouse. New Code § 2511(c)

Planning Note: Irrevocable Medicaid Planning Trusts must be grantor trusts and not just old fashioned "incomplete gifts" under Regs. 25.2511-2 (c). A power to control beneficial enjoyment exercisable only by Will does not cause the grantor to be treated as an owner under IRC section 674(a). Regs. 1.674(B)(1)(b)(2)

Rules Allocable to Basis Increase

The basis increase will be allocated by the executor on an asset-by-asset basis (for example, basis increase can be allocated to a share of stock or a block of stock), however, in no case can the basis of an asset be adjusted above its fair market value.

If the amount of basis increase is less than the fair market value of the asset who’s basis are eligible to be increased under these rules, the executor will determine which assets and to what extent each asset receives a basis increase. 2001 Act § 1022(d)(3)(A) and (B).

Reporting Requirements: New Code § 6018

a. Transfers at Death

For transfers at death of non-cash assets in excess of $1,300,000 (so-called " large transfers"), and for transfers of certain gifts received by a decedent within three years of death, the executor of the estate (or the trustee of a revocable trust) will report to the IRS;

- the name and taxpayer identification number of the recipient of the property;
- an accurate description of the property;
- the adjusted basis of the property in the hands of the decedent and its fair market value at the time of death;
- the decedent's holding period for the property;
- sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income;
- the amount of basis increase allocated to the property; and
- any other information as the Treasury Secretary may prescribe.

The return must be filed with the decedent's final income tax return and labeled IRC § 6018 Return.

Reporting Requirements: New Code § 6018 Continued

Additionally, the person required to make this return must furnish to each person who receives property a written statement showing (1) the name, address, and telephone number of the person making the return and (2) the information included in the return with respect to the property acquired from, or passing from, the decedent to the person receiving the property. The statement must be filed within thirty (30) days after the return is filed.

Reporting Requirements: New Code § 6018 Continued

b. Property acquired by the decedent within three (3) years of death. New Code § 1022(d)(1)(C)

In general, there will be no step-up in the basis for property acquired by the decedent by gift or by intervivos transfer for less than adequate and full consideration money or money's worth during the 3 year period ending or the decedent's death. This exclusion does not apply to property acquired by the decedent from the decedent's spouse unless the spouse had acquired the property by gift within such 3 year period.

Lifetime Gifts – New Code § 6019 (b)

If a gift tax return is required to be filed under IRC § 6019, the donees must be provided with a written statement containing the name, address and telephone number of the person making the return within thirty (30) days after the date the return is filed and such person must receive the information contained in the return relative to the property received by such person. New Code § 6019 (b). Was this effective in 2002?

Possible Planning Opportunities

- Transfer assets to sick spouse
- Use a lifetime QTIP
- Recommend using a joint trust
  - Rev. Rul. 200101021
  - Rev. Rul. 200210051
- Give sick spouse a general power of appointment exercisable through December 31, 2010
  - Rev. Rul. 200403094
  - Rev. Rul. 200604028
- Make a taxable gift with a disclaimer in the event Donor dies in 2010 (35% rate).

Part II
Joint Trusts

- Recommend using a joint trust

- Revenue Rulings

  -- 200101021

  -- 200210051

Estates Between $1,000,000 & $7,000,000 and Large IRA's (con't)

- Step-by-Step Analysis
- Husband & Wife are Donors and Trustees
- Surviving Spouse is Sole Trustee
- Children are Trustees Upon Death of Survivor

Estate Tax Treatment

- **All trust assets** are includible in estate of first spouse to die
- **Deceased spouse assets** includible under §2038 (revocable)
- **Surviving Spouse Assets** includible under IRC§2041 General Power of Appointment
- **Trusts break down into 3 shares**
  - Federal Marital
  - Mass. Marital (QTIP)
  - By Pass
- **Federal Marital -** income and principal to spouse upon request
- **Mass Marital -** income to spouse for life. Principal payable to spouse to maintain health and support
- **By Pass -** income payable to spouse for life. Principal to Spouse and issue for health, education, maintenance and support. (May include NON support distributions if co-Trustee is named)
- **Death of Surviving Spouse -** Trust divides into as may equal shares as there are children living; and children deceased leaving issue.
- **Surviving Spouse** does not have retained interest so By Pass assets are not includible.

Pre-Death Funding

- Joint Assets Transferred directly to the Trust
- Use Social Security Number of Either Spouse
- Real Estate Transferred to the Trust
- Retirement Plans payable to spouse with trust as contingent
- No need to re-allocate based on rising exemptions

Using General Power of Appointment Trusts

PLR 200403094 (January 16, 2004)
PLR 200604028 (January 27, 2006)

- In each of these rulings, the taxpayer proposed to establish a single revocable trust and fund it with his own assets, but giving his wife a general power of appointment over a portion of the assets in the husband's trust equal to the value of the wife's remaining applicable exclusion amount, less the value of the wife's taxable estate determined as if she did not possess this power.
- In PLR 200403094 and PLR 200604028, the wife executed a Will, which exercised the general power of appointment.
- Upon wife's death, who has little or no assets, the husband is required to pay over such amount from his trust to the wife's estate whereupon such assets will be held in a traditional by-pass share, as though the wife had established the by-pass share for the benefit of her husband.

Using General Power of Appointment Trusts (con't)

- The husband was the sole trustee of the wife's by-pass trust (which was funded with the husband's assets taken out of his revocable trust).
- The trust provides that the trustee will pay to the husband and to the husband's descendants any amount of income and principal of the wife's by-pass trust that the trustees deem necessary and advisable for the health, education, support, and maintenance of the husband and his descendants.
- If the trust holds wife's residence, during his life, husband will have the exclusive use of that residence and the wife's family trust will pay all costs associated with that use.
- Husband also will have a testamentary limited power of appointment to appoint the assets of the wife's by-pass trust among his then living descendants.
- Any assets not so appointed, will be distributed to the wife's then living descendants by right of representation.

Requests

1) On the death of the wife, <u>if wife exercises the power of appointment granted</u>, husband will be treated as making a gift that qualifies for the federal gift tax marital deduction to wife with respect to that portion of the trust appointed by wife.

2) If wife predeceases husband, the value of trust assets over which wife holds a general power of appointment will be included in wife's gross estate.

3) Any assets that originated in husband's trust and that pass to wife's by-pass trust will not constitute a gift from husband to other beneficiaries of wife's by-pass trust.

4) Any assets that originated in husband's trust and that pass to wife's by-pass trust established under her Will would not be included in husband's gross estate.

The IRS answered all questions favorably:

- Ruling 1: If wife predeceases husband, the value of trust assets over which wife holds a general power of appointment will be included in wife's gross estate.

- Ruling 2: If wife exercises that power of appointment, husband is treated as relinquishing his dominion and control over the property, subject to that power of appointment. Accordingly, on the death of wife, if wife exercises the power of appointment granted her, husband will have made a completed gift to her under Section 2501 and will be eligible for the federal gift tax marital deduction under Section 2523.

- Ruling 3: Any assets that originated in husband's revocable trust and that pass to the wife's by-pass trust will not constitute a gift from husband to the other beneficiaries of the wife's trust since wife, at her death, will be treated as the owner of the trust assets she appoints.

- Ruling 4: None of the assets in the wife's by-pass trust will be includible in the husband's estate, since in his role as either a beneficiary or a trustee, husband will not have a general power of appointment under Section 2041, because distributions of income and principal from wife's family trust are subject to an ascertainable standard. Also, any interest husband may have under wife's by-pass trust in a residence in which he may have had an ownership interest would not cause that residence to be includible in his gross estate under Section 2036. As a result, none of the assets in the wife's by-pass trust will be includible in the husband's gross estate.

Question: Does the spouse actually have to exercise the power to achieve the same result?

- In PLR 200403094 and in PLR 200604028, the facts showed that the wife intended to actually exercise the general power of appointment. In PLR 200101021, the power of appointment was not expressly exercised and the assets passed in default of appointment to a by-pass trust for the benefit of the donor. The IRS ruled that the gift qualified for the gift tax marital deduction.

- Treasury Regulations 25.2523(e)-1(G)(2) provides that the actual exercise of a testamentary general power of appointment is not required in order to qualify for the gift tax marital deduction. The Regulations provide that an income interest coupled with a general power of appointment will qualify for the gift tax marital deduction even though the donee spouse does not exercise the power and takers in default designated by the donor spouse ultimately receive the property.

II. Flow Chart

Will of John Q. Public
(Pourover) $2,000,000 in zero basis assets.

John Q. Public
Revocable Trust u/d/t 12/31/07
($2,000,000 in zero basis assets)

Federal Marital
ID No.
Year End 12/31

- Income to Spouse
- Spouse may withdraw principal up on request
- Souse has general power of appointment on her death

State Marital
ID No.
Year End 12/31

- Income is payable to the spouse
- Principal may be withdrawn by spouse for health, education, support and maintenance
- Spouse has limited power of appointment on her death

By-Pass
ID No.
Year End 12/31

- Income is payable to the spouse
- Principal is payable to the class consisting of spouse and issue in trustee's discretion for health, education, support and maintenance
- Spouse has limited power of appointment on her heath

YEAR	Federal Marital	State Marital	By-Pass
2008	$2,000,000	$1,000,000	$1,000,000
2009	$500,000	$2,500,000	$1,000,000
2010	Zero	$3,000,000	$1,000,000
2011	$3,000,000	Zero	$1,000,000

Part III

GIFTS ARE ON SALE…BUT TIME IS RUNNING OUT!

As we approach year end, it looks like wealth transfer taxes are here to stay and, for those who do not plan to die in 2010, consideration should be given to making substantial taxable gifts. Here is why…

Both the federal government and the Commonwealth of Massachusetts impose wealth transfer taxes. Beginning in 2011, the federal exemption amount is scheduled to be $1,000,000. In 2009, the federal exemption amount was $3,500,000 and in 2010 there is no federal estate tax, which is why this article will appeal to those who do not plan to die in 2010.

Wealth Transfer Taxes Takes Two Forms

Wealth transfer taxes take two forms, with either a gift tax imposed on transfers during life or an estate tax imposed on transfers during death. Massachusetts does not have a gift tax, but does have an estate tax, so that even in smaller estates lifetime transfers can save substantial Massachusetts estate taxes.

For example, if a single decedent had $2,000,000 in assets and died in 2010, there would be no federal estate tax, but the Massachusetts estate tax would be $99,600. If, upon his or her deathbed, $1,000,000 is gifted, so that the decedent had only $1,000,000 in assets at death, the Massachusetts estate tax would be reduced to $33,200 for a savings of $66,400. Additional savings could be realized by making additional annual exclusion gifts in excess of $1,000,000. Unfortunately, most taxpayers are reluctant to make large gifts in light of the federal gift tax system.

The Federal Gift Tax System in 2010

When Congress decided to eliminate federal estate taxes for one year in 2010, they nevertheless kept the gift tax system intact. Therefore, while a taxpayer can die in 2010 with billions of dollars and pay no estate tax, such as George Steinbrenner, a lifetime transfer of the same assets would give rise to a significant gift tax. Naturally, taxpayers are reluctant to pay any taxes, but a close analysis of the gift tax system versus the payment of estate taxes shows that there are significant tax savings by choosing to pay a gift tax over an estate tax. Moreover, the savings are leveraged for a gift made in 2010, when the maximum gift tax rate is 35%, as opposed to 55% beginning in 2011.

Gift Tax is Tax Exclusive and the Estate Tax is Tax Inclusive

It is often said that the gift tax is tax exclusive and the estate tax is tax inclusive. What exactly does this mean? Essentially, the gift tax is imposed on the amount received rather than the amount that is given. Consider the following example:

Assume an unmarried client with children has $25,000,000 in assets and assume that the client has not given away any assets during his or her lifetime. If death occurs in 2011 (assuming that the $3,500,000 exemption and rates for 2009 are extended to 2011) the combined Massachusetts and Federal estate tax would be $11,581,740, leaving the client's children to receive $13,418,260. The estate tax on larger estates is even more substantial since the federal estate tax could be as high as 55% and the Massachusetts estate tax could be as high as 16%) although the Massachusetts estate tax is deductible in computing the federal estate tax.

If, on the other hand, the same client with $25,000,000 in total assets, gifted $18,000,000 in 2010 to his children, the gift tax would be $6,300,000, leaving the children with over $4,500,000 more. Recognizing this dichotomy, Congress enacted IRC § 2035, which states that the estate tax paid on a gift tax made within three years of death is itself an asset subject to estate taxes. (Go figure how this makes sense!) If the taxpayer dies within three years of making the gift, the gift tax itself will be subject to an estate, which effectively neutralizes the tax savings of making a gift rather than dying with substantial assets.

The Use of Net Gifts Can Reduce the Gift Tax to Approximately 25%

Making the gift a net gift can also reduce the amount of the federal gift. With a net gift, the obligation to pay gift taxes is shifted from the Donor (who is primarily responsible for paying gift taxes) to the Donee. Since the amount of the gift tax is the tax based on what is actually received, the amount of the gift tax must be reduced from the amount that is received to compute the actual gift taxes due. The formula is as follows: tentative tax / (1 + 35 %).

Following the same example, using $25,000,000 in assets, the gift taxes on a net gift of $18,000,000 would be $6,300,000/135%, which is $4,666,666, leaving the client with $2,334,000. This would allow the individual to increase the gift to approximately $20,000,000, in which case the Net Gift would be $5,185,185. The family would have saved in excess of $6,500,000.

How Net Gifts are Paid

In a net gift situation, the obligation to pay the tax is the responsibility of the donee, but the donor would loan the funds to the children in order to pay the tax. In this case, the loan would be $5,185,185. In such a case, the children receive the full benefit of the $20,000,00 gift and, notwithstanding the historically low/nonexistent rate of return, there should be sufficient funds generated from the transferred assets to pay the debt service.

Use of a Self-Cancelling Note

The $5,185,185 note receivable would be an asset that is includible in the decedent's estate on death. Nevertheless, its value may not be its face amount, but, rather, the "fair market value" based upon applicable interest rates and what a willing buyer and a willing seller would agree upon should that note be sold. As such, a discount of up to 50% is possible.

Nevertheless, to eliminate any estate tax on the note receivable, it could be structured as a self-cancelling installment note (SCIN). A SCIN protects against the possibility that if the donor dies before the entire note is paid off, the unpaid balance is includible in the donor's estate – thus defeating the goal of reducing the size of the donor's estate. Under the terms of a SCIN, if the donor dies during the note term, the note is automatically cancelled. For this to work, however, the maker would have to pay either an interest rate or a principal premium for the privilege of not having to pay the note when death occurs. Given the historically low interest rate, the October 2010 annual federal interest rate is 3.32%, assuming a 10 year note. If the taxpayer were age 65, the self-cancelling note premium interest rate would be 5.58%. To further enhance this strategy, the note could be structured as an interest-only with a balloon payment after 10 years.

Using an Intentionally Defective Grantor Trust

This technique works most effectively when the gift is made to an irrevocable intentionally defective grantor trust (IDGT). While a full analysis of an IDGT is beyond the scope of this article, in general, pursuant to the provisions of IRC § 673 to IRC § 679, transfers between the Grantor and the Grantor trust are ignored for income tax purposes and the transferor is treated as the owner of the trust assets for income tax purposes only.

This means that any income or gain realized by the irrevocable trust, which now has $20,000,000, will not be taxable to the trust, but, rather, taxable to the grantor. The growth in the assets, however, will remain free of the grantor's estate taxes.

Generation Skipping Transfers

The generation skipping transfer tax has been repealed for transfers occurring in 2010. The generation skipping transfer tax will return in 2011 with a $1,000,000 exclusion amount if no legislative action is taken, or $3,500,000 if Congress extends the 2009 exemption. The theory behind the generation skipping transfer tax is that the government wants estate taxes once the money passes through each generation.

The logical solution to this is to skip multiple generations, but this is not permitted because generally transfers in excess of $1,000,000 to grandchildren will be subject to the generation skipping transfer tax. For example, in a $30,000,000 estate, if the taxpayer dies in 2011 (with a $3.5m exemption) and all of the assets are left directly to grandchildren, there would be a $4,266,800 Massachusetts state death tax; a $10,004,940 Federal estate tax; and a $8,224,138 Federal generations skipping transfer tax. The total wealth transfer tax would be $22,495,878. The grandchildren would receive only $7,504,122.

In light of the fact that generation skipping transfer taxes are eliminated in 2010, transfers should be made to an intentionally defective grantor trust (IDGT) that will last in perpetuity using a state (other than Massachusetts) where the rule of perpetuity has been abolished. In such a case, the assets will never again be subject to either wealth transfers, even in the form of estate taxes or generation skipping taxes.

Deaths in 2010 and Disclaimers

One risk to this technique is if a gift is made before the end of 2010 and the Donor dies before January 3, 2011. In such a case, a taxable gift would have been made whereas a tax-free transfer upon death would have been realized. This problem can be solved with a disclaimer. Under a state law recognized by Federal Internal Revenue Code provisions, any gift may be disclaimed within nine months of the date of the gift. In such a case, the lifetime gift will be returned to the grantor.

Sales Tax Holidays and One Day Sales be Damned!

Taxpayers should be taking advantage of the gift tax sale expiring on December 31, 2010.