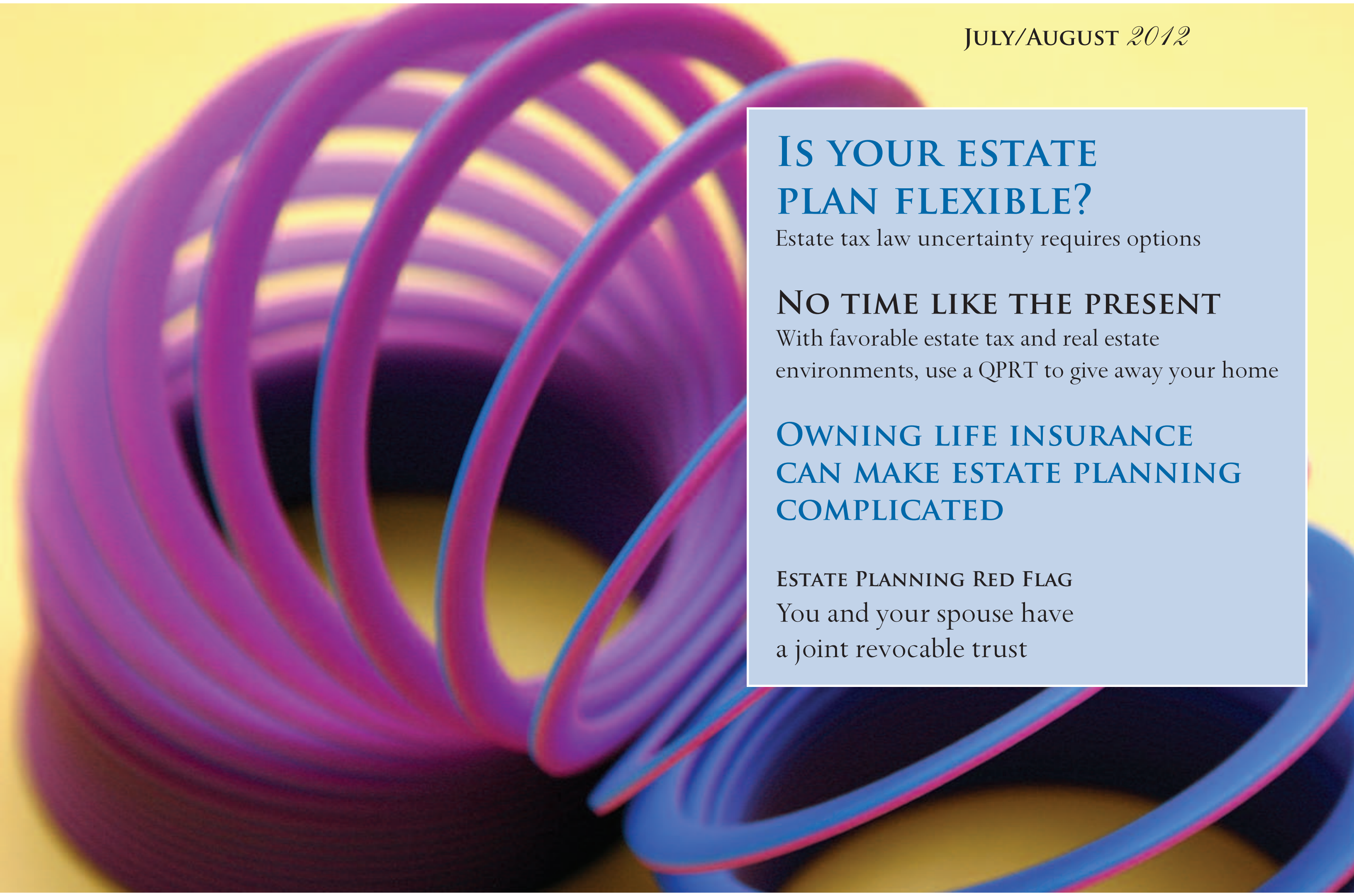
The Estate Planner

July/August 2012



Is your estate plan flexible?
Estate tax law uncertainty requires options

No time like the present
With favorable estate tax and real estate environments, use a QPRT to give away your home

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Estate Planning Red Flag
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Is your estate plan flexible?

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This year, just as in 2010, even the short-term future of the federal estate tax and other transfer taxes is uncertain. Currently, the exemption for gift, estate and generation-skipping transfer (GST) taxes is an inflation-adjusted $5.12 million, and the top tax rate is 35%. Absent congressional intervention, however, on Jan. 1, 2013, the exemption will drop to $1 million (indexed for inflation for GST tax purposes) and the top tax rate will jump to 55%. One proposal calls for a $3.5 million exemption and a 45% tax rate, but it's not yet clear whether that or some other transfer tax regime will be in place next year.

One thing is certain, though: A wait-and-see approach is risky. As witnessed in 2010, it's difficult to predict how — and when — the tax environment will change. Many people are taking advantage of the generous gift tax exemption by shifting as much wealth as possible to their heirs this year. But it's also important to build flexibility into your estate plan so that you or your family can react quickly to future changes in the law.

Qualified disclaimers

A qualified disclaimer gives your beneficiaries the power to reject inherited assets, allowing them to pass in a more tax-efficient manner to the contingent beneficiary. To qualify, a disclaimer must:

- Be in writing,
- Be delivered to the estate's representative within nine months after the transfer is made (or, if the disclaimant is a minor, within nine months after the disclaimant turns age 21), and
- Be delivered before the disclaimant accepts the property or any of its benefits.

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For qualified disclaimers to provide the desired flexibility, disclaimed assets must pass *automatically* to the contingent beneficiary according to the terms of your will or trust — without any direction from the disclaimant. So it's important to carefully select a contingent beneficiary for each bequest you're making in your estate plan.

For example, let's say Robert's will leaves his entire estate to his daughter, Maggie — or, if she predeceases him or files a qualified disclaimer, to a trust for the benefit of Maggie's three children. Robert dies in December 2012 with a $5 million estate, all of which is sheltered from estate tax by Robert's exemption.

The trouble with formulas

A typical estate plan for a married couple calls for assets up to the applicable federal estate tax exemption amount to be placed in a credit shelter trust, with any excess funneled into a marital trust (or left to the surviving spouse outright) at the first spouse's death. This strategy preserves the deceased spouse's exemption while also making the most of the marital deduction.

At one time, the exemption amount varied little from year to year, so it was common to fund a credit shelter trust with a fixed dollar amount. In recent years, however, exemption amounts have fluctuated dramatically, so this approach is no longer appropriate. If you haven't reviewed your plan in many years, check to see if it uses a fixed dollar amount to fund a credit shelter trust and, if it does, update its terms to provide more flexibility.

Formulas tied to the applicable exemption amount can do just that, but they can also produce unintended — and undesirable — results if they're not carefully designed.

For example, Ann, who has a $5 million estate, completed her estate plan in 2005. Under the plan, when Ann dies, an amount equal to the then-current exemption amount goes into a credit shelter trust and the excess goes to her husband, Jack.

At the time, this made sense: If Ann had died in 2005, $1.5 million would have gone into the credit shelter trust and Jack would have received the remaining $3.5 million. But if Ann dies in 2012, when the exemption amount is $5.12 million, her entire estate goes into the credit shelter trust, effectively disinheriting Jack (except for distributions of trust income and, in certain limited circumstances, distributions of trust principal that might be provided for Jack under the trust's terms).

To avoid this result, it's important to carefully draft formula clauses to ensure that they account for every possible contingency. For example, Ann's plan might have established a minimum bequest for Jack (say, $2 million) before funding the credit shelter trust.

On Jan. 1, 2013 — before Maggie has received her inheritance — the exemption amount drops to $1 million and the tax rate goes up to 55%. If Maggie were to die in 2013, the inherited assets would be subject to a $2.2 million estate tax, leaving only $2.8 million for her children.

Maggie is financially independent and doesn't need the inheritance to support her lifestyle. She files a qualified disclaimer, allowing the entire $5 million to pass tax-free to the trust for her children.

Credit shelter trust

Under current law, gift and estate tax exemptions are "portable" — that is, when one spouse dies, the surviving spouse can take advantage of both spouses' unused exemption amounts without the need for more-sophisticated estate planning vehicles.

In theory, portability is a valuable benefit. Unfortunately, it's set to expire at the end of 2012 and it's uncertain whether Congress will extend it (or make it permanent). If portability becomes unavailable next year, couples who've been relying on it to preserve their exemptions may face significant estate tax exposure.

The most effective way to protect yourself against loss of portability is to use a credit shelter trust to preserve both spouses' exemptions. These trusts also provide several other important benefits, including asset protection and GST tax reduction. (The GST tax exemption isn't portable.)

If you decide to establish a credit shelter trust — or if you already have one — review its funding provisions carefully to be sure they're flexible enough to adapt to changing laws and circumstances. A trust that's funded with a fixed dollar amount or according to a formula can sometimes produce unintended consequences. (See "The trouble with formulas" on page 3.)

Many options

There are a variety of other tools you can use to add flexibility to your estate plan, including powers of appointment, trust protectors, powers of attorney and trust provisions authorizing trustees to make discretionary distributions.

Experience has taught us that tax laws and family circumstances can change quickly. These tools allow your family members or trusted advisors to fine-tune your plan to address these changes in the event you die or become incapacitated before you have a chance to amend your plan. ✤

No time like the present

With favorable estate tax and real estate environments, use a QPRT to give away your home

A qualified personal residence trust (QPRT) can be an effective tool for transferring a home to your children or other family members at the lowest possible tax cost — while continuing to live in it. And given the current favorable estate tax environment and depressed real estate market, now may be the ideal time to establish one.

What are the benefits?

Taking advantage of a QPRT is relatively simple: You transfer your primary residence or vacation home to an irrevocable trust that meets certain requirements, retaining the right to live in the home for a term of years. At the end of the term, ownership of the home is transferred to your beneficiaries (although it's possible to extend your stay in the home by paying them fair market rent).

This strategy can save gift and estate taxes in two ways. First, when you contribute property to a properly structured QPRT, you remove it from your taxable estate and freeze its value for tax purposes. From that point forward, any appreciation in value is sheltered from gift and estate taxes.

Second, although your contribution is a taxable gift to your beneficiaries, its value for gift tax purposes is a fraction of the home's fair market value. Why? Because, under IRS rules, gift tax is imposed on the value of your beneficiaries' remainder interest in the home. Their interest is computed by taking the home's fair market value and subtracting the present value (using IRS tables) of your retained interest in the home — that is, your right to continue living there during the trust term.

The longer the trust term, the greater the value of your retained interest and, therefore, the lower the value of your gift. But keep in mind that, to enjoy a QPRT's tax benefits, you must survive the trust term. Otherwise, the home's full fair market value as of your date of death will be pulled back into your taxable estate.

Why now?

Several factors have created a favorable environment for QPRTs:

High exemption amount, low tax rate. This year, the federal gift and estate tax exemption amount is a record-high $5.12 million, and the marginal tax rate is only 35%. In 2013, absent new legislation, the exemption amount will drop to $1 million and the top tax rate will increase to 55%. Thus, there may never be a better time to transfer a home or other property at the lowest possible tax cost. Depending on the value of your home and your available exemption, you may even be able to transfer your home to a QPRT tax-free.

Depressed home values. The real estate crisis caused a dramatic drop in housing prices during the last few years. Transferring a home to a QPRT now, while its value is depressed, allows you to minimize the gift tax cost while maximizing the potential for tax-free appreciation.

Valuation discounts. Married couples may be able to enjoy additional tax savings by taking advantage of valuation discounts available for fractional interests in real estate. One strategy is for spouses to own their home as tenants-in-common and then to contribute their undivided 50% interests in the home to separate QPRTs.

In a 2010 case, *Ludwick v. Commissioner*, the U.S. Tax Court allowed a couple using this approach to claim a 17% valuation discount for gift tax purposes. Be aware that some lawmakers want to limit valuation discounts for intrafamily gifts, so it's uncertain how long this strategy will remain available.

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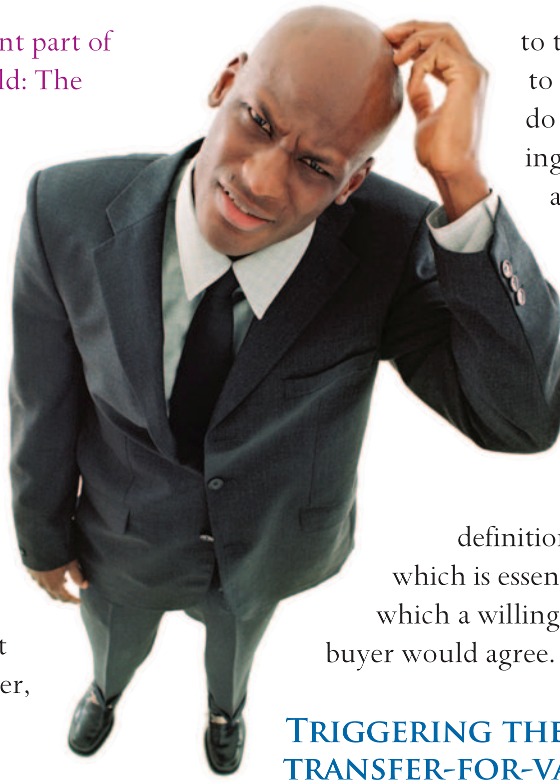
Is time running out?

If the current estate tax exemption and rates change with the new year as scheduled, if Congress passes new tax laws regarding valuation discounts, or if real estate values rebound, the potential benefits of this strategy may diminish. Your estate planning advisor can help you determine whether a QPRT is beneficial for your particular set of circumstances. ✤

Owning life insurance can make estate planning complicated

A life insurance policy can be an important part of an estate plan. The tax benefits are twofold: The policy can provide a source of wealth for your family income-tax-free, and it can supply funds to pay estate taxes and other expenses. However, if you *own* your policy, rather than having, for example, an irrevocable life insurance trust (ILIT) own it, you'll have to take extra steps to keep the policy's proceeds out of your taxable estate.



3-year rule explained

If you already own an insurance policy on your own life, you can remove it from your taxable estate by transferring it to a family member or to an ILIT. However, there's a caveat.

If you transfer a life insurance policy and don't survive for at least three years, the tax code requires the proceeds to be pulled back into your estate. Thus, they may be subject to estate taxes.

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Fortunately, there's an exception to the three-year rule for life insurance (or other property) you transfer as part of a "bona fide sale for adequate consideration." For example, let's say you wanted to transfer your policy to your son. You could do so without triggering the three-year rule as long as your son paid adequate consideration for the policy.

Determining adequate consideration isn't an exact science. One definition is fair market value, which is essentially the price on which a willing seller and a willing buyer would agree.

Triggering the transfer-for-value rule

The problem with the bona fide sale exception is that, when life insurance is involved, it may trigger another, equally devastating, rule: the transfer-for-value rule. Under this rule, a transferee who gives valuable consideration for a life insurance policy is subject to ordinary income taxes when the proceeds are received on the amount by which the proceeds exceed the consideration and premiums the transferee paid.

So, in the previous example, even if your son purchased the policy for the appropriate amount to avoid the three-year rule, he could be subject to some income tax when he receives the proceeds.

Selling to a trust

It may be possible to avoid the three-year rule — without running afoul of the transfer-for-value rule — by selling an existing life insurance policy for adequate consideration to an irrevocable grantor trust. A grantor trust is a trust structured so that you, the grantor, are the owner for *income* tax purposes but not for *estate* tax purposes.

You're also treated as the owner of any life insurance policy held by the trust. So the transfer-for-value rule won't apply because you're essentially transferring the policy to yourself.

Options available

An insurance policy can be a primary building block of an estate plan. But if you own the policy, consider implementing strategies to remove its proceeds from your estate and minimize the risk that they'll be pulled back if you don't live for the three years after the transfer. Discuss your options with your estate planning advisor. ✤

Estate Planning Red Flag

You and your spouse have a joint revocable trust

In community property states, it's common for couples to place marital assets in a joint revocable trust rather than separate trusts. Doing so preserves the assets' community property status so that, when one spouse dies, the surviving spouse receives a "double step-up" in basis. In other words, the bases of *all* of the assets are stepped up to their fair market value on the date of the first spouse's death, minimizing the surviving spouse's future capital gains tax liability.

In non-community-property states, only the deceased spouse's share of jointly held assets receives a basis step-up, so a joint revocable trust doesn't provide the same tax advantage. Nevertheless, these trusts are also popular in these states.

In both types of states, joint trusts offer many of the same benefits as separate trusts — including probate avoidance, guardianship avoidance, privacy, and asset management in the event of a spouse's incapacity. Plus, they offer administrative convenience and the psychological benefit of holding assets jointly.

But they don't provide the same level of creditor protection as separate trusts. If you live in a community property state, you should weigh the asset protection benefits offered by maintaining each spouse's separate property in a *separate* trust against a joint trust's tax benefits.

If you live in a non-community-property state and the value of your and your spouse's combined estates exceeds the estate tax exemption ($5.12 million for 2012, but scheduled to drop to $1 million next year), you'll also need to consider the potential tax *pitfalls* of a joint trust that can result in unanticipated gift or estate taxes. It may be possible to avoid these pitfalls by drafting the trust document carefully and keeping accurate records of each spouse's contributions. But even with careful planning, there's a risk that the IRS will challenge your tax treatment of the trust. So unless your potential gift and estate tax exposure is minimal, separate trusts are generally preferable.