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Estate Planning Tax Issues for 2011

Navigating the New Landscape for Estate, Gift and Generation Skipping Taxes

WEDNESDAY, APRIL 20, 2011

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Today's faculty features:

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By-Pass Trusts and Portability Planning

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Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (TRA)

Excellent materials

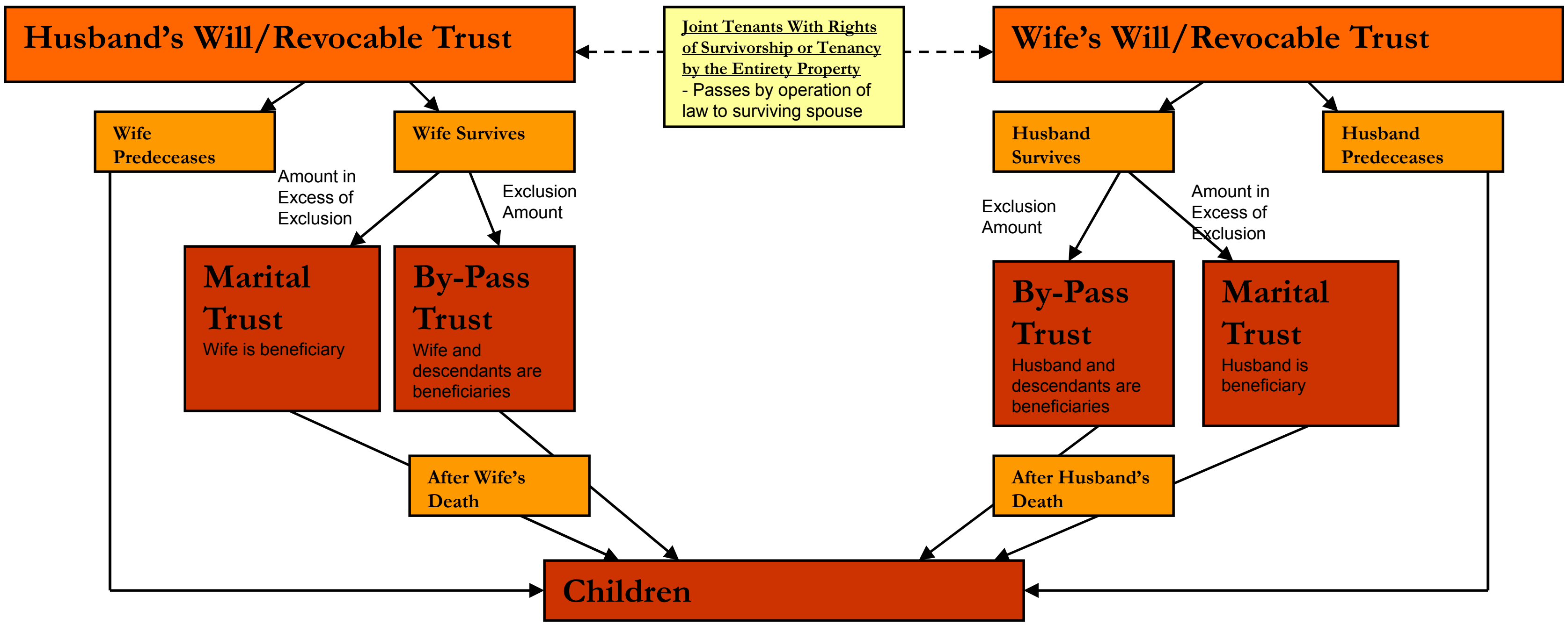
- Akers, *Estate Planning Effects and Strategies Under the "Tax Relief… Act of 2010"*
- Estate & Gift Committee, ABA RPTE Section, *Summary of the Tax Relief Act of 2010* -- http://www.americanbar.org/content/dam/aba/migrated/2011_build/real_property_trust_estate/summary_tax_relief_act_2010.authcheckdam.pdf

After TRA

By-Pass Trust Planning --- Now More Complicated & Rethinking is Necessary

- Higher Estate Tax Exclusion of $5 Million
- Income Tax and Estate Tax Rate are 35%
- Portability
- Greater Disparity to State Estate Tax Exclusions

Traditional By-Pass Trust Plan



Suppose that a couple has $5 million in assets (no IRD items), has the traditional by-pass trust plan illustrated above, and have followed the traditional approach of splitting their assets between them, $2.5 million in each of their respective names or revocable trusts. Suppose further that the husband dies in 2011, that during the wife's subsequent lifetime all of the assets double in value, and that upon the wife's death the portability feature is still part of the law.

The Problem with Traditional By-Pass Trust Planning, If Portability Works

Wife
$2.5 Million

Husband's Will/Revocable Trust
The entire estate of $2.5 million passes to the By-Pass Trust for the surviving wife's benefit.

➢Husband's estate uses $2.5 million of his exclusion amount funding the By-Pass Trust and ports the remaining $2.5 million to the surviving wife.

Upon Husband's Death

By-Pass Trust
$2.5 Million
Wife and descendants are beneficiaries of the By-Pass Trust during her lifetime.

➢During wife's subsequent life, the assets of the By-Pass Trust and the wife's assets double in value.

Upon Wife's Death

Wife's Property

Total Value $5 Million

Wife's Estate	
Gross Estate	$5,000,000
Exclusion	$7,500,000
Estate Tax	$ 0

➢By relying on the traditional By-Pass Trust planning, there is no federal estate tax in this example, but there is potential income tax liability on $2.5 million.

By-Pass Trust
$5 Million

By-Pass Trust	$5,000,000
Estate Tax	$ 0
Potential Cap. Gain	$2,500,000

Portability

- It is now possible to pass $10 million of wealth from a husband and wife to their children with no federal estate taxation and with a full basis for income tax purposes (of course, there are exceptions to the step-up in basis rule such as items of IRD – e.g., IRAs). An existing by-pass trust plan that does not achieve this result may subject the attorney to criticism.

- Imagine the plantiff's lawyer implying the by-pass trust planning was really to benefit the estate planning lawyer –

  "So let me get this straight, my client's parents paid you thousands of dollars in fees for this fancy by-pass trust planning when simple, probate avoiding and in some cases creditor protected joint property would have produced a better tax result and have been administratively less complicated?"

- IMPORTANT POINT:

  In some cases, the client might choose to forgo the possibility of using portability after receiving adequate advice – but it should be the clients' decision and your file should reflect that.

Portability

Basics

- Found in Section 2010(c) of the IRC
- If a deceased spouse's estate tax exclusion is not fully used, the balance of the deceased spouse's unused exclusion can be used by the surviving spouse against gifts and transfers upon death.
- The rationale for portability is as follows:

  "Without this portability provision, spouses are often required to retitle assets into each spouse's separate name and create complex trusts in order to allow the first spouse to die to take full advantage of his or her exclusion. Depending upon the nature of the couple's assets, such a division may not be possible. Such a division also has significant consequences under property law and often is not consistent with the way in which the married couple would prefer to handle their financial affairs. Portability would obviate the need for such burdensome planning." General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals, Department of the Treasury, p. 123 (February 2011).

Terms

To understand portability it is critical to understand the definitions in Section 2010(c) for the applicable exclusion amount, basic exclusion amount and the inherited exclusion amount (aka deceased spousal unused exclusion amount):

- Applicable Exclusion Amount: The applicable exclusion amount is the sum of the basic exclusion amount and the inherited exclusion amount.

- Basic Exclusion Amount: For 2011, the basic exclusion amount is $5 million. For 2012, the basic exclusion amount is indexed for inflation, rounded to the nearest multiple of $10,000.

- Inherited Exclusion Amount: The inherited exclusion amount is the *lesser of*:

  (A) the basic exclusion amount, or

  (B) the excess of (i) the *basic exclusion amount of the last deceased spouse* of the surviving spouse, over (ii) the amount with respect to which the tentative tax is determined under Section 2001(b)(1) of the Code on the estate of such deceased spouse.

Portability

The "lesser of" used in Defining Inherited Exclusion Amount

- Done because the basic exclusion amount could drop below the current $5 million (or whatever amount was in effect as the basic exclusion amount at the time of a particular deceased spouse's death).

- The reference to basic exclusion amount in (B) is the particular amount available to the "last deceased spouse" of the surviving spouse. This is a static number and would not change as changes to the basic exclusion amount may occur in the future, including the indexing for inflation.

- This means that the inherited exclusion amount, once determined upon the deceased spouse's death (i.e., the first spouse's death) is subject to being reduced if Congress changes the law by reducing the basic exclusion amount.

- In a traditional by-pass trust plan, once the deceased spouse dies and the by-pass trust is funded, it is removed from the estate tax system. The excluded by-pass trust is unaffected by any future change to the exclusion amount. Therefore, the inherited exclusion amount is always exposed to the risk of being reduced before being used.

Portability

No Indexing after Deceased Spouse's Death

- The (B) prong of the definition for inherited exclusion amount produces a static number, becoming fixed upon the death of the deceased spouse.
- Therefore, the inherited exclusion amount will not be indexed for inflation between the time of the deceased spouse's death and the surviving spouse's death.
- However, the basic exclusion amount would be indexed, starting in 2012, up to the time of the deceased spouse's death.
- A traditional by-pass trust, once funded, is excluded from the estate tax system. Any future appreciation between the deceased spouse's death and the surviving spouse's death is sheltered from estate taxation. The inherited exclusion amount, on the other hand, is a fixed number. Therefore, the value of the inherited exclusion amount is exposed to the risk of being eroded by inflation, as well as the risk of Congressional reduction.

Portability

The "last such deceased spouse"

- The inherited exclusion amount is limited to that of the most recent deceased spouse.
- This rule has numerous implications for surviving spouses of multiple marriages.
- It also has implications for surviving spouses of spouses that had multiple marriages.
- This is likely to be an area in which regulatory guidance will be beneficial.
- The Joint Committee on Taxation's explanation of TRA and examples on portability are helpful in explaining this limitation.

Portability

Example 1:

Husband 1	**Wife (surviving spouse)**
Dies in 2011	Applicable Exclusion Amt.
Taxable Gifts $3 million	BEA = $5 million
Taxable Estate $0	IEA = $2 million
Portability Elected $2 million	Total = $7 million

The Joint Committee's Example 1 illustrates the basic concept of portability. Note that portability is not an all or nothing deal. In this example, lifetime gifts made by the deceased husband reduced the inherited exclusion amount.

"Example 1.−Assume that Husband 1 dies in 2011, having made taxable transfers of $3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death."

Portability

Example 2:

Husband 1	**Husband 2**	**Wife (surviving spouse)**
Dies in 2011	Dies later in 2011	Applicable Exclusion Amt.
Taxable Gifts $3 million	Taxable Gifts $4 million	BEA = $5 million
Taxable Estate $0	Taxable Estate $0	IEA = $1 million
Portability Elected $2 million	Portability Elected $1 million	Total = $6 million

The Joint Committee's Example 2 illustrates the danger of remarriage. In this example, the wife looses $1 million of inherited exclusion amount upon Husband 2's death. Marrying Husband 2 potentially costs the wife's family $350,000 in tax savings, which is a point that she should consider prior to the remarriage. Add this for consideration to any prenuptial agreement checklist.

"Example 2.−Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made $4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's deceased spousal unused exclusion amount. Although the combined amount of unused exclusion of Husband 1 and Husband 2 is $3 million ($2 million for Husband 1 and $1 million for Husband 2), only Husband 2's $1 million unused exclusion is available for use by Wife, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount ($5 million) or the unused exclusion of the last deceased spouse of the surviving spouse (here, Husband 2's $1 million unused exclusion). Thereafter, Wife's applicable exclusion amount is $6 million (her $5 million basic exclusion amount plus $1 million deceased spousal unused exclusion amount from Husband 2), which she may use for lifetime gifts or for transfers at death."

Portability

Example 3:

Husband 1	**Wife (dies after marrying Husband 2)**	**Husband 2 (surviving spouse)**
Dies in 2011 Taxable Gifts $3 million Taxable Estate $0 Portability Elected $2 million	Dies later in 2011 Taxable Gifts $0 million Taxable Estate $3 million Applicable Exclusion Amt. $7 million Portability Elected $4 million	Applicable Exclusion Amt. BEA = $5 million IEA = $4 million Total = $9 million

In this example, it appears that the wife's estate was able to use the inherited exclusion of Husband 1 first before consuming her own exclusion. The example yields this interpretation because of the rule that Husband 2 can only use inherited exclusion from the last deceased spouse (i.e., the wife). The statute, however, does not mandate that result. Until there are regulations or further clarification of this point, the cautious approach would be not to rely upon this interpretation.

Joint Committee ERRATA – issued March 23, 2011 – proposes replacing the reference to basic exclusion amount of the last deceased spouse with applicable exclusion amount. With this change there is no need for an ordering rule (i.e., to say in Ex. 3 that the IEA of Husband 1 is used before his wife's BEA).

"Example 3.−Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2. Following Husband 1's death, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1). Wife made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is $4 million (Wife's $7 million applicable exclusion amount less her $3 million taxable estate). Under the provision, Husband 2's applicable exclusion amount is increased by $4 million, i.e., the amount of deceased spousal unused exclusion amount of Wife."

Effective Date and Sunset

- Portability applies to gifts and transfers upon death after January 1, 2011, but it is scheduled to expire in 2013 when the pre-Bush law comes back into effect.

- President Obama’s revenue proposals released in February 2011 (the Green Book) proposed making portability permanent.

Election of Portability

- Pursuant to Section 2010(c)(5)(A), the executor for the deceased spouse must do the following three steps to enable use of the inherited exclusion amount by the surviving spouse:
    - (i) file an estate tax return on a timely basis, including extensions,
    - (ii) on that return compute the inherited exclusion amount, and
    - (iii) make an irrevocable election that the inherited exclusion amount may be taken into account.
- The explanation of the Joint Committee makes clear that the election must be made in this manner even if the deceased spouse's estate would otherwise not need to file an estate tax return.
- Also, a late filed return will not suffice and Section 9100 relief will not be available for election, given that the statute specifically sets the timeframe for filing and states that the election is unavailable after that time has passed.

Portability

- Advise making election in all cases in which there is a surviving spouse.
- Authorize making election in all Wills and Revocable Trusts – Sample Language
  - Wills: "My Personal Representative may make the portability election under section 2010(c)(5)(A) of the Code for any portion of my basic exclusion amount that would otherwise be unused, even if it appears unclear that my spouse or my spouse's estate could benefit from such exclusion, and pay all expenses associated with making such election as an expense of administration."
  - Revocable Trusts: "The Trustee may make the portability election under section 2010(c)(5)(A) of the Code for any portion of my basic exclusion amount that would otherwise be unused, even if it appears unclear that my spouse or my spouse's estate could benefit from such exclusion, and pay all expenses associated with making such election as an expense of administration."

Portability

Pros

- Greater simplicity in planning (but perhaps more complicated tax reporting)
- Step up in basis upon surviving spouse's death for great portion of estates
- Solution for retirement account planning and state death tax planning
- Potential value to a new spouse

Cons

- No history and currently only for two years
- Only applies to estate and gift taxes, not GST
- No indexing for ported exclusion
- No creditor protection if by-pass trust is not used
- No protection of inheritance for deceased spouse's family
- Requires filing of estate tax return

Planning Stage

- Now it is possible to pass $10 million with no federal estate taxes and step-up in basis at surviving spouse's death
- Perhaps not plan to abandon by-pass trusts, but now must plan with awareness of portability
- Discuss with client and document reasons for approach
- Contact clients
- Create flexibility -- consider including these three devices to create flexibility:
  - a mechanism to allow for the appointment of an independent trustee who is authorized to distribute to the beneficiaries for any purpose,
  - authority for an independent trustee to distribute the trust funds to a new trust for the beneficiaries (also known as decanting), and
  - a mechanism to appoint a trust protector who is authorized to amend the trust instrument within certain parameters.

One Lung QTIP Trust Plans

Unneeded QTIP Elections and Portability

- Rev. Proc. 2001-38, 2001-24 I.R.B. 1335 (6/11/2001) provides that in limited situations a surviving spouse may request relief from an unnecessary QTIP election – i.e., a QTIP election for a trust that would have been completely protected by the applicable credit amount of the deceased spouse.
- If the estate passes to a QTIP trust and the amount in play is less than the remaining applicable exclusion amount, then the fiduciaries may not be able to put portability in play by making a QTIP election.
- The estate of the surviving spouse would always be able to argue the election is void.
- The taxpayer is not likely to be allowed to use this ruling to the government's disadvantage.
- Suppose the decedent spouse dies with $4 million all passing to a QTIP trust. The executor makes the QTIP election and elects portability for $5 million. If the QTIP goes down in value before the surviving spouse dies, then keeping the QTIP election in play and relying on portability is better. If it appreciates $6 million, then the taxpayer may wish to argue the QTIP election is void. The point is that with portability now in play, it is possible that the government could be hurt with this one sided after the fact ability to declare the QTIP election is void.

By-Pass Trust Planning

The following slides attempt to illustrate plans in which flexibility is added to use portability if it appears to be viable upon the first spouse's death and if the surviving spouse and fiduciaries don't find sufficient value in the reasons to not rely upon portability.

Estates Under $20 Million

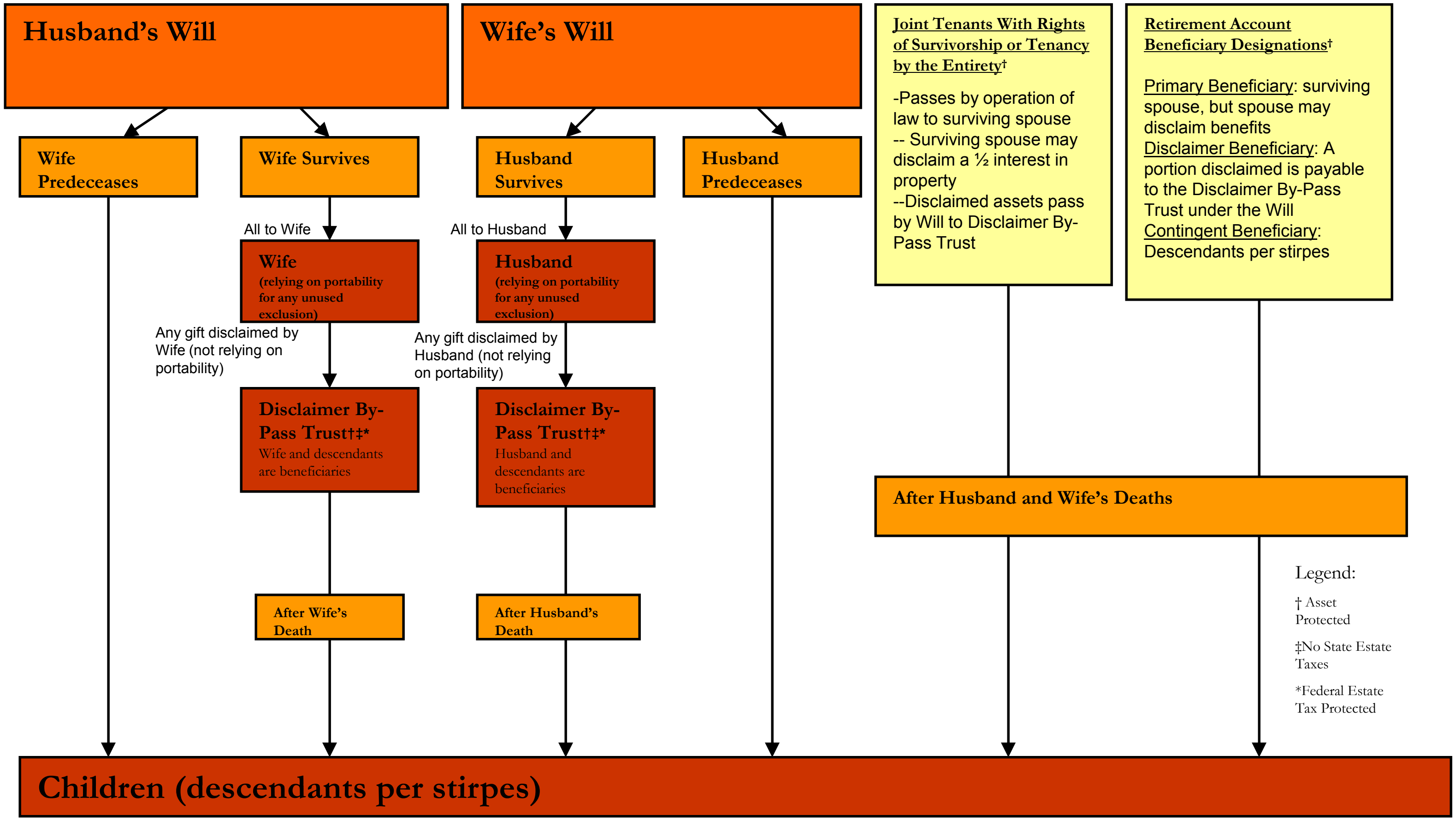
- Married couples with estates under $20 million or so may wish to consider a more simplified approach to the traditional by-pass trust planning. A simple disclaimer approach enables the surviving spouse to choose to use portability if at the time of the first spouse's death the law has developed to the point where portability appears to be reliable. Alternatively, the surviving spouse could choose to establish the more traditional by-pass trust and fund the trust by disclaimers of jointly held property or beneficiary designation assets.

- This estate planning structure places great control in the surviving spouse and would most likely be appropriate in first marriage situations where any children are common to that marriage.

- For couples of modest means, well under the anticipated applicable credit amount for a single spouse, may wish to forgo even the disclaimer approach.

- This relatively simple disclaimer approach has some favorable features. By the use of jointly held property, there should be little or no fuss with probate upon the first spouse's death. During their joint lifetimes, tenancy by the entirety property is typically protected from the claims of a single spouse's creditors. Retirement account assets are also frequently protected from the claims of creditors.

Simple Disclaimer By-Pass Trust Plan



Wife Survives. The Wife has the choice following the Husband's death to use portability, if it appears at that time it is a system that is reasonably viable, or to disclaim a portion or all of the Husband's assets passing to her to use the Husband's applicable credit amount. Any disclaimed assets will fund the Disclaimer By-Pass Trust, which will benefit the Wife and descendants. The Disclaimer By-Pass Trust would be excluded from the Wife's estate, protected from the claims of creditors, and GST protected following the Husband's death.

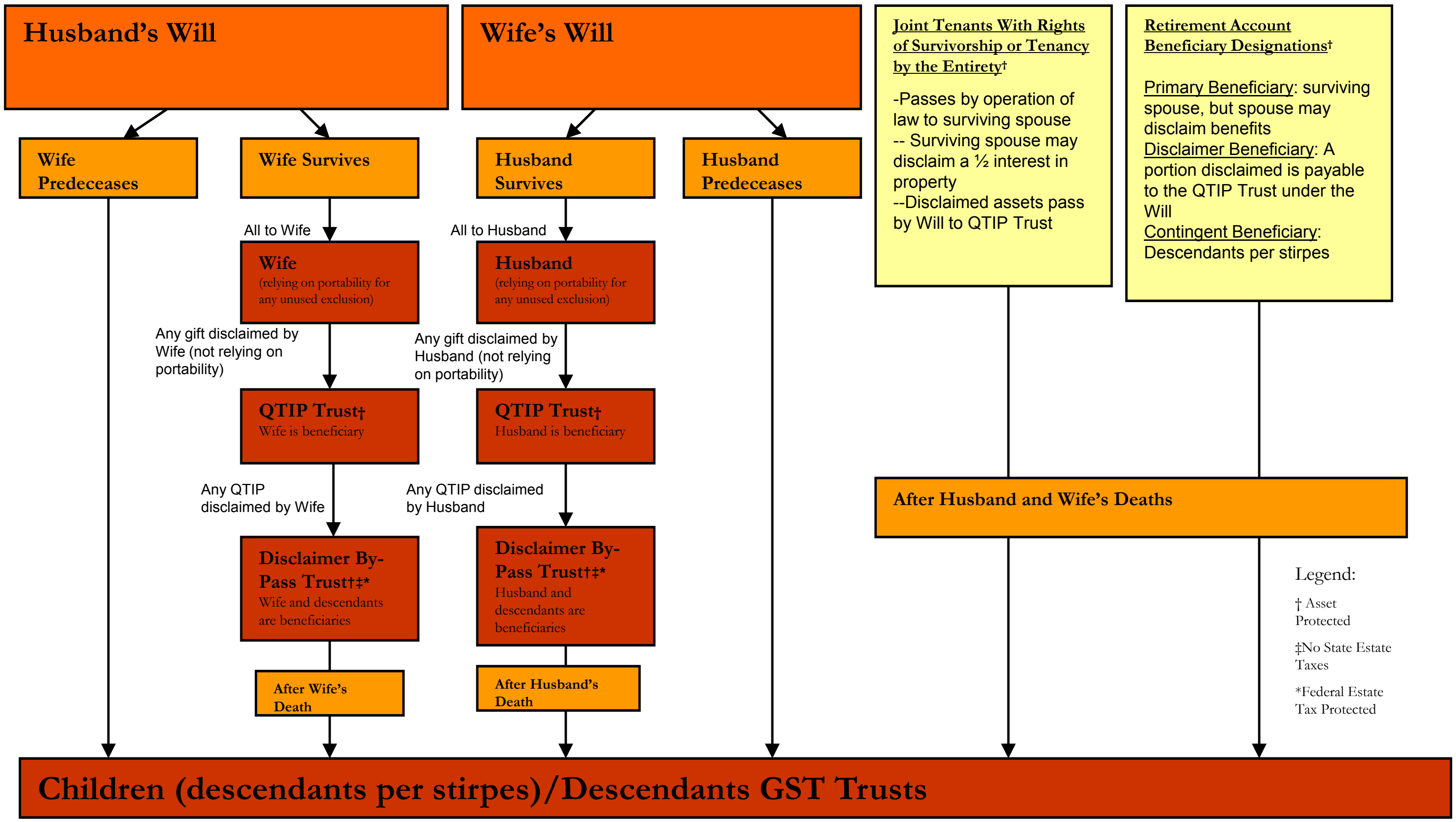
Husband Survives. Same options and implications.

By-Pass Trust Planning

State Estate Taxes

- One complexity results from the now greater difference between the state estate tax exemptions and the federal estate tax exemption.
- Taking advantage of the full federal estate tax applicable exclusion amount will in some cases require a greater payment of state estate taxes. If the state has a $1 million estate tax exemption, funding the credit shelter trust with $5 million upon the first spouse's death would require a payment of $391,600 in state death taxes, if the state death tax is charged to the credit shelter trust (i.e., resulting in a net funding of $4,608,400). It is also possible to fund the credit shelter trust with a net of $5 million. To do this, the taxable estate would need to be $5,444,091, whereupon the state death tax would be $444,091. The federal estate tax would still be zero, but state death taxes would increase by $52,491 ($444,091 - $391,600).
- In states that allow state only QTIPs, a more complicated approach may be warranted and is illustrated on slide #24. This structure allows for the following planning: the surviving spouse could disclaim up to $5 million to the QTIP Trust. The surviving spouse could disclaim $1 million of the QTIP Trust, which would allow the Disclaimer By-Pass Trust to be funded with $1 million (i.e., the state death tax exclusion amount). The remaining $4 million in the QTIP trust would not be qualified for the federal estate tax marital deduction, but could be qualified for the state estate tax marital deduction by making the state only QTIP election. Therefore, the full federal estate tax exclusion amount is used without triggering any federal or state estate tax upon the death of the first spouse. Upon the surviving spouse's death the state only QTIP would be subject to state estate tax (but not federal estate tax), if the surviving spouse died a resident of such state.
- Alternatively, the surviving spouse could rely upon portability, or disclaim enough to fund $1 million to the Disclaimer By-Pass Trust (i.e., the state death tax exclusion amount) and rely on portability for the applicable exclusion amount.

Tiered Disclaimer QTIP/By-Pass Trust Plan



<u>Wife Survives</u>. The Wife has the choice following the Husband's death to use portability, if it appears at that time it is a system that is reasonably viable, or to disclaim a portion or all of the Husband's assets passing to her to use the Husband's federal applicable credit amount. Any disclaimed assets will fund the QTIP Trust. Any of the QTIP Trust disclaimed will fund the Disclaimer By-Pass Trust, which will benefit the Wife and descendants. The Disclaimer By-Pass Trust would be excluded from the Wife's estate, protected from the claims of creditors, and GST protected following the Husband's death.

<u>Husband Survives</u>. Same options and implications.

By-Pass Trust Planning

State Estate Taxes

- There is a cost to using a state only QTIP trust or relying upon portability for the amount in excess of the state death tax exclusion amount. In either case, the lower brackets of the state death tax table between the first $1 million and $5 million are not used.

- The rates from $1 million to $5 million are 5.6% to 11.2% (see the table under Section 2011(b), which starts at a rate of 8/10th of 1% for amounts under $90,000 and goes to a maximum rate of 16% for amounts over $10,040,000, with 20 different brackets). Relying on portability puts an extra $4 million in the estate of the surviving spouse to be taxed at higher rates under the state death tax table, though perhaps deductible against a 35% federal estate tax. The examples below (assuming Maryland law) illustrate that not utilizing the lower brackets of the state death tax table may increase the aggregate tax paid by both spouse's estates.

$10 Million Estate - Married Couple	Pay State Estate on Each Spouse's Death	Pay State Estate on 2nd Spouse's Death
1st Spouse's Death		
Gross Estate Value	5,000,000	5,000,000
Marital Deduction	-	(4,000,000)
Taxable Estate	5,000,000	1,000,000
Maryland Estate Tax	391,600	-
Federal Estate Tax	-	-
Total Estate Tax	391,600	-
2nd Spouse's Death		
Gross Estate Value	5,000,000	5,000,000
Additional Marital from 1st Spouse	-	4,000,000
Taxable Estate	5,000,000	9,000,000
Maryland Estate Tax	391,600	916,400
Federal Estate Tax	-	- *
Total Estate Tax	391,600	916,400
Total Estate Tax for both Spouses	783,200	916,400
Increase(decrease)		133,200

*Assumes portability of $4 million of exclusion from 1st Spouse to die.

$100 Million Estate - Married Couple	Pay State Estate on Each Spouse's Death	Pay State Estate on 2nd Spouse's Death
1st Spouse's Death		
Gross Estate Value	50,000,000	50,000,000
Marital Deduction	(45,000,000)	(49,000,000)
Taxable Estate	5,000,000	1,000,000
Maryland Estate Tax	391,600	-
Federal Estate Tax	-	-
Total Estate Tax	391,600	-
2nd Spouse's Death		
Gross Estate Value	50,000,000	50,000,000
Additional Marital from 1st Spouse	45,000,000	49,000,000
Taxable Estate	95,000,000	99,000,000
Maryland Estate Tax	14,666,800	15,306,800
Federal Estate Tax	26,366,620	26,142,620 *
Total Estate Tax	41,033,420	41,449,420
Total Estate Tax for both Spouses	41,425,020	41,449,420
Increase(decrease)		24,400

*Assumes portability of $4 million of exclusion from 1st Spouse to die.

State Estate Taxes

- Residents of a state that does not provide a state only QTIP election are faced with a few imperfect options in using the full federal estate tax applicable exclusion amount upon the first spouse's death.

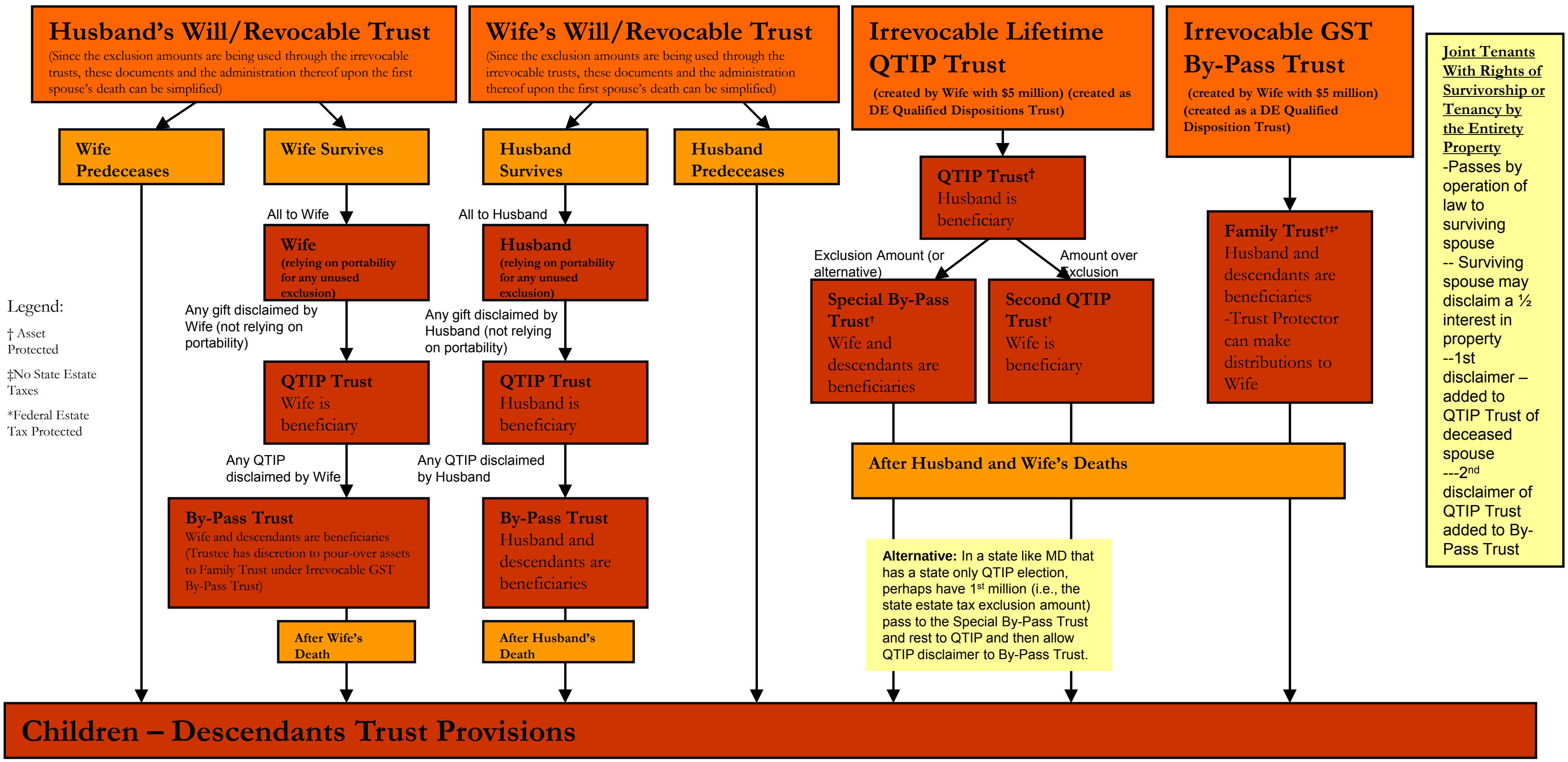
- These couples could plan to fund the by-pass trust with $5 million and pay $391,600 to $444,091 (depending on the apportionment of the state death tax to the by-pass trust or not). One pitfall with this approach is that if the surviving spouse changes residency to a state without a state estate tax, the state estate tax on this $5 million will have already been paid. If the surviving spouse would definitely remain a resident of such state, paying the state estate tax on this $5 million upon the first spouse's death may actually result in a lower total estate tax liability on the aggregate estates.

- Another alternative is to fund the by-pass trust with just an amount equal to the state estate tax exemption (e.g., $1 million) and rely upon portability for the balance of the estate. The disclaimer approach illustrated on slide # 24 would allow this flexibility, as well as covering the possibility that that state may change its law in the future to permit a state only QTIP election.

Estates Over $20 million

- One approach to funding a by-pass trust is to use an inter vivos QTIP trust – illustrated in the next slide as the Irrevocable Lifetime QTIP Trust. This approach provides the traditional benefits of a by-pass trust and income tax benefits that simulate the results of relying upon portability.
- Also, couples with estates in excess of $20 million are frequently interested in making gifts, particularly if they can see a tax savings. However, many couples with estates of $20 million to $100 million may not be ready to completely part with $10 million to use their new $5 million gift tax exclusions. Couples in this range may be interested in trust planning that allows for using all or a portion of the gift tax exclusions if they can retain some interests in the property.
- If the donor lives in a state with a state estate tax, there will be a larger rate differential. Most states do not have a gift tax, which creates a significant advantage of gifts over transfers upon death for state estate tax purposes.
- One approach is to use an asset protection trust – illustrated as the Irrevocable GST By-Pass Trust in the next slide. The asset protection features of this trust are used to accomplish the estate tax planning goals. *See* PLR 200944002 and Rothschild, D. Blattmachr, Gans, J. Blattmachr, *IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate*, 37 Est. Plan (Jan. 2010).
- Other gift approaches --

Ultimate By-Pass Trust Plan

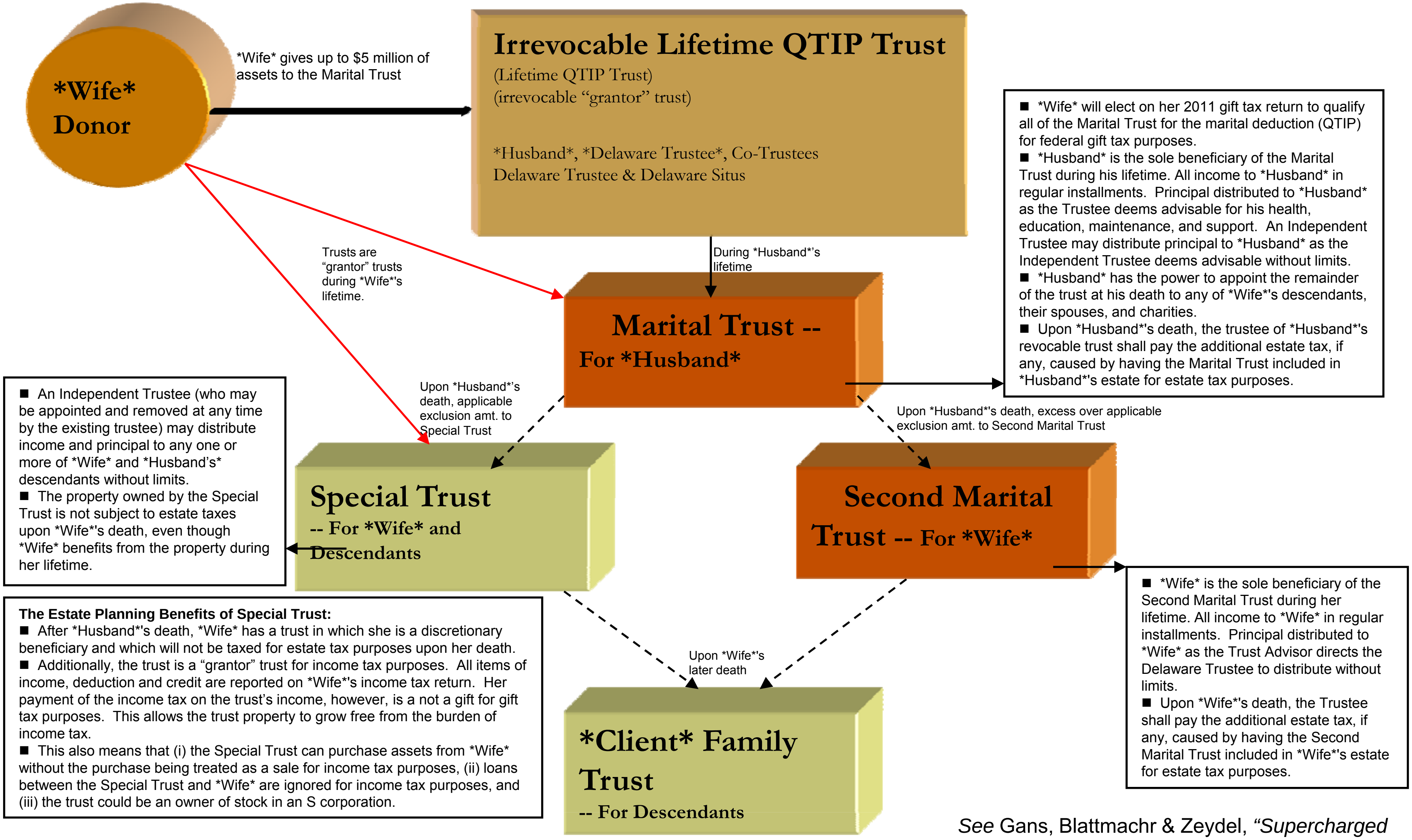


Wife Survives. The Husband's applicable exclusion amount will be first used through the Irrevocable Lifetime QTIP Trust which will be included in his estate. His applicable exclusion amount will fund the Special By-Pass Trust, which will benefit the Wife and descendants and it will also be a grantor trust as to the Wife. As a result of it being a grantor trust, the Wife will pay the trust's income taxes and be able to swap assets for trust assets. Essentially, the Wife could step-up the basis of the Special By-Pass Trust assets and thereby neutralized the income tax disadvantage of not relying upon portability. Also, this is better than relying upon portability since whatever the trust grows to in value will be excluded from the Wife's estate, protected from the claims of creditors, and GST protected following the Husband's death.

The Irrevocable GST By-Pass Trust uses the Wife's $5 million gift tax exclusion immediately. This promotes estate tax savings by removing all future appreciation in the trust's assets from estate taxation. This trust is also excluded from the Wife's and Husband's estates, protected from the claims of their creditors, is GST protected from its creation by allocation of the Wife's GST exemption. Also, if Wife resides in a state with a state estate tax, the gift to the trust prevents this portion of the estates from being subject to state estate taxes (i.e., most states do not have a gift tax, therefore gifts complete avoid the state estate tax).

Husband Survives. If the Husband survives, the Wife's initial $5 million applicable exclusion amount is used by the creation of the Irrevocable Asset Protection Trust, which provides for the Husband and descendants and is creditor protected. Any additional exclusion can be used through the Wife's revocable trust. If there is no utility to the Lifetime QTIP Trust, an Independent Trustee can distribute trust assets outright to Husband.

2011 Gift to Proposed Irrevocable Lifetime QTIP Trust



See Gans, Blattmachr & Zeydel, *"Supercharged Credit Shelter Trust*SM," 21 Prob. & Prop. 52 (July/Aug. 2007).

Summary of Benefits of the Special Trust

The Special Trust is similar to a trust designed to shelter the exclusion amount of the first spouse to die (a so called "credit shelter trust," "bypass trust," or "family trust"). A credit shelter trust and the Special Trust share several important characteristics: *Wife* can benefit from the trust during her lifetime and the trust (including any future appreciation or growth in value) escapes estate taxes upon her death. However, unlike a typical credit shelter trust, the Special Trust is a "grantor" trust as to *Wife*, which has the effect of increasing its effectiveness as a wealth transfer tax savings technique. This is summarized as follows:

1. **Payment of Income Taxes is NOT a gift for gift tax purposes**. *Wife*'s payment of the income tax on the trust's income is a not a gift for gift tax purposes. Rev. Rul. 2004-64. This allows the trust property to grow free from the burden of income tax.

2. **Purchase Assets from or Sell Assets to Special Trust without Income Tax Recognition**. The Special Trust could purchase assets from *Wife* without the purchase being treated as a sale for income tax purposes – there would be no gain to report. Rev. Rul. 85-13.

   Wife could also reacquire appreciated trust assets in exchange for higher basis assets and this can be achieved tax-free. The ability to reaquire assets and substitute assets without triggering gain is a way to neutralize the income tax advantage of portability.

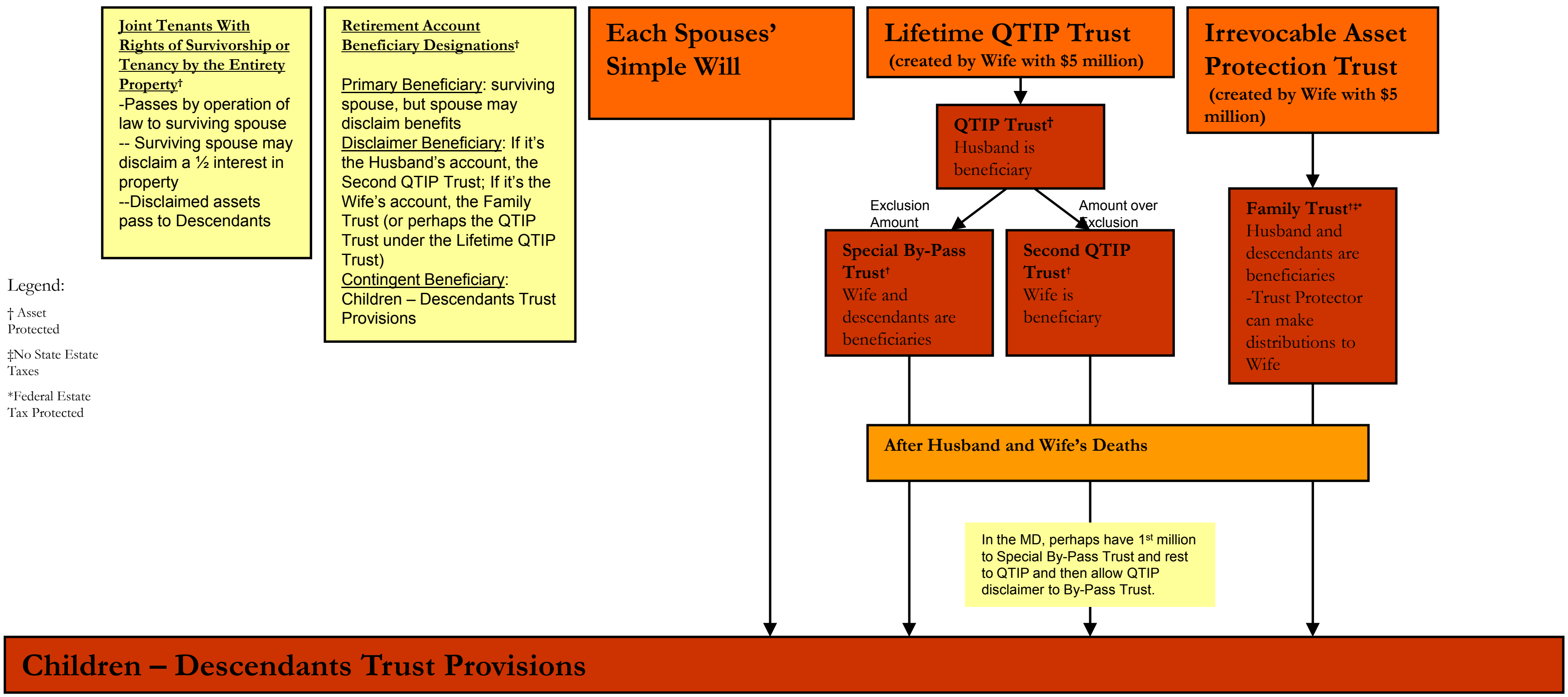
3. **Interest on Loans between the Special Trust and *Wife* is Ignored for Income Tax Purposes**. The interest paid on a loan between *Wife* and the Special Trust is ignored for income tax purposes. The interest payments are not included in the lender's income and are not deductible by the borrower. Notwithstanding this income tax non-recognition of interest, interest should be paid on any promissory notes to avoid gift tax implications.

4. **Special Trust can Own S Corporation Stock**. The Special Trust would be qualified to own stock in an S corporation. *Wife* would report on her income tax return any tax attributes of the S stock owned by the Special Trust. A typical credit shelter trust would have to qualify as a QSST or ESBT to own S stock, which is more complicated and perhaps less tax efficient.

5. **No Separate Income Tax Return**. As a "grantor" trust, the Special Trust can use the social security number of *Wife* for tax reporting purposes and no separate income tax return is needed for the Special Trust.

   In contrast, a typical credit shelter trust is a separate tax paying entity, which must file income tax returns. With a typical credit shelter trust, (i) if the grantor paid the trust's income tax liability, it would be a gift for gift tax purposes, (ii) if the trust purchased an asset from the grantor or if the grantor reacquired an asset from the trust by substituting cash or other property, it would be a taxable sale for income tax purposes, and (iii) loans between the trust and the grantor would generate taxable interest income.

More Simple Ultimate By-Pass Trust Plan



Notes:

1. Wife Survives. If the Wife survives the Husband, the Husband's applicable exclusion amount will be first used through the Lifetime QTIP Trust which will be included in his estate. His applicable exclusion amount will fund the Special By-Pass Trust , which will benefit the Wife and descendants and it will also be a grantor trust as to the Wife. As a result of it being a grantor trust, the Wife will pay the trust's income taxes and be able to swap assets for trust assets. Essentially, the Wife could step-up the basis of the Special By-Pass Trust assets and thereby neutralized the income tax disadvantage of not relying upon portability. Also, this is better than relying upon portability since whatever the trust grows to in value will be excluded from the Wife's estate and protected from the claims of creditors. The Irrevocable Asset Protection Trust is also excluded from the Wife's estate and is protected from the claims of her creditors.

2. Husband Survives. If the Husband survives, the Wife's initial $5 million applicable exclusion amount is used by the creation of the Irrevocable Asset Protection Trust, which provides for the Husband and descendants and is creditor protected. Any additional exclusion can be used through the Wife's revocable trust. If there is no utility to the Lifetime QTIP Trust, an Independent Trustee can distribute trust assets outright to Husband.

3. Joint Property. For simplicity, the spouses use TBE property to avoid probate upon the first spouse's death and provide asset protection. Since the irrevocable trusts are used to protect exemptions, only simple Wills are needed.

Mega Estates Over $100 million

- The fortunate couples in this lofty category are best positioned to use their applicable credit amounts during lifetime through outright gifts, such as gifts to dynasty trusts, perhaps of discounted assets, QPRTs and GRATs, and assorted other devices.

- Any remaining exclusion could be ported or used through a disclaimer type of plan illustrated on slide # 22.

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The $5 Million Gift Tax Exemption Amount

- Prior law - 2010
  - $1 million exclusion amount
  - Gift tax rate of 35%
- Current law for 2011 and 2012
  - $5 million exemption amount
  - Gift tax rate of 35%
- 2013 and beyond
  - Whatever Congress wants
  - Could revert back to $1 million exclusion amount with a rate has high as 55%

$5 Millin Generation Skipping Tax

- Prior law – 2010
  - Either $5 million Exemption or No GST Tax
- Current law of 2011 and 2012
  - GST Exemption Amount: $5 Million (per person)
  - GST Tax Rate of 35%
- 2013 and beyond
  - Whatever Congress wants
  - GST Exemption Amount: $1 Million (plus inflation since 1998)
  - GST Tax Rate: 55%

The Economics of Giving

- T gives $5 million in 2011
- T dies 30 years later
- If earning 3%, the $5 million grew to $12 million
- If earning 6%, the $5 million grew to $29 million
- If earning 10%, the $5 million gift grew to over $87 million.
- The growth, even if the $5 million is "clawbacked", is exempt from estate taxation
- Are there basis issues to be concerned about

Use Grantor Trusts

- Further leverage the $5 million gift by making the gift to an intentional defective grantor trust
- Typical Grantor Trust powers:
  - Ability to borrow, without adequate security
  - Ability to substitute property for property of equivalent value, in a nonfiduciary capacity
  - Use income to pay premiums on life insurance
  - Independent person ability to add beneficiaries
- The IRS has conceded that the grantor makes no gift by paying income tax on the trust income which the trust retains but that is attributed to the grantor for income tax purposes under the grantor trust rules. Rev. Rul. 2004-64
- Some commentators have argued that when Grantor dies and grantor trust status terminates, there is a step up basis, even though property not included in gross estate
- Can achieve step up basis anyway by having Grantor substitute low basis property with high basis property or by purchasing low basis property with high basis property just prior to death

Domestic Asset Protection Trust

- In PLR 200944002, the IRS has ruled that a self-settled trust created under Alaska law will not be included in the grantor's gross estate unless there is an implied understanding or other factor that would cause estate tax inclusion.
- May be able to use gift and GST tax exemptions, remain eligible to receive distributions and yet have the trust excluded from his or her gross estate for Federal estate tax purposes.
- Can also retain right to remove and replace trustees (as long as the substituted trustee cannot be someone related or subordinate to the grantor within the meaning of section 672(c)).
- Plan around 2036 – give nonsubordinate person right to remove Grantor as permissible beneficiary. If do so before death, then no inclusion under 2036 or 2035

Spousal Life Access Trust

– If happily married, then create trust for spouse and descendants, the so-called SLAT or Spousal Life Access Trust
– Can define spouse to be person married to at time when distributions are being made
– Give spouse broad limited power of appointment, exercisable only with consent of non-adverse party

Reciprocal Trust Doctrine

- If both spouses create trusts for each other, then must avoid reciprocal trust doctrine
- That doctrine causes the beneficiary of the trust created by the other trust to be treated, for tax purposes, as the actual grantor of the trust.
- For example, if the wife creates a trust for her husband and he creates a trust for her, he may be treated as creating the trust for his benefit and the she treated as creating the trust for her benefit.
- If the spouses have even an implied understanding that each would receive the income of the trust or have a power to control the beneficial enjoyment of the trust property, estate tax inclusion would occur.

Reciprocal Trust Doctrine

– Avoid reciprocal trust doctrine by drafting to have provisions are "substantially" different
  - Different assets or value of assets
  - Different dates of creation
  - Limited power of appointment
  - Mandatory income vs. discretionary income
  - Sprinkle power to other beneficiaries
  - Different trustees
  - Different ultimate takers

State Gift Taxes

- Some states have a lower estate tax exemption then the Federal estate tax exemption
- Many of these do not have a gift tax
- If make gift during lifetime, then, it should avoid state gift tax at death

Downside

- Loss of use of assets
- What happens if own assets decrease
- Can there be a gift or estate tax on gifts given when exemption is $5 million
  - While it may be possible for the gift to be recaptured and tax, the growth and income earned on the gift should escape recapture
  - The recapture may occur at death because the calculation of estate tax under section 2001(b) is based, in part, on the amount of adjusted taxable gifts
  - Could also be a gift tax if made taxable gifts before
  - Best to run the numbers

Advantages

- There is no apparent recapture of the $5 million GST exemption
- Future legislation to limit number of years of trusts or otherwise the effectiveness of a GST Trust are
- 55% top tax rate

Generation Skipping Tax

- There is no apparent recapture of the $5 million GST exemption
- Future legislation to limit number of years of trusts or otherwise the effectiveness of a GST Trust
- There is no portability of GST exemption
  - Therefore if do not use of GST exemption during life or at death, lose it. Surviving spouse cannot use it when he or she dies