Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2046

Date: 07-Jan-13
From: Steve Leimberg's Estate Planning Newsletter
Subject: **Marty Shenkman's Commentary on the American Taxpayer Relief Act of 2012 (2013) Fiscal Cliff and Estate Planning**

"The Post-ATRA estate planning environment appears to be dramatically different than any estate tax regime that has heretofore existed. For the first time in history there is a permanent very high, inflation adjusted and portable exemption amount that not only factually excludes all but the wealthiest of the wealthy, from gift, estate and GST tax. Even more significant is that the fear of the estate tax for the vast majority of clients is simply gone. While clients still require all the valuable non-federal estate tax minimization planning professionals can provide, educating clients that the KISS principal and lowest cost solution is not preferable may be the greatest challenge many practitioners face."

Since the enactment of the American Taxpayer Relief Act of 2012, **LISI** has provided members with detailed analysis from some of the best and brightest subject matter experts:

- In Estate Planning Newsletter #2044, **Ron Aucutt** provided members with his analysis of the transfer tax provisions contained in the American Taxpayer Relief Act of 2012.
- In Income Tax Planning Newsletter #36, **Michael Jackson** and **Jared Szychter** analyzed the bill's income tax provisions.
- In Estate Planning Newsletter #2045, **David Pratt** and **Scott Bowman** provided members with their analysis of the legislation's transfer tax provisions.

Now, **Marty Shenkman** weighs-in with his analysis. Marty would like to thank **Jonathan Blattmachr** for his comments, but notes that any errors are the author's responsibility.

Martin M. Shenkman, CPA, MBA, PFS, AEP, JD is an attorney in private practice in Paramus, New Jersey and New York City who concentrates on estate and closely held business planning, tax planning, and estate administration. He is the author of more than 40 books and 800 articles. In addition to authoring his amazing Heckerling notes for **LISI**, he is a co-author with **Jonathan Blattmachr** and **Robert Keebler** of 2012 Estate Planning: Tax Planning Steps to Take Now available through amazon.com .

He is the Recipient of the 1994 Probate and Property Excellence in Writing Award, the Alfred C. Clapp Award presented by the 2007 New Jersey Bar Association and the Institute for Continuing Legal Education; Worth Magazine's Top 100 Attorneys (2008); CPA Magazine Top 50 IRS Tax Practitioners, CPA Magazine, (April/May 2008). His article "Estate Planning for Clients with Parkinson's," received "Editors Choice Award." In 2008 from Practical Estate Planning Magazine his "Integrating Religious Considerations into Estate and Real Estate Planning," was awarded the 2008 "The Best Articles Published by the ABA," award; he was named to New Jersey Super Lawyers (2010-13); his book "Estate Planning for People with a Chronic

Condition or Disability," was nominated for the 2009 Foreword Magazine Book of the Year Award; he was the 2012 recipient of the AICPA Sidney Kess Award for Excellence in Continuing Education; he was a 2012 recipient of the prestigious Accredited Estate Planners (Distinguished) award from the National Association of Estate Planning Counsels; and he was named Financial Planning Magazine 2012 Pro-Bono Financial Planner of the Year for his efforts on behalf of those living with chronic illness and disability. He sponsors a free website designed to help advisers better serve those living with chronic disease or disability www.chronicillnessplanning.org.

Before we go to Marty's commentary, members should note that a new **60 Second Planner** by **Bob Keebler** was recently posted to the **LISI** homepage. In his commentary, Bob analyzes Section 901 of the new tax law liberalizes the rules for conversion of 401K accounts to Roth IRAs. You don't need any special equipment - just click on this link.

Join **Bob Keebler** for an important teleconference titled "Fiscal Cliff Legislation and What It Means for Your Clients" that will take place on Wednesday, January 9th at 11am Central. Join Bob for one of these special programs so that you can find out all that you need to know about what this new tax deal means for your clients. Your registration includes: Participation on a 90-minute teleconference (including a live Q&A session) that comes with handout materials, an audio recording of the teleconference, and a Certificate of Completion. You get all of this for everyone in your office for one low price of $149. If you have any questions or wish to register by phone, you can call The Ultimate Estate Planner, Inc. at 1-866-754-6477 or e-mail them directly at events@ultimateestateplanner.com.

In addition, **Marty Shenkman** is delivering two free webinars titled: Estate Planning After the 2012 (2013) Tax Relief Act-What to do Now, on Tuesday January 8th at 11 am EST, and again on Wednesday January 9th at 4pm EST. To register, click these links: Tuesday program Wednesday program

Now, here is Marty's commentary:

COMMENT:

New Year's Present. Congress bestowed upon all practitioners the lovely New Year's gift of a new tax act. Congress enacted this tax legislation as part of its effort to avert the fiscal cliff. The simple moniker for the new law, the "American Taxpayer Relief Act of 2012'' ("ATRA") belies the complex implications to the estate planning process and profession.

While the 157 pages have not been fully analyzed yet, a number of key points may be made about the impact on estate planning, bearing in mind that final legislation, interpretations, and more, are to follow. The face of estate planning has been forever changed; well, at least until it changes again.

It's a Game Changer. To facilitate the discussions following, and recognizing the risks of simplification, estate planning post-ATRA perhaps can be viewed as comprised of three categories:

- **1 - Moderate Wealth Clients**. Moderate Wealth Clients are those who perceive that the estate tax will never apply to them. The possibility and consequent fear of the imposition of estate tax - that may have been a primary driver of action in the past - is now mostly irrelevant. These are clients "safely" (whatever that means in reality, and also whatever this means in the client's perception, which measures may be light years apart) below the $5 million +/- single person exemption amount and $10 million +/- for married couples.

  As planning in the post-ATRA environment unfolds, many planning conventions of the past will be turned on their heads. Several of these situations will be discussed below. While this could have happened following the 2010 act to a degree, it did not, in part because of the perception at that time of the law's impermanence. This view may well have changed.

Hence, our planning for moderate wealth clients, numerically the vast *majority* of most practitioners' clients, will change dramatically and perhaps permanently. This may trigger profound changes in how estate planners of all stripes (attorneys, CPAs, insurance consultants, and others) practice.

These clients will assuredly continue to *need* the guidance of professional estate planners. But without the psychological action-driver of the threat of estate tax:

- What will get them in the door?
- What will they be willing to pay?
- How can practitioners cost-effectively serve these clients to maintain their business?

Planning will be fundamentally different for attorneys, insurance agents and anyone serving this large swath of "mere wealthy" clients.

- **2 - *Potentially* High Net Worth Clients**. Potentially High Net Worth Clients are those "in between" or potentially in the third category. In other words, they *might* (if not presently, certainly in the foreseeable future) be subject to an estate tax. The potentially wealthy client also includes those clients domiciled in decoupled states who will likely face a *state* estate tax.

  This category of client will be the most challenging type of client to serve. It will likely require creativity to address the *possibility* of a federal estate tax, and perhaps the certainty of a *state* estate tax, in an environment when the fear of the federal estate tax even for these "in between" clients is likely dramatically less than it has ever been.

  These clients too will need the guidance of professional estate planners. But with the fear of the federal estate tax so much less than it has ever been (remember that the exemption is not only permanent but it is also inflation indexed), the tax-driver may still motivate them, but perhaps much less so.

  As explained below, this category of "in between" clients might be quite small, not only because of wealth statistics, but because the facts and circumstances of these clients might clearly place them in either the moderate wealth or the high net worth client category for planning purposes.

- **3 - High Net Worth Clients.** Ultra-high net worth clients are those who are clearly and certainly in the range where their estates will be subject to federal estate tax. For those clients in this category, sophisticated planning will proceed as "usual" – *perhaps*! The "perhaps" as discussed below is that "usual" planning for these clients may get nipped by *future* fiscal cliff negotiations. The ATRA may prove to be only a short lived grace period to top off and perhaps expand the planning efforts consummated in 2012.

"How puzzling all these changes are! I'm never sure what I'm going to be, from one minute to another."
Lewis Carroll, Alice's Adventures in Wonderland

The real disappointment for some practitioners is that 'clawback' probably won't be the hot discussion topic at the Heckerling cocktail parties in next week. What will we all talk about?

Impact on Estate Practitioners. While all estate planners boast that their clients are primarily ultra-high net worth clients, the numbers just don't bear that out. The *reality* is that many, perhaps most, practices are dominated by the "moderate wealth" clients that, absent a tax-driver, will require education to appreciate the myriad of matters for which professional advisers can assist them. So practitioners serving this segment will likely have to educate these clients to a greater degree than ever before.

Even with education, however, the moderate wealth client will likely insist on lower costs and more simplicity then before. Practitioners whose clients are predominantly or almost entirely moderate wealth clients may need to reassess strategically which markets they wish to serve. If only a handful of clients will justify the more sophisticated tax planning techniques of the high net worth client, it may be prudent to refocus efforts and resources on the broad base of clients and their needs, rather than endeavoring to serve the very small number of remaining clients that might realistically benefit from GRATs, note sales and other more advanced planning.

Prior to ATRA many practitioners had a base of clients who wanted more sophisticated planning because of the fear of the exemption declining. For some practitioners that may no longer be the case. On the opposite side of the planning spectrum those practitioners whose clients are largely in the high net worth category may find it impractical to serve the newly more cost conscious mass of moderate wealth clients. The estate planning profession may become more specialized than it has ever been. That could have a host of profound ramifications for all.

Planning Considerations Affecting All Clients

General Planning For Many Taxpayers. Many taxpayers' *initial* reaction to the 2013 tax law is that *nothing* needs to be done. Moderately wealthy taxpayers may believe, since the federal estate tax will not apply to them, that no planning is necessary.

Wealthy taxpayers may think they completed all of their planning in 2012.

But, just like those late night TV infomercials, "But Wait, there's more!"

Some estate planning tools and techniques, and estate planning opportunities, will apply to a broad cross-section of wealthy taxpayers. These might include:

- **FLPs and LLCs**. Clients generally do not enjoy the formalities of maintaining family LLCs or partnerships (FLPs). If they view the estate tax as no longer applicable to them, moderate wealth clients might well want to dissolve these entities.

  Planning: Practitioners need to educate these clients that FLPs will continue to be vital to control assets, protect assets from creditors and irresponsible heirs, and more. Even if the federal estate tax benefits wane, these entities should remain the cornerstone of many plans.

  But given the restrictions on itemized deductions, and that the phase out is pegged at a lower income level than the maximum income tax rates, many high income taxpayers will find their personal deductions disappearing. For these taxpayers, creative and careful use of LLCs and FLPs to *shift income* (subject to the family partnership rules of IRC Sec. 704(e)) and *shift qualifying deductions* to their LLC or FLP, may provide valuable income tax benefits. Thus, LLCs and FLPs that had been intended for estate tax discounts may morph into *income* tax planning tools.

  The asset protection and control benefits of LLCs and FLPs will continue to be useful regardless of the tax changes. This will continue to make FLPs and LLCs, when properly planned for in the new tax environment, great tools for a broad cross-section of taxpayers.

- **Itemized Deductions, Residency and Domicile**. The restrictions on itemized deductions will push wealthy taxpayers who can shift their domicile and residency to a no or low tax state to do so with greater vigor. This will not only save state income taxes and property taxes for which deductions may be far more limited, but it will have a significant impact on where you should recommend the client revise and sign new estate planning documents.

- **State Estate Taxes**. With the federal estate tax now irrelevant to the vast majority of taxpayers (but don't forget to use software such as **NumberCruncher** to project inflation and long term growth in an estate before you count the federal estate tax out), and the thoughts now gone that the $5,000,000 exemption amount would be lowered, might some states re-evaluate the costs of administering state estate tax systems that were based on the assumption a much larger number of wealthy taxpayers filing returns that were subject to federal audit?

  The fact that so few estates will ever file *federal* estate tax returns for other than securing portable exemption may have a significant impact on the administration of *state* estate tax systems. With a permanent inflation adjusted exemption and portability, the number of returns that will be subjected to IRS audit will be miniscule compared to only a few years ago. Further, the portability regulations permit executors to use mere estimates. While state tax authorities may have thought the $5 million estate tax exemption was temporary, that is no longer the case.

  This will raise practical issues as to the ability of states to administer their estate tax systems without the backstop of the federal filing system. This situation will now be greatly exacerbated for the states by the fact that, with a permanent $5 million gift exemption, all that moderate wealth clients need to do to avoid or minimize state estate taxes is to make gifts prior to death (except for those clients living in a state like Connecticut which has a gift tax, and leaving aside that some states may try to tax transfers within 3 years of death).

  As presented in more detail below, for those potentially high net worth clients or those subject to state estate tax, forming a simplified low cost variant of an inter-vivos-SLAT (or a more costly DAPT for single elderly clients) may be all that is required to avoid state estate tax altogether. Thus, instead of the cost and complexity of a will with a bypass trust, the client in many cases can fund the simplified SLAT while alive, avoid what for many is the charade of pretending to live in a no-estate tax state, and legitimately avoid their home state estate tax. The combination of these factors over the years to come might well make some states consider whether their state estate tax is really beneficial to continue to administer in light of the loss of wealthy state domiciliaries, costly administration, lack of IRS backup, etc.

- **Roth Conversions**. Under prior law, there were only a limited number of times that your client could rollover a 401(k) or certain defined contribution plans into a Roth IRA. Specifically, unless your client changed jobs, retired or reached age 59 ½, rolling into a Roth was not permissible.

  This will require your client to pay current income taxes on the value of the plan rolled over, but perhaps that was the point. It may generate income tax to help the deficit.

  Why would any taxpayer undertake this type of planning? Simply because, in the right circumstances, it might be a valuable income tax saving step. If a client is considering such a conversion, likely you will want to prepare income tax projections to try to minimize rate bracket creep from the additional income.

  A meaningful advantage for some taxpayers will be that a Roth has no required minimum distributions so that the money might stay protected from creditors assuming state law protects Roth funds from claimants. For ultra-high net worth clients, especially those that are ill or elderly, rolling into a Roth and paying income tax may reduce their taxable estate.

- **<u>Asset Protection Planning</u>**. Practitioners are well aware that whatever happened in Washington, or might happen as future "cliffs" are addressed, it will have no impact on the litigious nature of our society. Clients at every wealth level need to be educated that the favorable $5 million plus exemption remains a golden opportunity to implement (or if the client started in 2012, to *continue* to implement) asset protection planning.

  Clients should be counseled *not* to dismantle existing irrevocable trusts or family partnerships or LLCs, but to instead focus on them as asset protection tools, even if the discounts no longer affect their estate planning. Use of the rules on Roth conversion noted above to convert retirement assets into Roth IRAs might aid the asset protection process by using exposed funds to pay the income tax triggered on conversion.

  Further, Roth IRAs, in contrast to regular IRAs, have no required minimum distributions, so assets can remain in what might be a protective Roth envelope for as long as the client desires. This, however, requires that applicable state law provide creditor protection for Roth IRAs.

- **<u>Divorce Protection Planning</u>**. As with asset protection benefits, clients need to be reminded, or perhaps educated, that the risk posed by the reality of a high divorce rate will not change and may be a great threat to their transmission of wealth down the generational line.

  Too many moderate wealth taxpayers will fall into the "Gee, I can get a simple will," attitude because "I won't face an estate tax." But the 50% oft quoted divorce rate can decimate an estate to a more significant degree than a top 40% estate tax rate. And, unlike the estate tax, the divorce courts won't give your client's heirs the first $5 million plus free of claims. There is no divorce "exemption." *All* assets might be at risk.

  So, regardless of whether estate taxes will ever be a concern, clients need to be counseled that they should almost assuredly use similar trust planning that perhaps they had used primarily for estate tax minimization, for heirs to protect their assets from the ravages of divorce. The reality, however, will be that many clients will want less costly and less complex versions of the trust planning practitioners have heretofore offered. See the discussions below concerning termination of trusts.

- **<u>Income Tax Planning for Most Income Taxpayers</u>**. For most taxpayers, the new tax law effectively eliminates the worries they had about becoming ensnared by the Alternative Minimum Tax ("AMT"). It also makes permanent the tax cuts enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") and the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA"). This means, for most Americans, the prior tax rate brackets of 10%, 15%, 25%, 28%, 33% and 35% remain. But higher marginal rates will likely apply to those clients most estate planners tend to serve, even perhaps moderate wealth clients.

  With the perceived permanency of the $5 million (inflation adjusted) exemption, most taxpayers will fare better *not* to make gifts. Instead, they should consider retaining assets in their own names in order to obtain a step up in basis for their heirs, even for what might remain historically low income tax rates. For wealthier taxpayers, the income tax planning implications are significant, and there are a host of estate planning implications. Will funding a SLAT to avoid state estate tax, help realize a tax savings at perhaps a 12% rate while subjecting appreciation to a higher capital gains rate for heirs? Will no planning provide a better net tax result?

<u>1 - Moderate Wealth Clients</u>

<u>Educating Moderate Wealth Clients</u>. Many more clients will simply view the estate planning process as perfunctory, perhaps something to address with a low cost website. Many moderate wealth clients may well believe the use of a professional estate planner's services is no longer relevant because they are safely under the permanent $5 million inflation adjusted exemption amount.

Practitioners need to educate these clients to think again.

- **Fear Factor**. While practitioners are well aware that estate planning *never* was *only* about federal estate taxes, the tax "hook" has always been the best marketing tool. And with a real fear of a $1 million exemption and 55% rate for 2013 a tidal wave of clients barraged practitioners of all stripes seeking guidance before they had to again watch Kathy Griffin and Anderson Cooper bring in the 2013 New Year. Much of the late 2012 deluge was pure fear by those clients who had neglected planning for years. But that fear has undoubtedly abated, and the worry of a lower exemption subjecting the moderate wealth client to estate tax is unlikely to be a motivating factor in the current environment, and perhaps never again.
- **Non-Tax Planning**. Practitioners need to reassert themselves and educate the moderate wealth clients as to the myriad of benefits a proper estate plan can afford: asset protection, succession planning, insurance and retirement planning, and much more. Even absent a federal estate tax, these issues remain relevant.
- **Moderate Wealth Planning Is Different**. For moderate wealth taxpayers, the good news is that the focus of planning can now more securely be on those issues. The bottom line for every client is that *now* is the time to act, but how clients should do so has be decisively and perhaps permanently affected by the recent tax legislation and in ways that might be quite different for moderate wealth clients as contrasted with high net worth clients.

Planning Steps for Moderate Wealth Clients. For those clients who are moderately wealthy, their perception might be that the $5 million exemption permanently makes the confiscatory estate tax a worry of the past. The combination of the $5 million estate tax exemption, inflation indexing, and the ability of spouses to use their deceased spouse's exemption under the portability rules, so long as they all remain law *does* in fact make *federal* estate tax worries academic for the vast majority of taxpayers.

While practitioners might be suspect of the permanence of any estate tax law, including the new $5 million exemption, if clients do perceive it as permanent, the planning landscape will have changed more dramatically than in 2012 when the large exemption was first enacted. The reinstatement of the $5 million exemption does seem to reinforce it as a likely permanent fixture to clients. So the worries that sometimes had moderate wealth clients planning until now have likely dissipated.

While plenty of other planning worries remain, and although practitioners fully understand that estate planning is just as important for moderate wealth clients as ever, clients may not feel this way. Again, educating the moderate wealth clients on the value added, and proactive planning steps, may be critical to retaining this market segment.

- **Review and Revise**. The prudent step for most moderate wealth clients is for them to re-evaluate their estate plans and documents. Since the estate tax exemption remains at $5 million, to be indexed for inflation, most moderate wealth clients will remain below the federal tax threshold. The reality is that many of these moderate wealth clients have been perennial fence sitters, reluctant to spend the money to update planning and documents because of the concern that yet another change in the law might make obsolete work they just paid for. That concern may be over. So even with a likely indifference to federal estate tax worries, many moderate wealth clients may come forward to update documents they know have been outdated for years. It is important to use these will/revocable trust update meetings to emphasize the myriad of *other* planning issues the client should address to help the client understand the value-added of a professional adviser.

- **Will Update**. While the obvious message to communicate to these clients is to update their documents and planning to address current drafting and law, more has to be done. Practitioners should guide the moderate wealth client not to forget the lessons of the estate tax roller coaster ride of the past few years: draft and plan flexibly. What if the exemption changes or *state* estate tax laws change?

  Many moderate wealth clients have wills that are five, ten or even more years old. Many of these were planned and drafted when exemption amounts were much lower and some may result in assets being distributed under old wills and revocable trusts far different then clients imagined. While there was extensive discussion of this issue after the 2010 tax act, many clients have still done nothing to update their documents. Illustrating the unintended results may help clients understand the need for more regular reviews and flexible drafting.

- **2012 Buyer's Remorse**. A client worth $4 million that feared the $1 million exemption that might have reoccurred in 2013 may now be feeling regret over having made significant 2012 gifts. This is in some ways similar to the issues that arose for clients that made taxable gifts in 2010 fearing higher rates in 2011.

  What can be done if a client is unhappy about a gift because the exemption remains high? Educate the client. If the client lives in a decoupled state, avoiding state estate taxes, especially for an elderly or ill client, may have been the primary tax motivation for the plan so that the permanency of the $5 million exemption has no impact. In these instances the planning was and remains appropriate and any buyer's remorse is simply misplaced. All clients exhibiting buyer's remorse should be reminded that the return of inflation, increasing longevity, and other factors could all work to make 2012 planning prove valuable. The inflation in the value of a residential property in New York City may dramatically exceed any inflation indexing of the $5 million exemption amount. The growth in the value of a family business or real estate operation may not only exceed the inflation adjustment to the $5 million exemption, but absent the 30%+ discounts and appraisal assumptions, the estate tax value of the business interest may have been dramatically greater had the planning not been consummated. However, the fact that the $5 million exemption is inflation adjusted might deflate this analysis for some clients, maybe. The stock market has historically over the long term grown faster than inflation. So a client with a meaningful portion of their estate invested in a diversified equity portfolio will over time have that portfolio grow faster than inflation, and hence faster than the inflation adjustments to the $5 million exemption. The combination of market performance and increasing longevity will potentially, given enough time, subject many who today have buyer's remorse, to an estate tax.

  Further, no one knows which way the fickle political tax winds will blow in the future, why dismantle a plan that is in place? It may not have been coincidence that on New Year's Eve CNN coverage bounced from interviews of Honey Boo Boo to updates on Congressional fiscal cliff matters.

  If the client attempts through disclaimers or other mechanisms to unwind a 2012 transfer, must the "unwound" transfer be reported on a gift tax return? Does it become a non-transfer that somehow avoids reporting?

  There are other ways to skin the buyer's remorse cat. If the trust was a

SLAT or DAPT, the client might be able to push for more distributions to remove assets from the now no longer desired trust. But that would certainly undermine asset protection, state estate tax minimization, and other benefits. Perhaps reassurance of the ability to appropriately access resources in the trust might suffice. If the asset transferred to the trust is now desired to be held by the client because the client no longer views the trust as worthwhile post-ATRA, the trust might loan some or all of the assets back to the client with a note at the current low interest rates. This could conceivably give the client the ability to garner the returns on the asset, e.g. a closely held business, and merely owe the value (based on the recent appraisal used to consummate the gift in 2012) and interest at a modest rate back to the trust. There is a risk with a gift-loan/leaseback that the IRS may argue that the initial gift was incomplete or otherwise a sham based on the implied agreement to loan the assets "given" back.

It is also important to explain again to the client that most sophisticated trust plans provide a range of valuable benefits, which are in addition to federal estate tax benefits. The odds are that many client plans remain worthwhile. Perhaps the flexibility of many trusts, the use of disclaimers, some of the options on gift tax return decisions, etc., may all afford opportunities to adjust planning that your client is not as comfortable with as they initially thought (or as they now think with the reality of a $5 million not $1 million exemption). This should be addressed as early as possible in 2013.

- **Insurance Generally**. While many of these clients had purchased life insurance in the past to cover estate taxes, that driver may be forever gone. So for this largest category of client, even if insurance to fund federal estate taxes will no longer be relevant, that same insurance may be recast to fund state estate taxes, serve investment and retirement needs, minimize current income taxes, and other purposes. The same product might ultimately be purchased (or retained) but the decision path to that result may be quite different than what it historically had been.
- **Trust Owned Life Insurance ("TOLI")**. If a moderate wealth client has owned life insurance for the purpose of paying an estate tax his/her estate may never face, caution the client not to merely cancel the policy before having it evaluated. A good policy might make sense to retain as a ballast against other investments the client holds, or to secure other benefits. If that policy is held in an irrevocable life insurance trust, after the client has the policy itself reviewed, practitioners should then review the trust itself. Sometimes, even with one of those funky old trusts, there is sufficient flexibility to facilitate your remaking a plan that was intended to pay estate tax into a new and more robust planning tool. There may be options the trustee or a trust protector can exercise, the possibility of decanting, and more.
- **Pension Owned Life Insurance**. If your client held life insurance inside a pension plan, you may have counseled the client to remove the policy because of the adverse estate tax consequences. However, if the client's estate is safely below the new estate tax exemption, it may no longer matter. In fact it might become de rigueur to use this approach to planning, especially for moderate wealth married couples with $10 million + of portable exemption.

- **ILITs and Crummey Powers**. While all of *your* clients have undoubtedly completed every Crummey power requirement religiously since the inception of their trusts, that is actually *not* the reality for most clients, or the experience of most practitioners. However, as simple we as practitioners view the process of filling in a number and date on a ½ page Crummey power form and having the kids sign it, Crummey powers have proved daunting to most mere non-professionals.

  Might it now become practical to actually draft ILITs *without* Crummey powers? For clients with moderate wealth estates, why burden them with annual homework they don't want to do and too often don't handle properly if at all? While practitioners might have such a client sign off acknowledging that the ILIT won't include Crummey powers and that a gift tax return will be required each year to allocate exemption since the trust won't qualify, is that really unreasonable for a $2 million estate? What about for a married couple with a $5 million estate inclusive of insurance? Perhaps there is another alternative that very few practitioners would have proffered prior to ATRA, but may be the practical (although certainly not the technically optimal) approach post-ATRA. Consider having beneficiaries sign a one-time statement waiving the right to future Crummey powers.

The alternative which no doubt many will follow is to draft ILITs as practitioners have always drafted them, inclusive of an annual demand power mechanism. But if clients were lax before the ATRA, how much compliance will there be for a client of moderate wealth post-ATRA? Also, if the client really does not feel comfortable with the demand powers, perhaps the children who are beneficiaries have issues, why include them? But if they are included, they do provide real rights to the beneficiaries. If the annual notices mandated by the trust are not given, what potential issues might that create apart from gift tax issues? What liability for the trustee? Is it really doing the moderate wealth client a favor to include complex Crummey powers that won't be used?

What about existing ILITs? If your client has an old insurance trust, it undoubtedly has annual demand (so called "Crummey" powers) that make the gifts to the trust qualify for the annual gift tax exclusion. If the client's estate, inclusive of insurance and likely future appreciation, will remain safely below the newly perceived permanent tax threshold, your client might not want to bother continuing to have the trustee issue these annual notices. If you are representing the trustee, it would not be appropriate to counsel him or her to simply ignore the notices required by the trust agreement as he or she has a fiduciary responsibility to carry out the terms of the trust. Might the advice to your client, the grantor, be different? If the mandated notices are ignored, might that raise an issue if the ILIT is challenged by a claimant or divorcing spouse? Might ignoring its terms undermine that protection?

Perhaps the client, with appropriate cautionary advice from counsel, might choose to have the beneficiaries of the existing ILIT sign a written acknowledgment waiving future Crummey notices. Even if such a waiver is insufficient for gift tax purposes, it might suffice to protect a trustee and demonstrate that the formalities of the trust were reasonably respected. The moderate wealth client may not care about the gift tax risk and gladly sign off on any indemnification letter for the practitioner. While no practitioner would willingly choose to practice in such a "loose" manner, is it really appropriate to insist on a client adhering to a provision that in the client's view is unlikely to have any meaningful consequence, and which felt to be nothing but a nuisance?

- **Irrevocable Trusts Generally**. Clients should be encouraged to evaluate any existing irrevocable trusts. If your client has an old trust, for example for children or grandchildren to hold annual gifts, with the possible permanency of the $5 million plus exemption, these may no longer be needed for estate tax purposes. The client might choose to forgo annual gifts since there may no longer be an estate tax benefit, in fact there may be an income tax detriment from the loss in basis step up on future gifts. These clients might well wish to simply cancel the trust and distribute the funds.

  Counsel such clients to consider the impact of an outright distribution if their heirs/beneficiaries divorce or are not financially mature and responsible. If you are representing the trustee, caution against the potential claims of beneficiaries if the trust is simply closed in violation of the terms of the governing instrument.

The bottom line is that all irrevocable trusts, just like the insurance trusts discussed in the preceding section, should be reviewed in light of the new estate tax paradigm. Determine how they can be modified, or even eliminated, to provide appropriate clients the best results consistent with their current wishes. Some irrevocable trusts may permit an independent trustee to distribute “so much, or all of, the principal….” This type of clause may suffice to distribute the trust to current beneficiaries and terminate the trust.

Caution, however, is still in order. What of contingent or other beneficiaries? Will terminating a trust that is no longer needed to address estate tax issues simply put those assets in harm’s way in the event of a recipient beneficiary’s being sued? There may be other options, such as decanting, to clean up an old trust and revitalize it.

- **Amend Durable Powers**. For the moderate wealth client, the standard planning technique before acronym planning (i.e., FLPs, GRATs, IDITs, etc.) became the norm was to make annual gifts. With the gift exemption growing to $14,000 per donee per year, for many moderate sized estates that may be just what the tax doctor ordered. However, many durable powers are long outdated some with smaller caps, rather than inflation adjusting references to the annual gift exclusion. Many clients have put off planning for years (many for more than a decade) waiting for certainty. When those plans and documents are updated the gift provisions should also be updated. Also consider the discussion below for potentially high net worth clients using SLATs to make state estate taxes an optional cost.
- **QPRTs**. If your client created a QPRT when the estate tax exemption was $2 million, and now with a permanent inflation adjusted $5 million exemption will never be subject to estate tax, perhaps on the termination of the QPRT term, the opposite advice of what you have customarily given might be appropriate under the new estate tax paradigm. Conventional advice would be to deed the house from the QPRT to the children or a remainder trust (which might well have been structured as a grantor trust for further tax burn that is no longer needed). Then that successor in interest would execute a written lease agreement with the parent/donor who typically would want to continue to live in the house. Likely you would advise the children or trustee to secure a written estimate of the fair rent for the property from at least a real estate broker, if not from an MAI certified appraiser.

  But alas, at this point properly carrying out the QPRT plan might assure that the house will not be included in the donor/parent’s estate, won’t achieve a step up in tax basis, and the estate tax savings will be nil under the now permanent $5 million exemption. What if, like Alice in Wonderland, all the opposite were not preferable for the client? Perhaps after the QPRT term ends, no lease should be signed and no rent paid. Arguably the house should be included in the parent’s estate and subject to estate tax (which won’t be imposed in the case of a moderate wealth client - state estate tax aside) and a basis step up on death could be realized.

“What a strange world we live in...Said Alice to the Queen of hearts”

Lewis Carroll, Alice in Wonderland

- **Embrace 2036**. The FLP or FLLC that was formed years ago really provides asset protection, divorce protection, organized management, investment economies of scale, and so forth. It provides every advertised benefit, but for one, estate tax savings. Dismantling the FLP may be foolhardy as it would undermine these many important non-estate tax benefits. Under the post-ATRA tax environment, there may even be some potential to secure some tax deductions that would not otherwise be allowed, and perhaps family income shifting, as discussed above.

  But the primary purpose for having set up the FLP (oops, one of the many important reasons for having set up the FLP) was estate tax savings. Now the estate tax savings is moot. Instead, a loss of basis step up could prove very detrimental in light of the new capital gains and Medicare tax structure. Perhaps revising the partnership or operating agreement, having the parent document certain controls over the FLP, will all serve to trigger Code Section 2036 and include the parent's FLP interest in the parent's estate. Then, via a Code Section 754 election, the heirs will receive a step up in tax basis.

- **Grantor Trust Déjà Vu**. Practitioners are well familiar with the tax benefits of grantor trusts and the estate tax burn it can create. This planning mechanism was created by flipping on its head the income tax Code provisions initially intended to prevent income shifting from high to low bracket taxpayers long ago. The concept of applying 2036 proactively to include assets in the estate of a client not subject to estate tax, and to thereby obtain a step up in income tax basis, is really no different than what we've all done with the grantor trust rules. So the new post-ATRA estate tax regime will likely be punctuated by similar inverse planning for clients well below the estate threshold. This will require creative and "out of the box" thinking, not mere application of prior planning concepts and methodologies. In addition, while it has been "conventional" wisdom to make a trust a grantor trust so the trust can grow free of income tax because the income of the trust is attributed to the grantor, it may be appropriate to reconsider that: it may be preferable for a trust not to be a grantor trust if, as a separate income taxpayer, it would face lower overall income taxes on the income it earns than would the grantor.

2 - Potentially High Net Worth Clients and Clients in Decoupled States

For clients that are not in the snare of the estate tax, but who might be, or who face a state estate tax in a decoupled state, planning will certainly be advisable. However, that planning may not take the form of planning pre-ATRA. Recognizing that this category is a "catch-all" and that some clients in this category should plan no different than the high net worth client, while for others, the moderate wealth planning approaches may be all that is tolerable.

The differentiation will often be obvious. A client in the "potentially high net worth" category who is in her 50s with a growing closely held business interest probably should be address planning no differently than those clients already firmly within the grasp of the estate tax post-ATRA. On the other hand, a widower in his late 80s with a $9 million estate and a $5 million + portable exemption from his deceased wife, if not residing in a decoupled state (does anyone have an older NY client that is *not* living in Florida?), would more likely insist on planning like a moderate wealth client above. So the actual number of "in between" clients might be relatively modest.

With the reduced fear of the estate tax, even these clients will likely demand greater simplicity. Efficiency and creativity may be a prerequisite to getting these clients to move forward on "modified planning." Clients have never been comfortable with the costs, and perhaps even more so, the complexity, of estate tax planning. With the reduction in the tax-fear as a driver, they may prove less willing to accept the complexity and costs. Practitioners will be challenged to implement planning that remains palatable to these clients, achieves client planning goals, and yet remains profitable to the practitioners.

- **Life Insurance May Lead the Way**. These clients may find that life insurance planning, which may be viewed as less costly and complex then some of the other planning acronyms (GRATs, DAPTs, SLATs, etc.) is relatively more enticing. This may be enhanced by the income tax benefits of permanent insurance in light of the new higher income taxes, capital gains rates and Medicare tax on passive income.

Potentially high net worth clients who are no longer in great fear of the estate tax, may well appreciate and be able to dollarize the potential income tax savings of the cash free build up inside a quality life insurance policy. Combined with the old standby of an ILIT, it can be used to address estate taxes as well. Only a few years ago a couple with a net worth approaching $10 million may have been willing to undertake a bevy of estate planning techniques. The well funded ILIT could provide, comparatively speaking, a simpler and less costly planning approach, hotly desired income tax benefits, and an estate tax savings "just in case it is needed." It might make more sense for these clients to structure their insurance plan as permanent insurance on a single life with the spouse as a beneficiary of the trust being in a position to benefit from the cash value of the policy if the trustee should access it. Thus, the plan can provide an inflation hedge, but also income tax benefits and financial/retirement planning options. In fact, if the ILIT is structured to serve the same objectives as an inter-vivos SLAT to which gifts can be made to avoid state estate tax, and possible federal estate tax if the estate grows, then perhaps a single trust can serve both purposes. This may in fact be the template for planning for many in the potentially high net worth category. This single trust could hold gifts and life insurance and would not be dissimilar to the ILIT of pre-ATRA days, although structuring such a trust in a more sophisticated manner with a situs in a jurisdiction with favorable trust laws, may be preferable.

- **Bypass Trusts**. While practitioners across the board may regale the benefits of using a bypass trust in lieu of relying on portability, it will be a much harder sell. Assume a married couple living in a decoupled state with a $1 million exemption. The combined estate is $8 million. One option which many would recommend is to fund a $1 million state exemption level bypass trust with the balance into a QTIP trust to which GST exemption should be allocated.

  While many clients accepted this type of planning in the past, in part that decision may have been the fear of what Washington would do next to the estate tax. But since we now have for the first time in more than a decade a "permanent" exemption (no matter how skeptical some might be that any tax provision is ever permanent), will the client accept the cost of such planning and the complexity? It is not only the complexity of "getting his or her head around" the bypass/QTIP trust plan, but the complexity and administrative cost the client may well perceive this creates for his or her surviving spouse. In contrast, if the client simply leaves all assets outright, there will be a greater state estate tax on the second death if the bypass trust is forgone on the first death. But proportionately, on an $8 million estate, the state estate tax savings on the $1 million state bypass trust is not a material amount. Also, the step up in income tax basis with the new higher capital gains rate and the Medicare tax on passive investment income, might make the non-plan a more advantageous plan (i.e., the benefits of basis step up on the amount that would have been in the bypass trust outweigh the state estate tax savings of using the bypass trust).

  But, there may be a better way. However, it is a different approach than what has historically been done, and will require an education process for the "potentially high net worth client" to accept.

- **Are Testamentary Bypass Trusts Passé**? Using bypass trust planning has been nearly ubiquitous in estate planning. But that might just change. While every practitioner can recite in his or her sleep the benefits of using a bypass trust over relying on portability, under the new paradigm, that may be the wrong discussion. Continue with the same example from above. The client may well view that as not worth the cost of the "hassle" involved in establishing and maintaining a testamentary bypass trust. And for all the effort and cost, it will only save state estate tax on $1 million. Hardly an optimal investment. More importantly, with a permanent $5 million gift exemption, a gift to an inter-vivos SLAT may provide potentially much greater state estate tax savings by applying a similar planning concept. Remember, we all recommended bypass trusts in part because portability was not permanent and neither was the exemption amount. So now, perhaps a new planning model will develop – a much simpler will, *without* a bypass trust, and a lifetime gift to a SLAT. And if that SLAT doubles as the insurance trust that still makes sense to use, there is really little if any incremental cost or administrative work.

In the end, the testamentary bypass trust will require the funding of a trust at death, a point in time when the spouse may prefer that the surviving spouse not be forced to deal with new complexities, an income tax return will have to be filed for the bypass trust, and new accounts opened. All to save state estate tax on $1 million? Creating that structure today in the form of a SLAT prevents the newly widowed spouse from having to deal with complexity at the emotional nadir of his or her life. More significant, the use of a SLAT has the potential to make far more meaningful inroads in reducing the state estate tax, *and* it provides the added benefit of asset protection during lifetime. Clients will need that non-estate-tax benefit to bite at the SLAT planning apple.

There are several options that might be presented to such a client under the new estate tax paradigm, ranging from the simplest and least costly to more sophisticated and costly, depending on the client's evaluation of the incremental benefits afforded. All of these however, may well make state estate tax (with the exception of a state like Connecticut which as a gift tax) a purely optional tax. The standard plan of yesterday, bypass to state exemption/QTIP (which may likely remain in many wills and revocable trusts in any event) may give way to the new standard plan of non-reciprocal SLAT/ILITs for all assets above the state exemption. Gee, maybe a few clients will "move back" *from* Florida!

- **Simple SLAT**. A SLAT could be formed in the client's home state with the spouse and another family member or friend as co-trustees. This would avoid the cost of an institutional trustee, the incremental (whether real or perceived) complexity of creating a trust in a different state (e.g., a state with more friendly trust laws than the client's home state), and provide easy access to trust assets if the spouse is granted a power to distributed pursuant to an ascertainable standard. If such a trust were completed with document generation software, with limited tailoring (i.e., keeping the plan as simple as feasible) the cost of this approach may well be evaluated by the client as worthwhile compared to just the state estate tax savings. Considering the asset protection and other benefits even this simplified version of the SLAT may be "icing on the cake" to the client in their cost benefit analysis.
- **Non-Reciprocal Simple SLATs**. If the clients wish to hedge their bets or expand the value of assets removed from the state estate tax both spouses could create SLATs and the respective trusts could be structured in a manner that minimizes the risks of the reciprocal trust doctrine.
- **Complex SLAT**. A SLAT could be formed in a trust friendly state, e.g. Delaware, South Dakota, Alaska or Nevada with an institutional trustee to provide professional administration, trust management and nexus to the trust friendly state. While this would incur additional costs and complexity, these can be well worthwhile to maximize GST and asset protection benefits. Further, the formation of the trust in a jurisdiction that permits self-settled trusts may provide an important safeguard in the event the settlor spouse's benefits might give rise to an IRS or creditor challenge, or in the event that the beneficiary spouse inadvertently contributed assets to the trust.

  For clients in the "potentially high net worth" category, like the young entrepreneur used in a prior example, the costs of the more sophisticated SLAT may be worthwhile. Certainly, for example, if the client involved is a physician who is quite concerned about malpractice risks, upping the caliber of the trust from the simple to the complex would be objectively worthwhile to provide better asset protection. Also, as noted above if this SLAT doubles as the ILIT needed in any event, the incremental cost may be modest. Like the old Doublemint commercial, you get two trusts in one!

In these instances, even without the fear of estate tax, the divorce and malpractice concerns of the client may justify the incremental cost and complexity. But it is likely that many clients, absent this extraneous factor (e.g., malpractice worries) will opt for the simpler and cheaper of options.

- **Non-Reciprocal Complex SLATs**. If the clients wish to hedge their bets or expand the value of assets removed from the state estate tax, and potential federal estate tax, both spouses could create SLATs and the respective trusts could be structured in a sophisticated manner in a trust friendly state, minimizing the risks of the reciprocal trust doctrine.
- **SLATs with Appointment Back**. In some instances, especially if only one SLAT is to be established, the risk of premature death of the beneficiary spouse, might possibly be addressed through a creative application of powers of appointments. For example, if Husband established an inter-vivos bypass trust for Wife, then Wife could be given a broad special power of appointment to designate who, following her death, can benefit from the property in the trust. This power of appointment is limited so as not to cause the trust assets to be included in Wife's estate. Wife could designate a class of beneficiaries that includes Husband as a limited beneficiary of that trust following her death. While there is a creditor and estate tax inclusion risk using this approach, forming the trust in a state that permits self-settled trusts may lessen that risk. However, the client may well view that risk as tolerable if the only estate inclusion risk is for state estate tax purposes.
- **DAPT for Single Elderly Client**. The SLAT plans above might make state estate taxes optional for married couples. But what about an elderly single client? The elderly client, if education can make them sufficiently comfortable, can gift all assets above the state exemption amount (recognizing that the calculations may result in some instances in a small state tax in any event) to a self-settled trust. The client could receive distributions in the discretion of the trustee.

  Might there be exposure to an IRS argument that there is an implied agreement between the trustee and the grantor causing estate tax inclusion? First, there is no assurance that the IRS will prove victorious in such an assertion. Also, some planning as to how distributions are made can perhaps reduce the risk of such a challenge succeeding. But for many clients whose only concern is a state estate tax, will they care? If the client is unlikely to ever face a federal estate tax, will their concerns be the same as pre-ATRA? What's the downside? This type of planning can be presented with a simple cost benefit analysis to the client. It will cost $X to prepare a simplified self-settled trust. It will cost $Y/year for trustee fees. Assume the client anticipated living five years. The potential state estate tax savings can be estimated and compared with the costs of the plan being implemented and administered. On a scaled down version this is similar to the same tax-fear analysis that pre-ATRA motivated clients to engage in planning, only on a reduce scale. Is this viable? Again, using technology, drafting software, efficient firm operations, and a cost effective trust arrangements (either a low cost administrative trustee or a full trustee for whom the cost of actively managing assets inside a self-settled Delaware or Alaska trust is not materially greater than the management fee the client is already paying) can make this a relatively cost effective option for some single clients worried only about state estate tax. See Steve Leimberg's Asset Protection Planning Email Newsletter - Archive Message #215, 06-Dec-12, Marty Shenkman & Gideon Rothschild: “Self-Settled Trust Planning in the Aftermath of the Rush University Case.”

- **Power of Attorney Funded SLAT/DAPT**. For clients using a SLAT plan, especially those residing in states that have decoupled from the federal estate tax, it can be structured as a bit of a “wait and see” plan. The client might fund the SLAT with $1 million today, and plan on gifting additional assets to the SLAT in the future, and prior to death (with the exception of Connecticut which has a gift tax).

  For these clients adding an express provision to their durable power of attorney authorizing gifts up to the client’s remaining estate tax exemption (and, perhaps, which will not trigger a gift tax) might be advisable. In this manner, if the client should become disabled before making the transfer, the agent under the durable power can complete the trust funding and endeavor to save state estate tax even if the client himself or herself cannot do so.

3 – ULTRA High Net Worth Clients

Educating Ultra-High Net Worth Clients. For wealthier taxpayers, a very different education process is in order than for moderate wealth clients. Many may believe that they’ve finished any planning they needed in 2012. If they don’t think that today, they might well think that when they receive all the professional bills for their late 2012 planning extravaganza.

High net worth taxpayers need to be educated to the fact that there are more “fiscal cliffs” coming up and Congress will have to deal with other aspects of deficit reduction. Any of these options could further impact estate planning for the ultra-wealthy. It would take little to enact restrictions on GRAT, discounts, GST allocations and other planning benefits.

The CNN sound bites won’t be able to capture the potential loss of these tools and techniques and it’s hard to imagine with all the acrimony that there will be any positive sentiment for the ultra-wealthy taxpayers losing grantor trust status. The ultra-wealthy client needs to be educated that the ATRA has given them a bit of breathing room, a sort of grace period, on planning, but they should not squander it.

Planning Steps for Ultra-High Net Worth Taxpayers. The $5 million plus exemption is positive news. But relative to the size of the ultra-high net worth client’s estate, the $3.5 million exemption initially proposed by President Obama, compared to the $5 million compromise made permanent by the ATRA, may not be significant. The 40% maximum tax rate is higher than 2012, but much lower than it could have been. That is great news to many.

But a 40% rate can still decimate the estate of the owner of a closely held business, or undermine wealth accumulation goals. In short, what most taxpayers herald as a taxpayer’s estate tax bonanza for the ATRA, remains a significant worry for the ultra-high net worth client. The perspective for the different level of estate owners is totally opposite. For the moderate wealth client, the permanence of the inflation adjusted exemption amount may be interpreted as the end of estate tax worries. For the ultra-high net worth client, that same permanent system may really cement the idea that the hopes for estate tax *repeal* are gone. For these clients ATRA may cement their fear of the estate tax. Action is in order.

- **<u>It Ain't Over</u>**. With Congress having more bites at the tax apple in coming rounds of deficit reduction negotiations, those with ultra-high net worth that think they can breathe a sigh of relief, should be cautioned to think more carefully. Restrictions on grantor retained annuity trusts ("GRATs"), valuation discounts, GST exemption allocations, and perhaps even on excluding grantor trusts from the grantor's estate, may all be up for grabs in future legislation. The fact that these matters appear not to have been addressed in the current legislation may only be due to time constraints. These could all show revenue additions to the federal budget as part of future deficit reduction activities. Given that the estate tax exemption is now an inflation indexed $5 million, doubled for married couples because of portability, there may be little resistance to these changes as they will only affect a tiny fraction of the wealthiest Americans.
- **<u>Finish a Good Thing</u>**. Consider "topping" off gifts to GST exempt grantor trusts that your client started in 2012 (or prior years). Many of these trust plans fell short of the $5 million gift goal because time was too limited to complete all desired transfers. Use the recent legislation as a reprieve to help clients complete the transfers of as much as they can to their trusts.
- **<u>Swap Now</u>**. Some clients in order to complete planning funded 2012 trusts with assets that may have already been appraised, or liquid assets that did not require an appraisal. The thought was "fund the trust in 2012 in case the exemption dropped and other changes were legislated and swap those assets out for the intended hard-to-value assets the client wanted held in the trust."

  These swaps should be done as quickly as possible. While no one can predict what coming rounds of fiscal cliff legislation may bring, what if restrictions are made on grantor trusts established in the future? Depending on the wording of future restrictions, such changes, if enacted, might subject existing trusts to new more restrictive estate inclusion rules – particularly if the valuations are incorrect. On the other hand, if the swap is completed *before* any restrictions are enacted on grantor trusts (if there are, in fact, any so enacted) it may be safer.
- **<u>Plan Before the Next Adverse Tax Change</u>**. Take advantage of this current window of opportunity to consummate note sale transactions and other steps to shift greater future values into protective trusts, and freeze the value of the client's remaining estate while it is still feasible. The 40% marginal estate tax rate is very high, and if your client's estate is, or will be, well in excess of the $5 million inflation adjusted exemption, you should encourage the client to take maximum advantage of sophisticated estate freeze techniques before Washington deficit cutters attack them.

  If a client completed sophisticated trust planning in 2012, the estate planning infrastructure may already be in place to complete more planning with relatively modest cost and effort. If an irrevocable trust was created in 2012 as a grantor trust in one of the states with favorable trust laws, that may be just what is needed to complete a note sale transaction, or perhaps an additional sales transaction if a sale transaction was completed in 2012. If the client contracted for appraisals in 2012 and if the client consummates additional transfers of the same assets (e.g., selling interests in a business that was appraised in 2012 for purposes of making a $5 million gift in 2012) the client might be able to use the same appraisal report to support a large note sale transaction if done early enough in 2013. If the same trust and same appraisal can be used, and if the 2012 gift provides adequate seed assets for the trust (believing that estate planning Chimera to be real) so that guarantees and other support is not deemed necessary, consummating a note sale may truly be a relatively palatable endeavor. See, Shenkman "Role of Guarantees and Seed Gifts in Family Installment Sales," Estate Planning

Magazine, November 2010, page 3.

- **Bypass Trusts and Title To Assets**. As noted above, practitioners reflexively tell clients to divide assets to facilitate the funding of bypass trusts. But for the first time, large numbers of wealthy clients have used up most or all of their exemptions. So this mainstay of the initial consultation discussion may not always be correct.

  Now a more thoughtful discussion of who should own assets and how they should be titled for purposes other than funding bypass trusts might be relevant. While many clients might just opt to leave remaining assets in one spouse's name (e.g., the spouse who has not used his or her exemption if the other one has), that may not be ideal given the growing issues of identity theft. So splitting assets into each spouse's name might still be good advice, but the explanation and rationale may differ for many. Even the use of bypass trusts in wills might require a somewhat different discussion. While practitioners might be loath to eliminate bypass trusts because of the indexing of the exemption amount and the desire for flexibility, perhaps a different drafting approach might be warranted for some clients that have exhausted existing exemptions in their 2012 planning or for clients in decoupled states whose bypass trusts are capped at a much lower amount, e.g. $1 million. Is it really beneficial to mandate the funding of a bypass trust that might be so small as to be uneconomical for some now moderate wealth clients to bother with?

  Perhaps the language in wills and revocable trusts should be revised for clients that have used much of their exemptions to give great latitude to the trustee of the bypass trust to simply distribute the funds outright to the beneficiaries of the trust and *not* fund the trust. Perhaps disclaimer bypass trusts would make more sense for these clients than bypass trusts that are automatically funded. That way the inflation adjustment that will grow in future years can be flexibly planned for after death.

  In the "old days" for a modest estate, it might have been common to have an outright marital and permit funding of a bypass trust by disclaimer. Perhaps for wealthy clients with limited or no exemption remaining the opposite might now make sense, a marital trust with an outright bypass disposition to heirs other than the surviving spouse. Clients with two $5 million non-reciprocal SLATs may hardly want to fund the $120,000 plus the exemption inflation adjustment and create more irrevocable trusts. See the discussion above "Are Bypass Trusts Passé."

- **GRATs**. The focus in 2012 was using exemption that might have been lost and locking in long term GST allocations and grantor trust status before these planning gems were legislated away. For most clients, unless these benefits were secured, GRATs really were suboptimal. Now, however, for clients that have maximized these benefits in their 2012 planning, it might be quite advantageous to revisit the idea of GRATs to lock in additional gift transfers before future "cliff legislation" brings back the frequently talked about 10 year GRAT and other limitations.

- **ILITs.** While the ILIT might need to be revamped in a more simplified user friendly fashion for the moderate wealth client as discussed above, for the ultra-high net worth clients insurance trusts remain a keystone of many plans. While it might be hard to fathom, there are actually many ultra-high net worth clients that remain ILIT-less. Many of these clients were finally pushed into planning by the 2012 year end estate tax fears. But with the focus on using $5 million gift exemptions before they might have disappeared, the old standard of an ILIT may not have been addressed.

  Now is a great opportunity to circle back to those clients and assure that they have addressed core insurance trust planning. While many of the more sophisticated 2012 acronym trusts (SLAT, DAPT, IDIT, etc.) might have included insurance provisions and even independent life insurance trustees, many practitioners might still prefer the simplicity and what they view as the security of a more typical separate ILIT. Given the pending future fiscal cliff negotiations, it might be prudent for any ultra-high net worth clients that don't yet have ILITs to put them into place and make initial gifts to them, even if they don't purchase insurance immediately. In this way, grantor trust status and GST exemption may be secured before the rules are changed.

Even clients that did extensive 2012 gift planning may have left a small cushion of unused exemption on the table. That, and the 2013 inflation increase to the exemption, may be all that is really necessary to fund an ILIT. If more costly premiums need to be financed, one option, in lieu of large gifts that cannot be covered by exemption that has been exhausted, might be to have the larger 2012 trusts make split-dollar loans to the new 2013 ILITs. And in sharp contrast to the comments made above for moderate wealth clients and Crummey powers, ultra nigh net worth clients should take advantage of including Crummey powers in ILITs. Many of the more sophisticated 2012 irrevocable gift trusts were drafted without Crummey powers, so their use in ILITs may be reasonably appropriate.

- **Annual Gift Planning Post-ATRA.** The old model of annual gift planning was to make annual gifts using the $13,000 (in 2013 $14,000) annual gift tax exclusion. For high net worth clients, annual gifting will take on a new meaning, and possibly a new complexity.

  With the inflation indexing of the $5 million exemption amount, even a modest inflation increase will result in a potentially meaningful dollar increase in the gift exemption. In 2012 the inflation adjusted gift exemption was $5,120,000. This may increase in 2013 to $5,250,000, an increase of $130,000. So each year advisers to the high net worth client may choose to gift to a GST exempt trust this incremental amount to compound growth outside of the client's estate.

  For dollar figures in this range, however, appraising interests in hard to value assets won't be practical. So the high net worth client might make a gift of cash or marketable securities to avoid the costs and complexities of appraisals. If the cash accumulates to a sufficient level inside the trust, then a swap for hard to value assets, perhaps every five years, might be worthwhile. Also, if the Administration's Greenbook proposals are enacted in a future fiscal cliff negotiation, it may become impermissible to make gifts to an existing trust or grantor trust status might be tainted. In contrast to the mere moderate wealth client, the high net worth client may well covet and protect grantor trust status and the tax burn it provides. So a segregated sub-trust that is not mixed with the grantor trust portion of the trust may be required to accept the gift, or in the alternative a new irrevocable gift trust to which perpetual GST exemption allocation may not be permitted and which cannot be a grantor trust, may be established in conformity with future post-Greenbook type changes.

Other Estate Planning Changes to Consider

As with every new tax law, even one pushed through at beyond the 11th hour like ATRA, there are a myriad of other changes that can have some impact. Some of these include the following:

- For practitioners trying to pick their way through the statutory language, the mechanism by which the $5 million exemption was made permanent is achieved in the somewhat circuitous manner of eliminating the provisions of the 2001 and 2010 tax acts that provided for the sunset of these benefits. Eliminating the sunset makes the sunrise on the permanent exemption.

- The privity requirement that some believed limited the application of portable exemption amounts has been clarified as *not* applying. This is consistent with the recently issued Regulations. Reg. Sec. 20.2010-2T(c)

(1)(ii)(A). The definition of the Deceased Spousal Unused Exemption Amount ("DSEUA") is now determined by reference to the *applicable* exclusion amount instead of the *basic* exclusion amount. So the amount of portable exemption can include the exemption ported from a prior spouse to the deceased spouse in question. IRC Sec. 2010(c)(4)(B).

- Tax free retirement plan distributions from IRAs to charities are permitted to be made in 2013. These include the restrictions that have existed previously. The donation is limited to $100,000. The client/donor must have attained age 70 ½ (not just become 70 ½ in 2013), etc.

- A number of GST tax rules some had feared might disappear have been made permanent. These include automatic allocation of GST exemption to indirect skips, elections regarding GST Trusts, qualified severances, Code Section 9100 relief for late allocation of GST exemption.

- The rules on the estate tax deduction for conservation easements under Code Section 2031(c) have been liberalized.

- There was also a slight easing of the rules on the deferred payment of estate taxes on closely-held business interests under Code Section 6166 by increasing the number of equity owners in a qualified business from 15 to 45.

- A waiver of the statute of limitations on certain special use valuation of farm real estate under Code Section 2032A was provided.

- The deduction for family owned business interests ("QFOBI") has been permanently eliminated. So anyone writing a treatise on post-ATRA estate planning cannot reuse the materials from their prior books on this one.

Estate Planning Implications of the New Income Tax Paradigm

Income Tax Planning for High Income Taxpayers. Income tax planning will become the new estate planning for many moderate wealth taxpayers. For those who had previously been more worried about estate tax, income tax worries may become paramount. While most Americans are breathing a sigh of relief that the Bush era tax cuts did not end for them (although they will be struggling with a not insignificant payroll tax increase), for high income taxpayers a combination of higher rates and phase out of itemized exemptions will create significantly more income tax cost. When this is combined with the 3.8% tax on passive investment income, the overall income tax costs are pretty substantial.

- **Higher Income Tax Rate**. A new 39.6% tax bracket has been added. This higher rate will apply to those earning over $400,000 for single taxpayers, $425,000 for head of household taxpayers, and $450,000 for married taxpayers. Coupled with the new 3.8% Medicare Tax (applicable at $250,000 for married couples and $200,000 for a single taxpayer), where it applies, brings the rate up to 43.4%.

- **Capital Gains**. A new higher 20% capital gains rate will apply to capital gains and dividends at the same threshold the higher 39.6% rate above will apply. For middle income taxpayers the 15% rate is retained and for taxpayers in the lowest 10% and 15% brackets a 0% rate will apply. See the discussion about using FLPs and LLCs to shift income. Coupled with the new 3.8% Medicare Tax (applicable at $250,000 for married couples and $200,000 for a single taxpayer), where it applies, brings the rate up to 23.4%

- **Medicare Tax**. Starting January 1, 2013 a 3.8% Medicare tax will apply to net investment income. Wages are subject to a 2.9% Medicare payroll tax. Workers and employers each pay half, or 1.45%. The Medicare tax is assessed on *all* earnings or wages *without a cap*. Starting in 2013, a 0.9% Medicare tax will be imposed on wages and self-employment income over $200,000 for singles and $250,000 for married couples. IRC Sec. 3101(b)(2). That will make the marginal tax rate 2.35%. Under 2012 law only wages/earnings were subject to the Medicare tax.

Starting January 1, 2013 a 3.8% Medicare tax will apply to net investment income if adjusted gross income ("AGI") is over $200,000 for single taxpayers or $250,000 on a joint tax return. IRC Sec. 1411. The lesser of net investment income or the excess of modified adjusted gross income ("MAGI") over the threshold, will be subject to this new tax. Investment income derived as part of a trade or business is not subject to the new Medicare tax on investment income unless it results from investment of working capital.

- **Entity Choice**. As the impact of the new income tax regime is evaluated, clients might reconsider the choice of entities and in some instances structure investment and business activities in a different manner. Might C corporations actually prove more advantageous in some instances then the flow through LLCs that have been ubiquitous to planning? (See **LISI** Income Tax Planning Newsletter #134 by **Bryan Davis** and **Jim Magner**).

- **Itemized Deductions**. Personal exemptions and itemized deductions will be phased out at new thresholds: $250,000 for single taxpayers, $275,000 for heads of household and $300,000 for married taxpayers filing jointly. Note that every tax rule has different income thresholds. This was certainly intentional in that the Republicans can claim partial victory by having kept "tax increases" to taxpayers making over $400,000 single and $450,000 married. The *reality* is that, as the itemized deduction phase out proves, the tax increases occur at *lower* levels.

  From a planning perspective, having different thresholds for almost every tax benefit/reduction makes planning very complicated. Having rules of thumb as to what level of income triggers tax implications won't be practical.

- **Medical Expenses**. Deductions for certain medical expenses will be reduced, and for many eliminated. Under prior law a taxpayer could deduct medical expenses only to the extent they exceed 7.5% of adjusted gross income (AGI). This restriction was in addition to the others that limit the tax benefits of itemized deductions, above.

  Starting with 2013, clients will only be able to deduct medical expenses as an itemized deduction if they exceed *10%* of AGI. IRC Sec. 213. For most wealthy clients, this will mean the end of any medical expense deductions.

- **FLPs and LLCs**. The use of family partnerships and LLCs to shift income will take on new importance for some families. See discussions above.

- **Grantor Trust Burns Fingers not Estates**. For a large number of clients who established grantor trusts before the $5 million inflation adjusted exemption amount became permanent, the estate tax burn of the grantor trust was a fire that warmed the client's tax-saving heart. But for many it may merely result in an income tax burden that they'd rather not have in light of the income tax increases, capital gains tax increase, and the Medicare tax on passive income.

If the tax burn is no longer likely to provide an estate tax savings in the post-ATRA environment, many of these clients might just prefer turning off the grantor trust status impact. There may be a number of means to achieve this result:

- Some practitioners included the discretionary right to an independent trustee to reimburse the grantor for income taxes in trusts formed in states where this right would not permit creditors to reach the trust and thereby cause estate inclusion (e.g., Delaware). While some practitioners are concerned that a regular reimbursement of taxes might create an argument that the grantor and trustee had an "understanding," this may no longer be an issue for the moderate wealth client. So in those instances, the reimbursement might be a simple solution.
- Some trust documents provide a mechanism to facilitate turning off the grantor trust powers. This might be accomplished, depending on the terms of the trust, by actions of a trust protector, or perhaps by those holding the power to renounce it.
- For many trusts, decanting into a new trust that is perhaps identical but which excludes the powers that trigger grantor trust characterization, may be a plausible solution.
- "Wait and see" may still be the better approach. With several bites at the fiscal cliff apple still to come, perhaps some patience is the best recommendation for clients. If other estate tax changes occur (like the enactment of the Administration's restrictive Greenbook proposals many have suggested) perhaps the client should wait until those changes are known before unraveling what still might prove useful as an estate planning tool.

- **Minimizing Higher Capital Gains Taxes**. Charitable remainder trusts ("CRTs") had fallen into disuse because of the low capital gains rates. The new tax rate structure should increase the use of CRTs to minimize or defer capital gains taxes for those selling businesses or valuable assets, such as a large concentrated stock position. Better coordinating the harvesting of gains and losses to minimize the now higher income tax rates will have increased importance. Since many wealthy taxpayers created one or more complex grantor trusts (trusts on which they remain liable for the income even though the earnings remain in the trust) the "pots" over which the harvesting will have to be coordinated will be broader.

Trust Income Tax Planning. Planning for trusts and estates to address the higher rates and compressed brackets, and timing distributions to beneficiaries to minimize overall trust/beneficiary tax burdens, will take on new importance and complexity. It may even change historical distribution patterns for some trusts. Trustees will face new challenges as beneficiaries pressure the trustees to make distributions to them so that income will be carried out to beneficiaries under the DNI paradigm to be taxed at lower marginal income tax rates, and perhaps so that the new Medicare Tax on passive income doesn't apply. This is a complex issue and there will undoubtedly be more detailed discussions of this in the literature.

Conclusion

The Post-ATRA estate planning environment appears to be dramatically different than any estate tax regime that has heretofore existed. For the first time in history there is a permanent very high, inflation adjusted and portable exemption amount that not only factually excludes all but the wealthiest of the wealthy, from gift, estate and GST tax. Even more significant is that the fear of the estate tax for the vast majority of clients is simply gone. While clients still require all the valuable non-federal estate tax minimization planning professionals can provide, educating clients that the KISS principal and lowest cost solution is not preferable may be the greatest challenge many practitioners face.

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

Marty Shenkman

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LISI Estate Planning Newsletter #2046, (January 7, 2013) at http://www.leimbergservices.com

3 Comments Posted re. *Marty Shenkman's Commentary on the American Taxpayer Relief Act of 2012 (2013) Fiscal Cliff and Estate Planning*

Raymond Odom 08-Jan-13 12:23 PM

The clarity, conciseness and boldness of Marty's comments is stunning and in my analysis 100% correct. We should have started down the path outlined by him after the 2010 repeal scare but the marketing leverage offerred by the fiscal cliff was too much for us to resist. The good news is that the development of the SLAT may not have occurred without the cliff and the SLAT may prove to be the most effective and profitable planning device left for married wealth owners. In my 3 Years of reading the newsletter this is THE most insightful piece I have read. Thank-you

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John K. Heuisler, CLU 08-Jan-13 12:50 PM

"Life Insurance May Lead the Way" What a wonderful headline. As we approach the 100th birthday of the Sixteenth Amendment, it is worth noting that life insurance, properly structured, is still one of the most efficient and cost effective planning tools we have for both income and estate tax planning. Excellent article all around and useful for all levels of net worth.

Natalie Choate 10-Jan-13 05:58 AM

I would like to comment about one minor "QPRT" point in Marty Shenkman's excellent article.

As he points out, many clients who adopted QPRTs may now not need the estate tax savings they sought, and would wish instead to have the residence pass from the parent's estate to the children so it would get a stepped up basis, rather than having it pass as a gift under the QPRT with carryover basis. So he suggests: "Perhaps after the QPRT term ends, no lease should be signed and no rent paid. Arguably the house should be included in the parent's estate and subject to estate tax (which won't be imposed in the case of a moderate wealth client - state estate tax aside) and a basis step up on death could be realized."

It is not advisable to assume that simply because the parent remains in the residence after the QPRT term ends until his or her later death, the house will be includible in the parent's estate and automatically qualify for a stepped up basis.

True, normally the parent's staying on in the residence after the QPRT term ends has the result that residence will be included in the donor's estate under § 2036 as a gift with retained possession. But this result is not guaranteed, as the following discussion shows. Generally, for income tax purposes, "the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent" is "the fair market value of the property at the date of the decedent's death." § 1014(a)(1). § 1014(b) lists various types of property deemed to be acquired from a decedent, including "property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B…." Emphasis added. Although § 2036 is not specifically mentioned in § 1014(b), it is generally recognized that property includible in a decedent's estate under § 2036(a) is considered property acquired from the decedent for purposes of the basis provisions of § 1014(a). See Rev. Rul. 66-283, 1966-2 C.B. 297, and PLR 2002-40018. For estate tax purposes, there is a presumption that a parent who continues to reside in a residence he has transferred to his children does so pursuant to an "understanding" that he would do so. For estate tax purposes, the IRS enforces a legal presumption that the continued occupancy was "retained" by the parent-donor, thus causing estate inclusion of the property under § 2036(a). However, the children cannot simply assume that estate inclusion automatically entitles them to a stepped-up basis under § 1014(a). A presumption that the IRS is entitled to use for estate tax purposes cannot be used by the taxpayer to establish income tax basis. For income tax purposes, the taxpayer has the burden of proving that the property was required to be included in the estate. Hahn v. Comm'r, 110 T.C. 140 (1998), § 3(b). Thus, even if the parents stay in residence for life (rent-free) after expiration of the QPRT term, the burden of proof would be on the children to establish that the parents "retained" possession of the residence.

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