GF&M GORDON, FOURNARIS & MAMMARELLA, P.A.

TWO YEARS CAN LAST FOREVER
PLANNING UNDER THE NEW TAX ACT

Presented by:

Michael M. Gordon
Gordon, Fournaris & Mammarella, P.A.
1925 Lovering Avenue
Wilmington, Delaware 19806
302-652-2900
mgordon@gfmlaw.com

Todd A. Flubacher
Morris Nichols Arsht & Tunnell LLP
1201 North Market Street
Wilmington, DE 19899
302-351-9374
tflubacher@mnat.com

Elizabeth W. King
The Northern Trust Company of Delaware
1201 North Market Street, Suite 1202
Wilmington, DE 19801
302-428-8725
Ek51@ntrs.com

2011 DELAWARE TAX INSTITUTE

TWO YEARS CAN LAST FOREVER
PLANNING UNDER THE NEW TAX ACT

I. Traditional Planning

1. Traditional estate planning took into account the use of the credit exemption amount (previously known as the unified credit equivalent) and the unlimited marital deduction. Most clients established plans directing that the maximum amount of their estates that could pass free of federal estate tax would fund a "credit trust" and the remainder would pass to the surviving spouse either outright or in trust. The plan was intended to use the first deceased spouse's exemption by placing the maximum amount of the exemption in trust so that the second spouse to die would have a full exemption applicable to his or her assets, thereby, sheltering two times the exemption amount in both estates.

2. The key to estate planning for most individuals was to be certain each spouse used his or her credit exemption amount. This was done primarily with the use of living trusts. In addition, most good estate plans included well-drafted wills, durable powers of attorney and health-care directives.

II. Changes to the Law

1. The so called Bush era tax cuts (enacted through the Economic Growth and Tax Relief Reconciliation Act of 2001) substantially increased the credit exemption amount available to estates over time and reduced the top marginal rate applied to taxable estates pushing toward eventual repeal of the federal estate tax. The chart below illustrates the changes:

Year of Death	Credit Exemption Amount	Top Rate
2001	$ 675,000	55%/60%
2002	1,000,000	50%
2003	1,000,000	49%
2004	1,500,000	48%
2005	1,500,000	47%
2006	2,000,000	46%
2007	2,000,000	45%
2008	2,000,000	45%
2009	3,500,000	45%
2010	Repeal	0%
2011	Sunset - 1,000,000	55%/60%

2. After 2002 (including 2010, the year of repeal) the gift tax exemption was frozen at $1 million.

3. While the estate and GST tax system steadily improved for decedents dying during this time, the ability to make lifetime gifts was stymied by the gift tax exemption stuck at $1 million. People were actively engaged in estate freeze techniques such as GRAT's, installment sales to intentionally defective grantor trusts and annual exclusion gifts. In addition, throughout 2010, there was a threat that the ability to use two-year GRAT's and family entities with discounted valuations would be legislatively eliminated.

4. Under the Bush era tax cuts, the benefits of the tax act were to "sunset" after 2010. The federal estate law was then to be reinstated as it existed prior to the tax cuts with a $1 million federal estate tax exemption and tax rates of 55% to 60% on large estates.

5. In 2010, we saw the unthinkable: estate tax repeal. Throughout the year, planners believed there may be retroactive legislation that would reenact the estate tax. People feared it could be taken away at any time. Some planners even suggested that it might be advisable to have clients make taxable gifts to take advantage of the 35% gift tax rate.

6. All of us are familiar with the stories of the very wealthy dying in 2010 and not paying any federal estate tax. Most notably, George Steinbrenner, the owner of the New York Yankees died purportedly leaving his family a $500 million life insurance trust with which to pay the federal estate tax on his prized Yankees. Of course, there was no federal estate tax in 2010 and the family was able to keep the Yankees and the $500 million of life insurance as a windfall.

7. In response to the chaos created by the one year of estate tax repeal and then the return to the tax laws that existed before the Bush era tax cuts, Congress acted and on December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Tax Act"). The 2010 Tax Act made significant changes to the estate, gift and generation-skipping transfer ("GST") tax laws. These changes will remain in place for two years, 2011 and 2012, but can have an impact that lasts forever. The chart below illustrates the changes:

Year of Death	**Credit Exemption Amount**	**Top Rate**
2010	Repeal or $5,000,000	35%
2011	5,000,000	35%
2012	5,000,000	35%
2013	Sunset - 1,000,000	55%/60%

8. The changes in the 2010 Tax Act include:

- A reduction in the top tax rate for estate, gift and GST taxes to 35%.
- A reunification of the estate, gift and GST exemptions with all exemptions at the $5 million mark.

- Portability of the estate tax exemption for married couples so, for example, if one spouse dies having used only $1 million of a $5 million exemption, the surviving spouse will have a $9 million exemption comprised of the surviving spouse's own $5 million exemption and $4 million of unused exemption from the predeceased spouse.

- In general, those settling the estates of 2010 decedents will have a choice—either to apply the federal estate tax/basis step up regime to those estates (with a $5 million exclusion and a 35% flat tax rate); or to elect to apply the 2010 regime that was in effect prior to the 2010 Tax Act (no federal estate tax but a carry-over basis regime with complex adjustments).

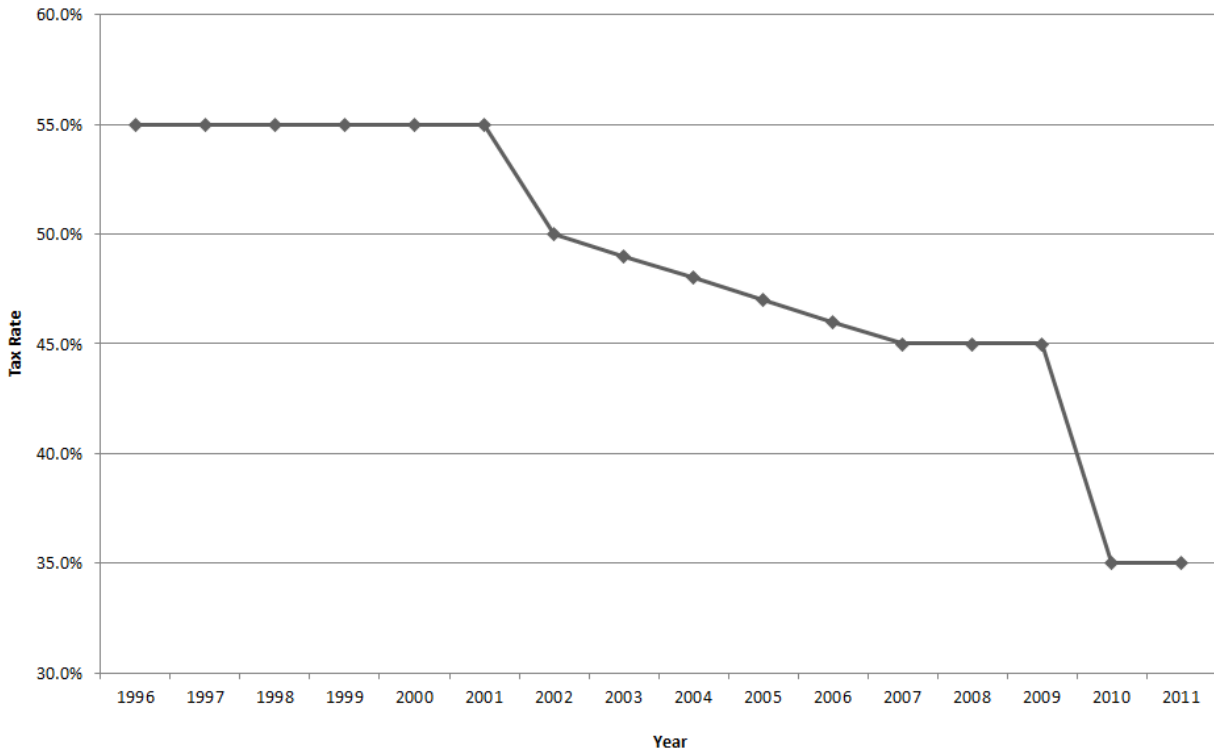
- The 2010 Tax Act made no direct changes to the gift tax structure for 2010 gifts; they continue to be subject to a $1 million exclusion and a 35% top marginal tax rate for taxable gifts.

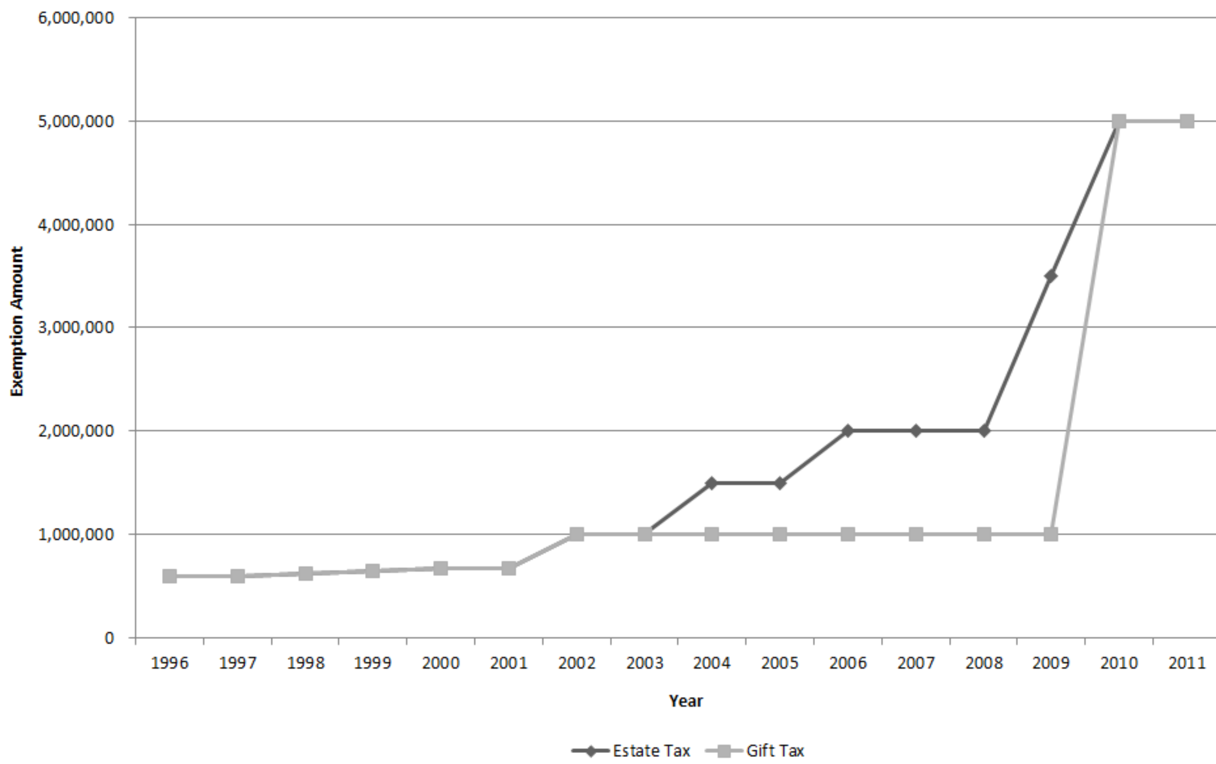
- In the case of GST gifts in 2010, there is a choice between electing to use the 0% generation-skipping tax rate applicable in 2010 or to apply some or all of the GST exemption. This gave flexibility.

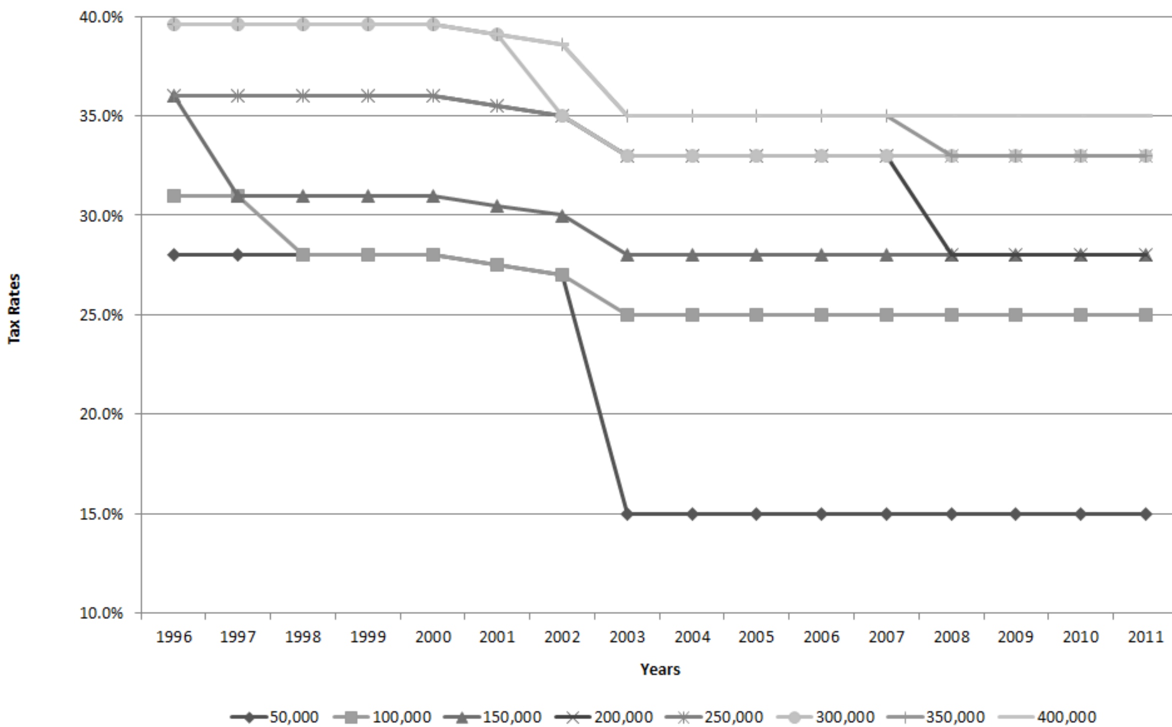
- Many GST non-exempt trusts made taxable distributions and taxable terminations to get assets to the lower generation with a 0% GST tax.

9. The 2010 Tax Act by its terms will expire on January 1, 2013. Unless Congress acts before that date, the estate, gift and GST tax changes will sunset and the tax law in effect in 2001 will be reinstated subjecting estates over $1 million to taxes with top marginal rates on large estates at the 55% to 60% level.

- The Joint Select Committee on Deficit Reduction (the "Super Committee") is scheduled to announce its proposals on November 23. There are rumors circulating that suggest that the proposals may include changes in the current estate, gift and generation skipping transfer tax laws. In particular, there is concern that the Federal gift tax exemption could be reduced from the current $5 million to $1 million, possibly as soon as December 31, or, while less likely, as early as the November 23 announcement date.


Estate Tax Rates Over 15 Year Period
60.0%
55.0%
50.0%
45.0%
40.0%
35.0%
30.0%
Tax Rate
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Year


Estate And Gift Tax Exemptions Over 15 Year Period
6,000,000
5,000,000
4,000,000
3,000,000
2,000,000
1,000,000
0
Exemption Amount
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Year
Estate Tax
Gift Tax



III. Planning After the 2010 Tax Act

1. Existing estate plans should be reviewed to determine if it is still appropriate to place the maximum amount of a person's estate that can pass free of tax in the credit exemption trust. This formula was widely used when the maximum credit exemption amount was scheduled to go no higher than $3,500,000. Under the new law, the exemption will be $5 million until 2013.

- In many second marriage situations, the credit shelter amount was left to the children of the prior marriage and the remainder to the surviving spouse. This formula may drastically reduce the benefits of the surviving spouse as a result of the new law.

- Many plans use the same formula to leave the credit exemption amount to family or other individuals with the remainder to charity. The formula could substantially reduce the amount that passes to charity because of the increasing exemption under the new law.

- For those who are not in favor of using trusts but consider them a "necessary evil" the formula may result in too much of the estate passing

into trust when it otherwise could pass to the surviving spouse free of trust.

- Many wealthy individuals should consider using their $5 million gift tax exemption to transfer wealth before the exemption reverts to $1 million. There are creative techniques for transferring wealth to generation skipping trusts (discussed below) that will allow the wealth to pass from generation to generation in perpetuity with no further transfer taxes.

- The 2010 Tax Act also extended certain charitable giving incentives that otherwise would have expired.

2. Asset holdings of spouses should be reviewed and re-balancing considered. Many individuals with large estates transferred enough assets to the "less wealthy spouse" to avoid wasting the exemption at his or her death. Because of the increased exemption it is important to be certain, in larger estates, that each spouse has sufficient assets to fully use the credit exemption amount under the new law. This is true regardless of portability. There are still good reasons to fully fund a credit shelter trust at the death of a spouse. These include the following:

- There is no guarantee that portability will continue after 2012.

- The estate tax exemption could revert to $1,000,000 in 2013.

- The unused exemption of a predeceased spouse will be lost if the survivor remarries to a person who has already fully used the exemption.

- Credit trust assets are protected from creditor claims, including claims of a divorcing spouse for property division, and will pass tax free at the survivor's death.

- Future growth is guaranteed to escape estate taxation at the death of the surviving spouse.

- Assets can be earmarked to pass to the first deceased spouse's children avoiding loss of the assets to a new spouse.

3. As the credit exemption amount increases, consideration should be given to the following:

- The use of a "joint trust" to simplify the estate plan and still avoid probate (even in joint death situations) where the combined estates of a husband and wife are clearly under the credit exemption amount.

- Different formulas in trusts so that the maximum credit exemption is not put into a trust for the surviving spouse but a lesser amount determined by

a formula, e.g., the lesser of the credit exemption amount or one-half of the decedent's estate.

- Some practitioners are recommending disclaimer provisions so that everything is left to the surviving spouse except the amount disclaimed to fund the credit trust. The disclaimer approach postpones the decision and leaves it to the surviving spouse to decide how much, if anything, will fund the credit trust. There are some practical problems with this approach, as well as, the loss of the survivor's ability to direct how the funds will pass if a change in circumstances occurs, i.e., a second look power.

IV. Dynastic Planning Through Gifts: Making Transfers Last Forever

1. The 2010 Tax Relief Act has provided an expanded opportunity for individuals to make large gifts and remove significant assets and appreciation on those assets from their estates. While it is clear that the new law allows tax free lifetime gifts to children, grandchildren and more remote descendants of $5,000,000 per donor and $10,000,000 per married couple, there is additional planning that can make these transfers last forever passing tax free from generation to generation with no future transfer tax.

2. Most significantly, in states like Delaware that have abolished the rule against perpetuities for personal property held in trust, Dynasty (perpetual) Trusts are being created with individuals transferring $5,000,000 (or married couples transferring $10,000,000) in trust to which gift tax exemption and generation-skipping transfer tax exemption is allocated.

- These trusts may continue potentially forever and benefit countless future generations with no future gift, estate or GST taxes.

- Example: If a grantor transfers $5 million to a dynasty trust, the GST-exempt trust would have an approximate value of $185 million after 75 years, while the same $5 million held outside of trust would be hit with transfer tax at each generation and would only grow to about $50 million (Assumptions: 5% after-tax rate of return, a new generation every 25 years, and a federal estate tax of 35% applied at each generational transfer).

- The dynasty trust is structured as a grantor trust, which means that the grantor is treated as the owner of the trust for income tax purposes (but not for estate tax purposes). The grantor pays all of the income tax on the trust, which enables the grantor to further reduce his or her taxable estate and allow the dynasty trust to grow unencumbered by income taxes. Also, the grantor's payment of income taxes for the trust is not considered a taxable gift to the trust and is therefore an additional tax free transfer to the beneficiaries of the trust.

3. If a client wishes to create a non-grantor trust, by carefully choosing a favorable situs for the non-grantor Dynasty Trust, it is possible to avoid state fiduciary income tax on the trust. In Delaware, for example, a resident trust will receive a deduction for any trust income that is held for future distribution to non-residents of Delaware. Therefore, so long as the trust does not own Delaware real property or tangibles, or have income from a Delaware business, then the trust will not pay any separate fiduciary income tax. This will further augment the value of any lifetime gifts that are made to such a Dynasty Trust.

- Example of Potential Tax Savings

	Sale in Delaware Trust	Sale in California Trust
Sale Proceeds	$5,000,000	$5,000,000
Tax Cost	$0	$0
Gain on Sale	$5,000,000	$5,000,000
State Tax	$0	$465,000
Federal Tax	$750,000	$750,000
Proceeds Net of Tax	**$4,250,000**	**$3,785,000**
Delaware Benefit	**$465,000**	

Assumptions: Federal capital gains rate: 15%; California state income tax rate: 9.3%

4. The new gift and generation skipping transfer tax exemptions are being used to leverage dynasty trusts through the purchase of large life insurance policies. The following examples illustrate use of the $5,000,000 exemption to purchase a single-life policy and use of the $10,000,000 exemption to purchase a second-to-die policy.

- Example #1: $5,000,000 Gift to Dynasty Trust
  - 55 year-old male, preferred non-smoker
  - Single-life policy purchased with $3 million premium in first year and $2 million premium in second year
  - life expectancy: 90 years old
  - **death benefit purchased: $22,000,000**
  - internal rate of return: 4.37%
  - pre-tax equivalent: 7.077%

- Example #2: $10,000,000 Gift to Dynasty Trust
  - 55 year-old male and female, preferred non-smokers
  - second-to-die policy purchased with $3 million premium payments in first three years and final payment of $1 million in fourth year
  - life expectancy: 90 years old
  - **death benefit purchased: $65,000,000**
  - internal rate of return: 5.69%
  - pre-tax equivalent: 9.215%

- Some insureds prefer to seed the trust with $5,000,000 or $10,000,000, pay a fixed guaranteed premium (such as $500,000 annually) and invest the remainder.

- The full value of the insurance proceeds held in a trust, such as a Delaware Dynasty Trust, can be excluded from the grantor's estate and will continue in perpetuity free of future transfer tax for the benefit of the grantor's descendants.

5. Dynasty Trusts which are grantor trusts are often referred to as "intentionally defective income trusts" or "intentionally defective grantor trusts" also called "IDITs" or "IDGTs." These trusts are used by wealthy individuals for installment sale transactions of existing closely held businesses or investment limited partnerships/investment limited liability companies funded entirely with marketable securities. Using the new gift tax and generation-skipping transfer tax exemptions, these individuals may now transfer up to $150,000,000 in business interests which, once again, will continue in trust for the benefit of the grantor's family perpetually with no future transfer tax.

- These transactions are scalable and need not be for the full $150,000,000. The same principles work with lower amounts.

- For example, Grantors seed a Dynasty Trust with $10,000,000 in cash. Their $150,000,000 business is valued with lack of control and lack of marketability discounts of 1/3 so the fair market value of the entire business is $100,000,000. The business ownership interests are then sold to the Dynasty Trust in exchange for a return of the $10,000,000 in cash as a down payment and a $90,000,000 note at the Applicable Federal Rate which is currently less than 2% for a nine year term with a balloon. The note can be amortized over as many years as necessary to allow the cash flow from the full $150,000,000 business to cover the $90,000,000 note.

- Future appreciation in the value of the business escapes the grantor's estate.

- The grantors will remain liable for the income tax on the Dynasty Trust (which is a grantor trust for federal income tax purposes) even after the note is paid, thereby allowing them to deplete their remaining estates by paying the income tax on the income earned by such trust as an additional tax free gift to the beneficiaries.

- There is no recognition event on the transfer of the family owned business to the trust because the trust is a grantor trust and is disregarded for income tax purposes but not for estate tax purposes.

6. The 2010 Tax Relief Act has presented clients with a unique estate planning opportunity over the next two years to transfer significant amounts of wealth out of their estate without the imposition of transfer taxes. However, even the wealthiest clients are often concerned with giving such large amounts of money away based on the fear that they may need access to the assets in the future. One option that clients may have is to

create a trust in a jurisdiction such as Delaware which allows for self-settled asset protection trusts. A client can make a transfer to a trust established in such a jurisdiction, to which the client allocates gift tax exemption, that provides that the trustee may distribute income and principal from the trust to a class of beneficiaries, which includes the client, in the sole and absolute discretion of the trustee. The client can also allocate GST exemption to the trust which would allow the trust to continue in perpetuity if established in a jurisdiction such as Delaware which has abolished the rule against perpetuities.

- A transfer is incomplete for federal gift tax purposes if the grantor retains a sufficient dominion and control over the property. Treas. Reg. § 25.251111-2(b).

- If an individual creates a self-settled trust in a jurisdiction where his or her creditors may attach the assets, the grantor has retained sufficient dominion and control over the assets because under local law the grantor is able to relegate his or her creditors to the assets of the trust. See Rev. Rul. 76-103; Rev. Rul. 77-378; and Paolozzi v. Commissioner, 23 T.C. 102 (1954). As such, the trust must be established in a jurisdiction that allows for self-settled asset protection trusts thereby preventing the grantor from being able to relegate his or her creditors to the assets of the trust.

- Section 2036(a)(1) of the Internal Revenue Code provides that a decedent's gross estate shall include property transferred in trust other than for full and adequate consideration if the decedent retained the right to income from the property. The use, possession, right to income or other enjoyment of the transferred property is considered as being retained by the decedent to the extent the use, possession, right to income, or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent. Treas. Reg. § 20.2036-1(b)(2).

- Revenue Ruling 2004-64 held that assuming there is no understanding, express or implied, between the grantor and the trustee regarding the trustee's exercise of its discretion to reimburse the grantor for income tax liability, the trustee's discretion to satisfy such obligation will not alone cause inclusion of the trust assets in the grantor's gross estate for federal estate tax purposes.

- In a 2009 Private Letter Ruling, the Internal Revenue Service concluded that a grantor who established an Alaska asset protection trust in which the grantor retained a discretionary beneficial interest made a completed gift when the assets were transferred to the trust. The 2009 Private Letter Ruling also concluded that the trustee's discretionary authority to distribute income and/or principal to the grantor does not by itself cause the trust to be includible in the grantor's estate for federal estate tax

purposes under Section 2036(a)(1) of the Internal Revenue Code. PLR 200944002.

- A question has arisen as to whether the mere fact that a family creditor could reach the trust assets is enough to cause the transfer to the trust from being an incomplete gift or otherwise cause the trust assets to be included in the grantor's estate under Sections 2036(a)(2) and 2038 of the Internal Revenue Code. All states that have enacted self-settled asset protection trust legislation, other than Alaska and Nevada, allow certain creditors to access the trust. For example, the Delaware Qualified Dispositions in Trust Act allows for certain family claims, including child support and alimony, provided that with respect to an alimony claim the spouse must have been married to the grantor before the trust was created. 12 Del. C. §§ 3570(1) and 3570(9).

- Proponents of Alaska and Nevada law have argued that the 2009 Private Letter Ruling only applies to Alaska and Nevada trusts because of certain creditor exemptions contained in the statutes of other jurisdictions. However, what is overlooked in this argument is the theory of acts of independent significance.

- The theory of acts of independent significance is applied when determining whether the grantor retained a power which rises to the level of a power which will cause inclusion in the grantor's estate under Sections 2036(a)(2) or 2038 of the Internal Revenue Code or otherwise result in an incomplete gift. If the retained power allows the grantor the ability to act in such a way so as to affect the beneficial interest of the Trust, but the possibility of such action occurring is so diminimus and speculative, the power will be found to be an act of independent significance. See Estate of Tulley, 528 F.2d 1401 (1976); Ellis v. Comissioner, 51 T.C. 182 (1968), judgment aff'd, 437 F.2d 442; Rev. Rul.80-25; and PLR 9141027.

- Courts have ruled that the possibility of divorce is an act of independent significance. See Estate of Tulley, 528 F.2d 1401; PLR 9141027. Courts have also determined that acts of independent significance include failure to support a spouse as well as the ability to have or adopt children. Ellis v. Commissioner, 51-T.C. 182 (1968), judgment aff'd, 437 F.2d 442; and Rev. Rul. 80-255.

V. <u>Charitable Giving</u>.

1. **<u>Philanthropy</u>**. The sagging economy has hurt virtually everyone. Perhaps no one has been hurt more than charitable organizations and those they serve. A report in *CNNMoney.com* determined that average charitable giving by wealthy households declined by 34.9% in 2008 and more than 40% of charitable organizations and private foundations said that contributions declined in the first five months of 2010. While there are tax incentives for charitable giving, most charitable giving is motivated by a donor's true desire to contribute to the public good and not by taxes. Nonetheless, there are certain tax and other economic benefits to be derived from charitable giving.

2. **<u>Times Have Been Tough For Delaware Charities</u>**. There was a report entitled Philanthropy In The First State Report: 2009 Report by Mark Kress Littlepage, KB&T Associates that analyzed philanthropy in Delaware

- More than 35% of Delaware nonprofits operated in the red each year from 2002-2007

- Only 8 private foundations in Delaware made significant investments in Delaware nonprofits in 2007

- Corporate giving comprised less than 2% of the State's organized philanthropy in 2007

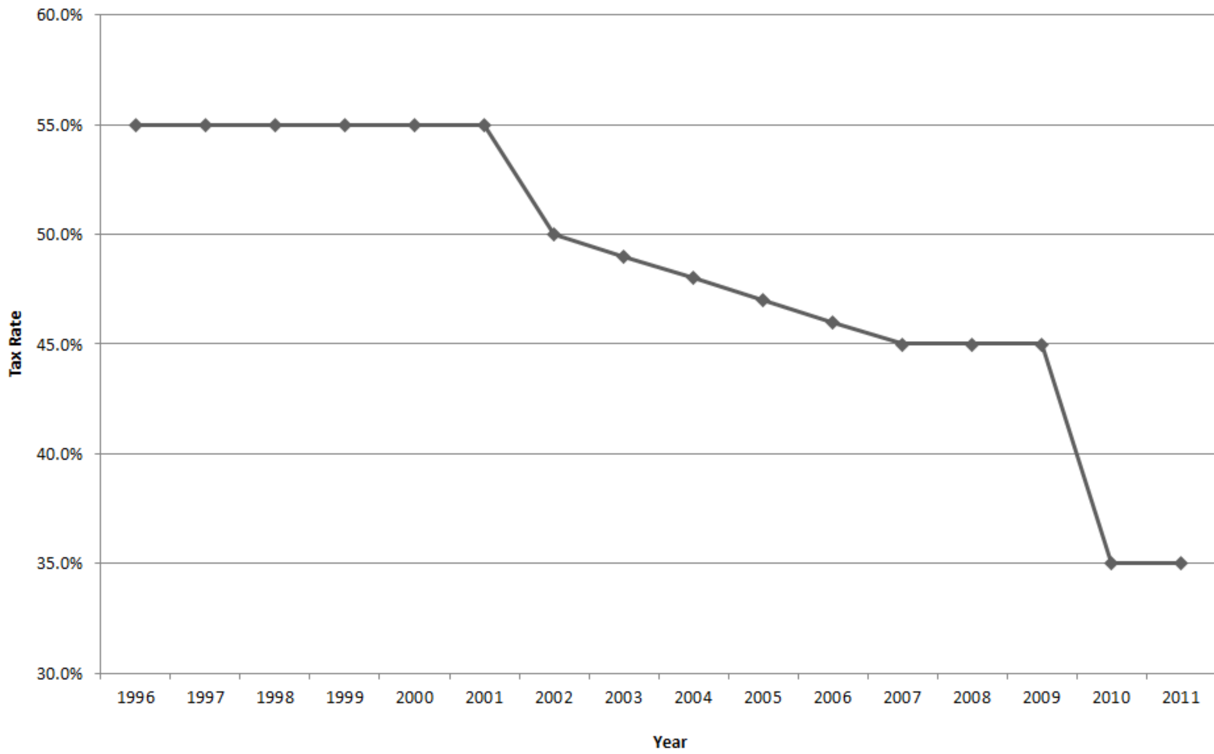
- Though Delaware incomes are 3% higher than the national average, Delaware donors give 9% less than the national average

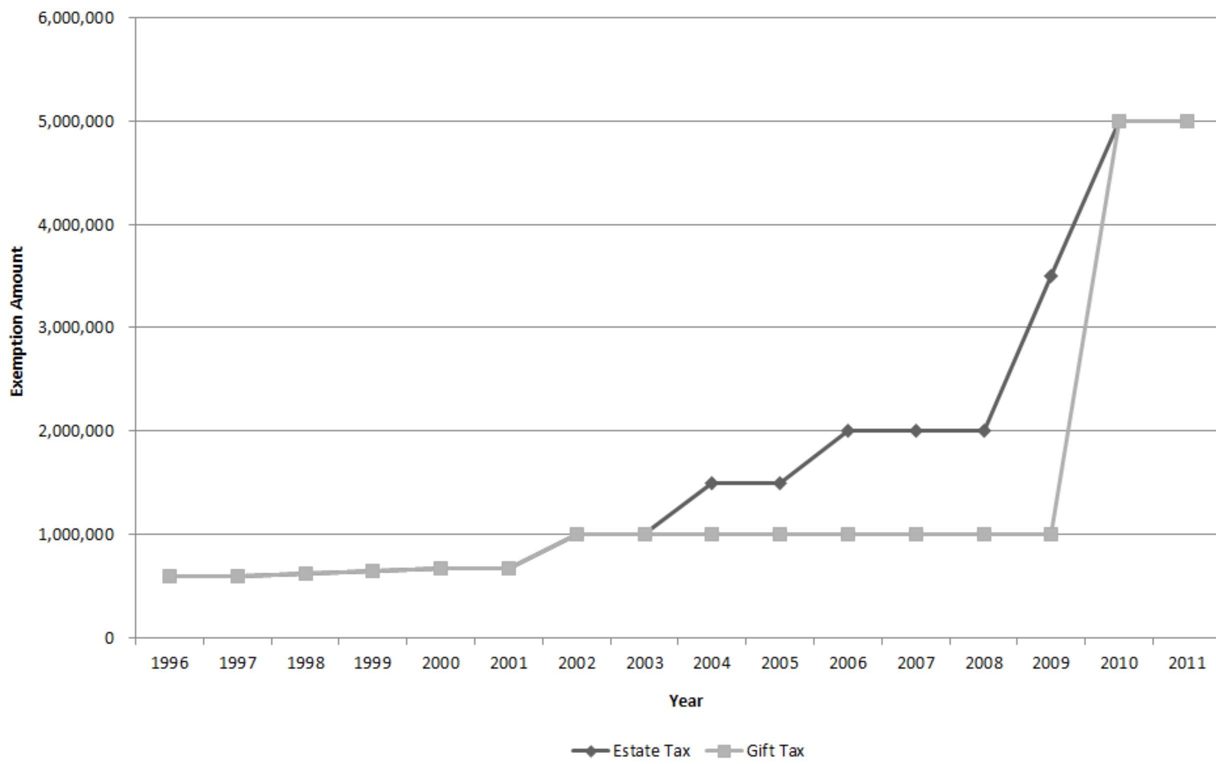
- A higher proportion of Delawareans (33%) make charitable contributions than the national average (30%)

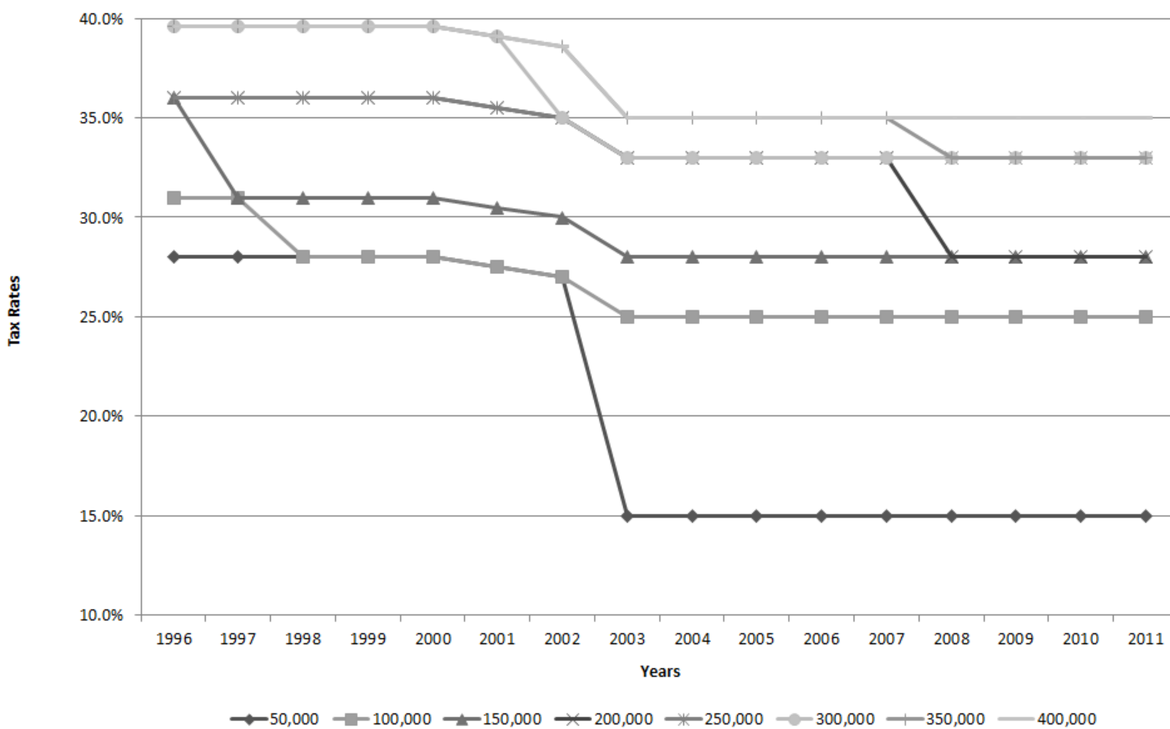
- Some communities gave substantially higher than the average. Four communities (two zip codes in Wilmington, Rockland and Hockessin) had charitable giving rates higher than 50% and 79 communities were higher than 40%

3. **<u>Characteristics of today's economic environment</u>**.

- Low interest rates
- Low income tax rates
- Low estate tax rates
- High estate and gift tax exclusions
- Uncertainty created by two-year horizon of tax laws
- Bad economy
- Appreciating securities markets


Estate Tax Rates Over 15 Year Period
60.0%
55.0%
50.0%
45.0%
40.0%
35.0%
30.0%
Tax Rate
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Year


Estate And Gift Tax Exemptions Over 15 Year Period
6,000,000
5,000,000
4,000,000
3,000,000
2,000,000
1,000,000
0
Exemption Amount
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Year
Estate Tax
Gift Tax



4. **What does the current economic realty mean for charitable giving?**

- With income tax rates at historic lows, clients may defer charitable donations until tax rates are higher and the deduction is more valuable to them
- Lower estate tax rates and higher exemptions mean lower tax incentive to give to charity at death
- Some couples with taxable estate under $10 million may no longer make testamentary gifts to charity if 100% of their estate can go to their descendants tax free
- Bad economy means less wealth available to give
- Low interest rates mathematically hurt some strategies but help others

5. **<u>Itemized Deductions</u>**. Itemized deductions for wealthy individuals are generally phased out as certain income levels are attained. For calendar years 2011 and 2012, these itemized deductions will not be reduced.

6. **Cash Gifts**. Cash gifts to charity provide an immediate benefit to the charity. They may be deducted against 50% of the donor's adjusted gross income. Accordingly, these gifts provide both an income tax deduction and an estate tax benefit, because the cash gift is removed from the donor's estate.

7. **Gifts of Property**. A gift of appreciated property (such as appreciated stock) provides an even greater benefit to the donor. The donor is not taxed on the appreciation when the charity sells the stock. Nonetheless, the donor may deduct the full fair market value of the appreciated property against 30% of the donor's adjusted gross income. Amounts in excess of the 30% may be carried forward and used in later years.

8. **Charitable Gift Annuity**. Sometimes, a donor is willing to give a valuable asset to a charity but is concerned about having sufficient income to support the donor's lifestyle. In this case, the donor can gift the appreciated property to the charity in exchange for a charitable gift annuity. A charitable gift annuity is a contract providing the donor with a stream of income in return for the gift. The actuarial value of the income stream is deducted from the value of the gift and the donor is entitled to deduct the actuarial value of the remainder interest which will benefit the charity. When the appreciated property has built-in capital gain, the capital gain is not realized by the donor upon the making of the gift. Instead, it is realized by the donor ratably over the term of the annuity payments.

9. **Charitable Lead Trusts**. Charitable lead trusts are most commonly created at death. The decedent establishes a trust that provides for distribution of income to charity over a period of time with remainder to the decedent's beneficiaries. The actuarial value of the income interest to the charity is deducted from the value of the asset for purposes of determining the taxable value. If the earnings on the asset transferred beat the charitable lead payout and the property appreciates in value, substantial wealth can be transferred to the decedent's beneficiaries with very little gift or estate tax.

- Charitable lead annuity trusts are very appealing when interest rates are low because the charitable deduction is higher and the gift of the remainder interest is lower. This means you will be making a smaller taxable gift and get a larger charitable deduction than you will when the AFR is higher.

10. **Charitable Remainder Trusts**. Charitable remainder trusts permit a person to sell appreciated assets without recognizing taxable gain, diversify portfolios and increase income during lifetime while obtaining an income tax charitable deduction at the same time. For example, if a sixty year old couple contributes $300,000 worth of zero basis stock producing a 1.5% dividend to a charitable remainder unitrust with a 7% unitrust payment, the stock can be sold by the unitrust with no capital gain tax. The sale proceeds can be reinvested in higher income producing assets. The couple's income will increase from $4,500 per year to $21,000 per year. The couple will receive an income tax charitable deduction for the remainder interest that passes to charity valued at $50,865. The couple can establish an irrevocable "Wealth Replacement Trust" funded with $300,000 worth of second-to-die (survivorship) life insurance and pay the annual premium with some of the increased cash flow. The insurance will pass income and estate tax free to the couple's family.

- In a low interest rate environment (low AFR), the present value of the annuity or unitrust interest in a charitable remainder trust (i.e. the taxable gift to the individual) is higher than in a high interest rate environment (high AFR), and the value of the charitable remainder interest and charitable deduction is lower. This means you will be making a larger taxable gift and get a lower charitable deduction than you will when the AFR is higher.

11. **Donor Advised Funds**. Sometimes an individual can use a large charitable deduction in a particular year but desires to distribute funds to the individual's church or other charities over a period of years. That individual can transfer cash or appreciated property to a donor advised fund through an organization like a local Community Foundation and obtain an immediate charitable deduction. Thereafter, the donor can direct the fund to distribute the donor's account to the charities of the donor's choice over time.

12. **The Gift of IRAs**. The 2010 Tax Act extended a provision that originally was enacted by Congress in 2006. This provision allows an exclusion from gross income of up to $100,000 of transfers from an IRA directly to a charity. The IRA owner would have to be in pay status (over 70 1/2) at the time of the distribution. The distribution could be made directly from the participant's IRA to the charity or by a check given by the IRA custodian to the participant made payable to the charity so the participant has the benefit of delivering the check in person to the charity. The gift meets the RMD requirement and there is no income tax on distribution to the charity, although there is no additional charitable income tax deduction. The law expired on December 31, 2011. The advantages include an opportunity to reduce the taxpayer's AGI, and may be advantageous for non-itemizers. Additionally, this can be a benefit for gifts exceeding 50% of AGI.

13. **Gifts Made Through Your Will or Trust**. You may wish to consider a charity of your choice when your estate planning documents are being prepared. Including a charitable bequest in your Will or trust will allow the charity to benefit at a time when you clearly no longer need the funds. The bequest will be deductible for federal estate tax purposes and is a good way for you to remember the charity of your choice.

VI. Grantor Retained Annuity Trusts

1. A Grantor Retained Annuity Trust ("GRAT") is another means by which a grantor can transfer substantial wealth to a lower generation at reduced or no gift tax cost. A GRAT is particularly attractive to someone who has used his or her exemption amount but would like to transfer additional wealth.

2. A GRAT is an irrevocable trust in which the grantor retains the right to receive a fixed annuity for a set number of years and at the expiration of that term, the remainder passes to the lower generation pursuant to the terms of the trust instrument.

3. GRATs work best when interest rates are depressed and asset values are expected to appreciate. In a low interest rate environment, the present value of the annuity seems big, and

the remainder seems small. The gift tax calculated is based on the value of the remainder that passes to the lower generation. As long as the assets earn more than the Applicable Federal Rate for determining the present value of the annuity (the "hurdle rate" for GRAT purposes), the grantor will have obtained a break on gift taxes. Also, future appreciation of and earnings from the gifted assets are removed from the grantor's estate (*note*: the grantor must outlive the GRAT term in order for the remainder to be excluded from the grantor's estate).

- Example: In January 2011, Father, age 55, transfers $500,000 of assets to a GRAT. The annuity payment to the Father is $40,000 annually for 15 years. Based on a 2.4% AFR in January, the Father's retained annuity interest is $464,440, so the amount of the gift upon creation of the GRAT is $35,560. If the trust assets provide a rate of return of 7%, the assets in the trust will be worth $374,355 at the end of 15 years.

- The AFR for November 2011 is 1.4%.

4. **"**Zeroed-out GRAT.**"** A zeroed-out GRAT can be used so that there are no gift tax consequences when the GRAT is created. If the GRAT is structured so that the present value of the annuity equals the value of the property transferred, the grantor will be able to transfer wealth without using any gift tax exemption or paying any gift tax. A zeroed-out GRAT works best when the annuity term is short and the GRAT is funded with one stock. The property transferred to the GRAT only needs to sustain high performance for a short period of time. Isolating separate stocks in separate GRATs is advisable so the losers do not pull down the winners.

- Example: In January 2011 (AFR at 2.4%), Father funds a two-year GRAT with $500,000 of stock with a current price of $25 per share. The annuity payment is 52.5%, or $262,500, for two years. The present value of the annuity is $500,000 and the gift to the remainder beneficiaries is $0, so there is no gift tax. If the stock increases in value by 20% each year, there will be $142,500 left in the GRAT after two years to pass to the remainder beneficiaries tax-free.

    - Initial Value of Stock $500,000
    - Year 1 Ending Value $600,000
    - Year 1 Annuity Payment ($262,500)
    - Year 2 Beginning Value $337,500
    - Year 2 Ending Value $405,000
    - Year 2 Annuity Payment $262.500
    - **Property Passing Tax-Free $142,500**

5. In addition to the new planning options discussed above that are now possible as a result of the 2010 Tax Act, it is also important to note what was *not* in the 2010 Tax Act. Several of the legislative proposals that were raised prior to the enactment of the 2010 Tax Act, including the bill proposed by Senator Max Baucus, included a limitation of Grantor Retained Annuity Trusts ("GRATs") that would have greatly reduced their utility. Under the various

proposals, GRATs would generally be required to have a minimum term of 10 years, and the value of the remainder interest in the trust, as determined at the inception of the GRAT, must have a value greater than zero. The 2010 Tax Act is notable in that it did not contain any GRAT limitations.

6. Due to the fact that interest rates, while above their historical lows, are still very favorable, advisors should continue to implement GRATs when appropriate for their clients. As with other planning in 2011 and 2012, however, there may be an end in sight for more aggressive GRAT planning. The Obama Administration has continued to raise the GRAT limitations as a goal in its Fiscal Year 2012 Revenue Proposals (commonly known as the "Greenbook"), and it is possible that these limitations may be enacted in the future.

VII. Conclusion

The 2010 Tax Act makes substantial changes to the credit exemption amount and the tax rates applicable to estates and gifts. While these changes are scheduled to expire on January 1, 2013, there is a two year window of opportunity for gift giving and wealth transfer that should not be ignored.