Top 10 Planning Ideas to Consider Before December 31, 2010

By

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Executive Summary

There is no doubt 2010 has been a watershed year for transfer tax planning. Some would say it has been a watershed year because so many clients have shed so many tears trying to figure out what to do.

Actually, and more literally, 2010 is and has been a transition year. While we still don't know what type of tax reality we are transitioning to, we can reasonably expect that the tax cost of transferring wealth with be higher in the near future. In

other words, after December 31, 2010, we have reason to expect that the tax situation for transferring wealth is likely to be worse – not better - for clients.

Nevertheless, and perhaps as a result, there are still important opportunities for clients to consider before the end of the year.

Discussion

Here are 10 things estate planners and their clients may wish to consider before the end of the year.

10. Review all estate plans as well as nuptial agreements – it is not too late – or is it?

a. Although this probably should have been done by now, in case some clients have not yet reviewed their estate plans to consider if death in 2010 (with our "no estate tax" and carryover basis regime) impacts their plans, and in particular any formula clauses. We all know that formula clauses in 2010 may potentially lead to unintentional consequences, such as cutting out a spouse, cutting out descendants from a prior marriage, triggering an elective share or litigation, and more. Plus, there are also potentially unintended GST planning issues and state estate tax concerns as well.

> **Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1570: FLASH - Problems for Married Persons Who Die in 2010 in States with Independent Death Taxes**
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> **Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1605: Sample Client Letter Explains Estate Tax Changes & Encourages Action**

b. In addition, you should consider how or if a state law "estate tax patch" might be used to benefit (or potentially to harm) estate plans you have prepared and/or estates currently being administered. At least 10 states appear to have adopted federal estate tax patch laws.

> **Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1634: States Enact Legislation Construing Formula Dispositions in the Absence of a**

c. Also, it is important for those of us who work with our clients on nuptial agreements (and for all of our clients with nuptial agreements) to have them reviewed in case of death in 2010. In particular, clients should beware of provisions in nuptials tied to the federal estate tax and/or the estate or GST exemption. For example, a nuptial might say that the 1st spouse to die is free to leave "the maximum amount that will pass free of GST tax to his grandchildren." And the wife may have waived all of her rights based upon the assumption that the husband's estate after the GST tax exemption portion would be more than sufficient to support her. Such a plan must be reconsidered in light of 2010 tax laws.

While reviewing nuptials, it is also a good idea to revisit any "altered net worth" provisions in nuptials. Some nuptial agreements have "savings" clauses that are tied to the net worth of the wealthier spouse which may have been impacted or triggered by the dramatic market declines of the past few years.

Nuptial agreements could be ticking time bombs if they are not reviewed. Ultimately courts could choose to void them, if it turns out one spouse fails to receive the "benefit of the bargain" because of a changed tax law nobody realistically contemplated when the document was drafted.

9. Address awkward GST issues

a. For clients with GST non-exempt trusts, this is the year to consider taxable distributions/terminations. If clients have non-exempt trusts, it is imperative that they consider making distributions before the end of the year. Even if they chose not to do so, advisors will benefit from at least discussing the issue with any clients managing non-exempt trusts.

b. For clients considering gifting, outright gifts to grandchildren (and lower generations) should also be part of the discussion. There appears to be a significant probability there will be no GST tax applied on 2010 transfers so gifting "down multiple generations" may be more favorable in 2010 than ever before or after. Some have suggested outright gifts of FLP or FLLC interests or non-voting corporate stock, for example, but have warned that transfers to trusts or UTMAs may wind up "caught up" in the GST tax when it returns in 2011 (as taxable distributions some day).

c. There may be some interesting issues before the end of the year for clients needing to fund Irrevocable Life Insurance Trusts ("ILITs") which are GST exempt. Given there is no exemption to apply this year, planning to avoid creating a future inclusion ratio is a must. Some options include:

    i. Make a late allocation in 2011
    ii. Making loans to the ILIT instead of gifts in 2010 and then making gifts in 2010 to pay off the loans (and applying exemption to those gifts, of course).
    iii. Using cash value to carry the policy until next year.

    Before making major decisions regarding life insurance policies in trusts (including the advisability of borrowing against cash value to pay premiums in 2010) it is prudent for the trustee to investigate or audit the policy/policies to review their likelihood of achieving their anticipated objectives. In fact, a periodic life insurance policy audit is a good idea for any ILIT.

d. For clients with GST exempt ILITs, advisors should check to see if premiums have been paid this year and if any planning needs to be done either now or early next year to deal with the consequences.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1705: Problems Caused by Absence of Estate & GST Taxes and Reinstitution of Carryover Basis

8. Trigger Capital Gains?

a. Here's a deceptively simple but perhaps overlooked planning idea: clients may wish to consider selling assets in 2010 in order to recognizing capital gains at the present 15% rate.

b. Capital gains tax rates are scheduled to rise to 20% in 2011 and 23.8% in 2013

c. Like the Roth IRA discussion and the gift tax discussion (both hereinabove), some clients may wish to recognize gains in 2010 in order to avoid future taxes at potentially higher rates. The logic is fairly simple and generally quite similar to the arguments for making taxable gifts and/or Roth conversions.

d. If a client does elect to increase income/gains in 2010, then please note the potential to defray some of that via charitable gifting below.

7. Consider Roth Conversions

a. The big change in 2010 regarding Roth conversions was the elimination of the income cap on converting. As a result, many more clients are eligible for Roth conversions than in the past, and more clients and advisors are talking about Roth conversions.

> **Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter - Archive Message #537:** Bob Keebler Charts
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> **Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter - Archive Message #510: The Roth Conversion Trap**
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> **Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter - Archive Message #527 & 528: Analyzing the Misunderstood Factors Influencing Roth IRA Conversions: PART 1 and PART 2**

b. As indicated in the newsletters/articles cited directly above, deciding on whether or not to convert is a complicated matter requiring clients and

advisors to probe certain assumptions and complex issues in order to make informed decisions. Obviously it makes the most sense for clients who can afford to pay the tax from other assets and who would not have needed/wanted to make withdrawals from the IRAs after age 70 1/2. Nevertheless, some clients have indicated they will not convert based on their fear that the IRS will ultimately change the rules and tax the growth in their Roth IRAs someday in the future, and there are no guarantees, of course, that the IRS will not do so.

c. However, for those clients inclined toward converting, 2010 is a good year to consider Roth conversions in particular since income tax rates will likely be rising in 2011 and again in the near future (with the extra 3.8% surtax starting in 2013).

d. Converting a traditional IRA to a Roth IRA also gives clients a "free bite at the apple" – as they can re-convert by October 15, 2011 (if they file their 1040s on extension).

e. Some commentators have urged clients converting large enough IRAs to consider segmenting the conversions by asset classes, like some clients fund GRATs. If some asset classes over-perform while others under-perform, the client can pick and choose which to re-convert next year.

f. Clients considering converting should also "watch out" for some overly aggressive conversion techniques, such as the intentional contribution of excess amounts to a Roth IRA in its first year and then withdrawing the contribution (but not the earnings) after the October 15 deadline in the second year. Natalie Choate highlighted this dangerous planning technique.

> **Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter - Archive Message #532: The Intentionally Excess IRA: Worst Roth Planning Idea Yet?**

g. Clients considering Roths, should also consider coupling the conversion with charitable planning (see more below). Outright gifts to charities, to

private foundations and to community foundations (to fund Donor Advised Funds, for example) as well as charitable lead trusts can help clients generate deductions to help offset income from conversions.

> **Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter - Archive Message #539:** Using Charitable Giving Techniques to Offset Income Tax from Roth IRA Conversions.
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> **Compare:**
>
> **Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter - Archive Message #534:** "Roth" the Traditional IRA or Give to Charity?

6. Make Gifts

a. Clients should consider making taxable gifts before December 31, 2010. As we know, this year only, there is a 35% gift tax rate.

b. "With an effective transfer tax rate as low as 25.93% (if the donor survives the gift by three years), **every affluent client needs to consider the idea of gifting in 2010**. Transfer tax rates are only going up in future years. …"With **a 71% increase** in the top transfer tax rate (i.e., from 35% for gift taxes in 2010 to 60% in 2011)…and with the additional benefits of no GST taxes in 2010, **clients need to understand the benefit of pre-paying transfer taxes before the end of 2010**." (emphasis added)

> **Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1668: Scroggin & Douglas: Should Clients Consider Gifting Before the End of 2010?**

c. The reasons for making taxable gifts are well documented, and mostly stem from the nature of the gift tax as being "tax-exclusive" as compared to the more expensive "tax-inclusive" estate tax. All of those arguments and the time value of making gifts now so they grow outside clients' estates are equally - if not more - apt in 2010. Prepaying gift taxes can be hugely beneficial compared to passing wealth at death.

> **"Planning Example:** Assume a donor has $6,000,000 available to make a lifetime gift and pay the resulting gift tax. Assume further that the full amount of the gift is taxable and that a 55% marginal estate tax rate (i.e., assuming death occurs after 2010) and 35% gift tax rate

applies. The donor can make a $4,444,444 gift and pay the resulting gift tax liability of $1,555,556 (i.e., $4,444,444 x 35%). If on the other hand, the donor bequeathed the entire $6,000,000, then the Donor could only transfer $2,700,000 (i.e., $6,000,000 less a 55% tax). **The net result is that the donor transferred an additional $1,744,444 (i.e., $4,444,444-$2,700,000) - 64% more - by making a taxable gift as opposed to a bequest**." (emphasis added).

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1668: Scroggin & Douglas: Should Clients Consider Gifting Before the End of 2010?

d. Some clients are not comfortable "giving up" their money (paying taxes electively) even if they acknowledge the net benefit of doing so tax-wise. For those clients, an opportunity to make the gifting more "tolerable" might be terminating a QTIP trust. If the client is the surviving spouse and has enough other assets, perhaps he/she would be willing to give up the marital trust today and trigger a gift at the 35% rate. The termination of the QTIP is a taxable gift pursuant to section 2519. Generally, the termination is taxed as a net gift, although some commentators have suggested also disclaiming/giving up the right of reimbursement to increase the net amount of the gift to the family.

e. Even for clients willing to make taxable gifts before year end, it is important to discuss the timing of such gifts. Clients need to weigh the risks of (i) waiting until late December to be sure they live to year-end, versus (ii) starting the 3 year rule/clock ticking. It seems prudent to time a large 2010 gift for late December to make sure the client doesn't die in 2010 (no tax) <u>after</u> a large taxable gift is made (big tax/headache). On the other hand, the 3 year inclusion period to bring the tax back into the estate will not begin until the gift is made. So the longer the client waits the longer the 3 year window stays open.

f. Some planners have suggested using revocable trusts that become irrevocable on December 31, 2010 as a means to set up the gift, pre-fund it and not miss the opportunity. Others have suggested executing all of the

documentation and setting up the transfers via an escrow arrangement with a direction to consummate a closing as of December 31, 2010.

g. Beware of the less than $1 million gift tax exemption for certain clients who have made some taxable gifts and used up some exemption previously. Before suggesting taxable gifts for such clients, you should read the article by Dan Evans:

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1704:
The Less-Than-$1,000,000 Gift Tax Exemption

h. Don't let clients forget annual gifts before the end of the year.

5. Time to consider a Financed Net Gift?

a. An idea presented at the University of Miami Heckerling Institute this year – but not much discussed, really – was "Financed Net Gifts". If you have not looked at it, there is a very interesting discussion (and reasonable in length) by David Handler in the 2010 Heckerling materials.

b. The financed net gift concept works as follows: a client makes a net gift (which further reduces the effective gift tax rate and perhaps makes paying the tax more tolerable for certain clients) typically to an irrevocable, "grantor" trust, and then finances the gift tax payment via an AFR-rate loan from the grantor to the trust. This technique is favorably compared to a sale to a dynasty trust since the amount being financed is only the tax (about 26% of the total amount transferred) and clearly avoids any debt/equity ratio (90/10%) issues associated with grantor trust sales. Plus, the payments back to the grantor are much less, leaving more in the trust to appreciate/grow for the family.

c. Further, for clients considering gifts, but on the fence about writing a check, the net gift has the effect of reducing the effective gift tax rate to about 31% when the gift rate was 45% and all the way down to about 26% for net gifts in 2010 based on the current 35% gift tax rate environment.

4. Create and fund GRATs before their utility is curtailed

a. We have been told several times this year that "the end is near" for GRATs as we know them. Most of the discussion has focused on the following changes to GRAT planning:

(i) GRATs may have a 10 year minimum term
(ii) GRATs may not be allowed to have declining payouts
(iii) GRATs may be required to have value of their remainder – no more "zeroed-out" GRATs

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1669: GRATs on the Chopping Block - Again.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1656: FLASH - GRATs - Time Running Out?

a. If there is some estate tax reform passed either before the end of 2010 or in 2011 which has the effect of increasing the estate tax exemption from $1 million and/or decreasing the top rate below 55%, revenue raisers would likely be introduced at the same time. As changing the terms of GRATs has already been discussed frequently, if there is a need for revenue enhancers to go along with an estate tax reform, the time for GRATs is definitely now.

b. As an aside, if Congress does change the rules and require 10 year GRATs, a rather obvious option to consider for some clients will be tying 10 year GRATs with 10 year ILITs (probably funded with term life insurance – perhaps using convertible term life insurance in case the client subsequently wants to convert to permanent insurance).

3. Act on FLPs before their utility is curtailed

a. Like GRATs, there has been a reasonable amount of discussion this year (including the President's budget proposal) regarding the elimination of

intra-family discounts. If that happens, nobody can be sure what will be "grandfathered" - if anything.

b. Thus, for clients with FLP or FLLC interests, now seems like the time to consider gifting and/or selling those interests in an attempt to lock-in discounts before the laws change and take the discounts away. Now is the time for clients to consider gifts, GRATs (both discussed above) and sales (discussed below) as a means to transfer interests in FLPs and FLLCs.

c. However, note that transferring FLP or FLLC interests with the intent to qualify for the annual exclusion from gift tax became a bit harder this year, due to the Price case. Walter M. Price, et ux v. Comm'r, T.C. Memo. 2010-2 (January 4, 2010); The IRS successfully argued that the restrictions on transferring the interests in FLPs gave the recipients no present economic interest, and thus did not qualify for annual gifting. Some have suggested modifying operating agreements and partnership agreements to give some current economic benefit such as a right to transfer (perhaps limited in time, however). Others suggest having the donor give the recipient a "put" right to put the interest to the donor and get cash for a limited time, and presumptively that would satisfy the IRS's arguments.

d. For clients considering forming FLPs, we know that forming FLPs too close in time to gifting or selling them opens the door for IRS attacks under the step transaction doctrine. When successful, the result is no valuation discounts, as the transfers are deemed made of the underlying assets. See Heckerman v. United States., 104 AFTR 2d 2009-5551 (W.D. Wash, 2009); Pierre v. Comm'r, 133 T.C. No. 2 (2009); and Pierre v. Commissioner, T.C. Memo. 2010-106 (2010).

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1668: Scroggin & Douglas: Should Clients Consider Gifting Before the End of 2010?

2. Sell assets to Dynasty Trusts

a. Considering the October 2010 AFR ties February 2009 for the lowest AFR ever recorded, now is a great time to implement sales of assets to "grantor" or "dynasty" trusts.

b. For example, we noted above that now is the time for clients to lock in FLP and/or LLC discounting opportunities. For clients unwilling to pay gift taxes, the sale technique will likely resonate.

c. In addition, now is an important time to consider sale transactions as a means to lock in depressed asset values before there is too much of a recovery. While I won't predict the economy, it appears property values may have stabilized a bit (based on recent appraisals) and closely held business valuations seem on an uptick as well. However, it is still possible for clients to capture the recent market declines in value by using dynasty trusts sales as soon as possible.

d. One confusing issue for those without already funded and GST exemption dynasty trusts will be the application of GST exemption. Some commentators have suggested that on January 1, 2011 clients can make late allocations and thus fully exempt dynasty trusts funded in 2010.

e. At the same time, clients should consider locking in depressed real estate values along with discounts for tenant in common interests. The Stewart case from NY was a major taxpayer victory in 2010 and many clients should consider fractional interest discount transactions.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1692: Estate of Margot Stewart v. Commissioner: Major Taxpayer Victory

f. Of course, in 2010, there was also the holding in Ludwick offering a 17.2% discount on a tenant in common interest in Hawaiian land.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1653: Akers on Ludwick v. Commissioner

g. For more on the Stewart case, with a focus on the potential for using tenancy in common agreements (including a model co-tenancy/TIC agreement form), see Baskies and Zaritsky, Second Circuit Boosts Residence Tenancy-in-Common Gifts, Probate Practice Reporter, Vol 22 No. 9 (Sept. 2010).

h. Tenant-in-Common discounts are a developing area in the law, and the IRS's partition arguments are still being sorted out by the courts, but evaluators still seem to point to the LeFrak case as a model. In that case a 20% minority discount plus a 10% marketability discount were provided by the Tax Court. Samuel J. LeFrak v. Commissioner, T.C. Memo. 1993-526.

i. When planning sales to dynasty trusts, the use of defined value formula clauses was bolstered in 2010 with the case of Petter v. Commisioner.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1578: Petter - Defined Value Clause Upheld; "One-Two Punch" to IRS's Fight Against Defined Value Clauses

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1562: Petter v. Commissioner - Defined Value Formulas, Do They Work and How!

1. Time to Talk Philanthropy - Charitable Planning

a. 2010 is a unique and important year for charitable planning. High income earners can optimize the federal income tax deduction in 2010, as the phase-out rules – Sec 68(a) IRC – do not apply in 2010. However, they do return in 2011. For clients who have groaned in the past about how "pesky" hidden taxes like the phase-out have limited their interest in philanthropy, 2010 is the year to put up. We should expect many high-income clients will take advantage of the opportunity to make large tax deductible gifts this year, and we should plan for major gifts to flow into private foundations as well as donor advised funds at community foundations.

In the past, as a result of the 80% phase-out of itemized deductions for certain clients, the effect of the deduction was reduced to only 7%. As a

result, for charitable gifts, the clients effectively paid 93% and the government only paid 7%. For charitable gifts in 2010, it is possible these same clients will only effectively pay 65% and the government will pay 35%.

Obviously the charitable gifts are still limited to 50/30/20% of adjusted gross income, so clients must consider those caps.

b. Some client may still wish to modify their estate planning documents in case they die in 2010, to reduce charitable legacies paid directly from their estates preferring to give more to the children with a direction (one outside the documents and thus moral, although not legally binding) to make gifts to charity. Such a switch may mean the difference between leaving a large charitable gift via the estate in 2010 for which no estate tax deduction is afforded to a situation where the same amount passes to charity after death (but from the children) and an income tax deduction is created.

c. As a result of low interest rates, many forms of charitable planning work better now. For example, a charitable planning concept that may have been previously ignored is the gift of a remainder interest in a residence or a farm. The valuation of the retained income interest goes down as interest rates go down, so the value of the remainder is higher when interest rates are low – like they are today. This technique and others work extremely well in low interest rate environments and may be of interest to clients looking to take advantage of the opportunity to make charitable gifts in 2010 without the Sec 68 phase-out.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1661: 7520 Rate Drop Opens Up Planning Opportunities

d. Due to the low AFR, the low gift tax rate for 2010, and the availability of reduced value assets, the last few months of 2010 presents a perfect time to consider Charitable Lead Trusts ("CLTs").

In some respects, however, the opportunities presented right now turn the conventional wisdom on CLTs on its head.

i. For example, commonly when looking at CLTs, many have suggested creating "zeroed-out" gifts. However, in 2010, perhaps paying some gift tax (at 35%) makes sense.
ii. Also, many clients prefer "non-grantor" CLTs for a few reasons, not the least of which being a fear that any deduction will be "shaved" by the Sec 68 phase-out. Well, in 2010, the opposite is true. There is no phase-out, so large income tax deductions may be preferred, and more clients might be more inclined toward "grantor" CLTs.

Finally, much has been made recently about CLT design. Should we use increasing payout CLTs? If so, what payment plan is optimal? Is a 50% increasing payout better than a 20% increasing payout? And very recently, we have shared in the great "shark fin clat" debate of 2010. Some practitioners worry that a CLAT with a nominal annual payout for a very long period of time coupled with a huge payout at the end may not be valued as some of the supporters of shark-fin clats have suggested. However, the debate about them and their utility is very interesting and highlights how important CLT planning – and indeed all charitable planning - is in the last few months of 2010.

LISI Charitable Planning Newsletter #163: **Biting Back: Responding to the Attack on Shark-Fin CLATs)**

vs.

LISI Charitable Planning Newsletter #162: Validity of "Shark-Fin" CLATs Remains in Doubt Despite IRS Guidance.)

e. For clients generating income in 2010 (from Roth conversions, for example), generating off-setting, 2010 charitable deductions might be particularly important. This opportunity will be lost at the end of the year, so it is vital to address with clients now.

Conclusion

All things considered, it does not seem like much of a stretch to wonder if 20 years from now we will look back at the last few months of 2010 as the most interesting and important months in the modern history of estate planning. The confluence of forces and opportunities that have come together at this moment in time present a unique opportunity for our clients to transfer wealth at a substantially reduced tax cost.

Now is the time for advisors to alert clients of this closing window and to prepare for a very busy 4th quarter of planning.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Jeff Baskies

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