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Some Advanced Trust-Estate Tax Planning Considerations for 2010 and Beyond

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The indecision by Congress to update our estate tax system have left many wondering how to plan in this environment. As the law stands, if you die in 2010, there is no estate or generation-skipping transfer (GST) tax. Beginning January 1, 2011, the estate and GST tax will be activated at tax rates of 55% with exemption amounts of \$1.1 million GST.

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 provided guidance for estate tax rates and exemption amounts through 2009. EGTRRA provided that the rates and exemption amounts would repeal in 2010 to “reset the system” to pre-2001 levels of a 55% tax rate and \$1,000,000 exemption amount in 2011. Prior to 2010, it was presumed that Congress would pass new laws to provide suitable 2010, and beyond, levels of tax and exemption. If legislative agreement is reached for estate tax rates and exemption amounts, Congress may elect to apply such new laws retroactively, but more likely prospectively. This article addresses a few estate planning options you may want to consider.

Scenario #1: No Action by Congress – Exemption \$1,000,000/Tax Rate 55%

Under this scenario, it will be incredibly important to have effective estate planning in place. Due to the limited exemption amount and higher tax rate, you will want to move as many assets out of your estate as you can.

Generally, life insurance policies owned by you are subject to estate tax. To avoid paying estate tax, you can establish an Irrevocable Life Insurance Trust (ILIT). An ILIT is an irrevocable trust which owns one or more life insurance policies. When the insured dies, the named trustee will administer the trust pursuant to the trust document for the designated beneficiaries. Ideally, the trustee should be the purchaser of the life insurance policy. However, if the policy already exists and you wish to transfer it, the transferor must survive the date of transfer by at least three years or the policy will be brought back into the estate. After transfer to or set-up of the ILIT, the trust will need to be funded so it can make the premium payments on the insurance policies. The most tax efficient way to fund the ILIT is through annual exclusion gifts (\$13,000 in 2010).

As with most tangible assets, your personal residence and vacation home are includable in your estate. However, to keep your residences out of your taxable estate, a Qualified Personal Residence Trust (QPRT)

can be created. The law allows a QPRT to be established for one personal residence and one occasional/vacation residence. A QPRT is structured as an irrevocable split-interest trust where you transfer title of the residence to the trust but retain the right to reside in the home for a specified term (e.g. 10 years). During that term, your living patterns remain the same because, as an offset to living rent-free, you still would be responsible for paying the expenses of the home (i.e. real estate taxes, repairs and maintenance, etc.). At the end of the specified term, if you are still living, the home would pass to the beneficiaries of the trust removing it from the estate. If, however, you die before the term of the trust is complete the residence will revert back to your estate.

Although the transfer to a QPRT takes your residences out of your estate, the transfer is otherwise subject to gift tax, yet at a discounted value. The amount of the gift is calculated as the fair market value of the residence less the actuarial value of the retained term interest. The actuarial value is determined through Internal Revenue Code (IRC) §7520. Therefore, at the end of the trust term, any appreciation on the residence above the §7520 rate will also pass to the beneficiaries tax free.

Another estate planning/trust technique which would allow the transfer of a large portion of your estate is through a sale to an Intentionally Defective Grantor Trust (IDGT). An IDGT is considered a complete and separate trust for estate tax purposes. However, the IDGT is considered “defective” for income tax purposes and treated as a “grantor” trust because the grantor will retain a certain specified power. Therefore, the assets within the IDGT are removed from your taxable estate but you still pay the taxes on the trust’s income personally. The “defective” feature of the IDGT is another way to reduce estate taxes since each income tax payment would also reduce your gross estate.

After the IDGT is established, you would typically sell assets in exchange for a promissory note (likely at a discounted rate if lack of marketability or minority interests are inherent in the assets). The minimum interest rate that must be used is the Applicable Federal Rate (AFR). As the IDGT earns income from the assets, it can repay the promissory note. If structured properly, the value of assets sold to the IDGT would exceed the amount paid back on the promissory note, resulting in a tax-free transfer of the excess. Finally, since each party in the sale is considered the same taxpayer, the income tax benefits are two-fold: 1) there is no gain recognized on the sale to the IDGT, and 2) the interest payments to you do not constitute income. The defective feature may alternatively be turned off by waving the power retained.

The three trust considerations listed above are some of the most effective ways to move large portions of your estate to the next generations with little to no gift taxes.

Scenario #2: Action by Congress – Exemption \$3,500,000/Tax Rate 45% – Applied Prospectively

Under this scenario, there are some crucial planning points that should be considered since 2010 would remain with no estate tax and unlimited exemption amounts.

First, in 2010, there is a change in the calculation of income tax basis for inherited assets. If you die during 2010, the inherited property of your estate no longer receives a stepped-up basis to the fair market value of the property at the date of death. Instead, your income tax basis is carried over as of the date of death to your heirs. There is a limited step-up provision for unrealized gains of up to \$1,300,000 (\$3,000,000 for surviving spouses) and cannot exceed the fair market value at the date of death. To properly account for this, all estate property should be reviewed to ensure that accurate basis records exist.

Second, all estate documents should be reviewed, especially for married individuals. Some estate documents (e.g. wills or revocable trusts) may reference formula clauses for the funding of GST Exempt Family Trusts (Exempt Trust) and/or Marital Trusts. Generally, estate documents will use a formula clause for the funding of the Exempt Trust to guarantee the maximum tax-free amount (previously \$3,500,000). By placing a stipulated amount in this type of trust, it ensures that the assets will not be included in your spouse’s estate. At the termination of the Exempt Trust, the trust distributes the assets as designated by the trust document.

The formula clause used to fund the Exempt Trust will usually leave a remainder amount that will then be included in the Marital Trust. The Marital Trust does become part of your spouse's estate and will be taxed when he/she dies. However, in a year like 2010, this type of formula clause may cause unintended results for the distribution of your estate. Depending on the wording of the formula clause, all the assets of your estate could go into the Exempt Trust. If this trust only grants income distributions to your children (or other more remote descendants), your spouse could be left with nothing from your estate. To plan for this scenario, all estate documents should be reviewed to ensure that appropriate language is used for the distribution of your estate.

Since any change by Congress to the estate tax laws would be applied prospectively, planning options that were available and widely used in 2009 will still be applicable beginning in 2011.

Scenario #3: Action by Congress – Exemption \$3,500,000/Tax Rate 45% – Applied Retroactively

Under this scenario, any estate plan you currently have in place (prior to any changes as mentioned in Scenario #2) will still be applicable for 2010 and 2011. The one downfall to the retroactive application of the estate tax law would be if a loved one had previously died in 2010. Along with the requirement to file an estate tax return, the estate distributions that occurred already may be incorrect.

Likely, the estate distributions were made based upon the understanding that there would be no estate tax and unlimited exemption amounts. It is possible that some heirs may have inherited property in excess of what was expected. These distributed amounts may need to be recovered from the heirs in order for the estate to pay an estate tax that is now due, which would adjust the amount the heirs were to receive. In this situation, the worst case scenario would be that an heir who received an inheritance outright, may have spent the money already and is unable to refund it to the estate.

Under any of these scenarios, creating a grantor retained annuity trust (GRAT) can be an effective way of transferring assets. A GRAT is created when a grantor transfers assets into an irrevocable trust where the grantor retains a current income interest for a specified time. IRC §2702 requires that the grantor's retained current income interest must be an annuity interest, paid at least annually. The remainder is treated as a present gift of a future interest. The amount of gift tax is calculated based on the fair market value of the property transferred to the GRAT less the present value of the annuity payments, based upon the Internal Revenue Service's (IRS) assumed rate of return under §7520. At the end of the trust's term, any remaining assets pass to the beneficiaries free of estate and gift taxes. If the assets transferred to the GRAT have appreciated at a greater rate than the IRS's §7520 rate, this appreciation will pass tax-free to the beneficiaries. Therefore, to achieve the greatest efficiency, the GRAT should be funded with highly appreciable assets.

The major drawbacks of creating a GRAT are three-fold. First, when assets are transferred to the GRAT, the grantor loses flexibility and control of the assets. Secondly, if the assets within the GRAT do not appreciate greater than the §7520 rate, there will be no remainder interest to pass to the designated beneficiaries. Finally, if the grantor dies prior to the termination of the GRAT, all of the assets revert back to the grantor's estate.

If the GRAT planning option appeals to you, you should consider establishing one immediately as the rules surrounding the current structure of GRATs may change when/if Congress passes the Small Business Jobs Tax Relief Act of 2010 (H.R. 5486) or some similar legislation. Under this Bill, three main changes are proposed: 1) GRATs would be required to have a minimum term of 10 years thereby requiring longer term planning, 2) the remainder interest must be greater than zero, and 3) the annuity payments must not decrease during the first 10 years of the GRAT term. These changes would presumably apply only to GRATs created after the date enacted by Congress.

In summary, estate planning is difficult during this uncertain time. Reviewing your estate documents and implementing some of these ideas will help ensure your estate is in the best position it can be no matter what laws are enacted.

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