Under the new law, it is possible for the surviving spouse to use the deceased spouse’s credit for gifts during lifetime or upon the surviving spouse’s death.

**Special rules for 2010 GST transfers.** The Act reactivates the GST for 2010, but it sets the GST rate for transfers made during 2010 at 0 percent. This allows the direct skip gifts made in 2010 to stand but also permits taxpayers to allocate GST exemptions to 2010 transfers into trust. The GST rate for 2011 and 2012 transfers will be 35 percent.

**Portability of lifetime exemption for married couples.** For estates of decedents dying after December 31, 2010, the executor of a deceased spouse’s estate may transfer any unused exemption to the surviving spouse. This portability eliminates the need for an A/B trust for transferring up to $10 million tax free. It is important to note that the executor must make an election on the estate tax return in order to carry this exemption over to the surviving spouse. Also note that this portability doesn’t apply to the $5-million GST exemption.

Under the new law, it is possible for the surviving spouse to use the deceased spouse’s credit for gifts during lifetime or upon the surviving spouse’s death. Note, however, that if the surviving spouse has had multiple marriages, then he/she can use only the exemption amount of the deceased spouse who died most recently (the last spouse). If the last spouse has previously used his/her exemption, then the surviving spouse cannot use the portability rule. Higher-net-worth individuals also should take into account the following:

- When grandchildren are beneficiaries of an estate, note that the GST exemption is not portable and is lost upon the first spouse’s death unless his/her plan uses this GST exemption.
- States that have their own estate or inheritance taxes don’t have a portability provision. Failure to apply the state credit to the first spouse to die can create unneeded liability. For example, a deceased spouse’s Illinois exemption shelters $2 million of estate assets. If the Illinois exemption is not used, then a special Illinois estate tax of more than $350,000 may be due upon the surviving spouse’s death.
- Many spouses have personal wishes regarding the disposition of assets acquired before marriage. Reliance on the surviving spouse’s plan may eliminate the deceased spouse’s personal plan and result in a “survivor takes all” situation whereby the surviving spouse controls all combined estate assets disregarding the deceased spouse’s wishes.
These new provisions end on December 31, 2012. Table 1 shows the dramatic reductions of benefits effective in 2013.

Give until It Hurts
The 2013 deadline creates a “use it or lose it” situation. Failure to use the $5-million lifetime credit ($10 million for married couples) in 2011 or 2012 could result in an increase to the client’s federal estate tax liability of up to $1.4 million ($2.8 million for married couples). Absent any further changes to the laws, now is the time to create a gifting program.

Depending upon the client’s residency, failure to gift also may result in adverse state tax implications.

### Table 1: Estate, Gift, and GST Rates and Exemptions 2011–2013

<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estate Tax Rate</td>
<td>35%</td>
<td>35%</td>
<td>55%</td>
</tr>
<tr>
<td>Estate Lifetime Exemption</td>
<td>$5,000,000</td>
<td>$5,000,000*</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Gift Tax Rate</td>
<td>35%</td>
<td>35%</td>
<td>55%</td>
</tr>
<tr>
<td>Gift Tax Exemption</td>
<td>$5,000,000</td>
<td>$5,000,000*</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Gift Tax Ann. Exemption</td>
<td>$13,000</td>
<td>$13,000*</td>
<td>$13,000*</td>
</tr>
<tr>
<td>Maximum GST Tax Rate</td>
<td>35%</td>
<td>35%</td>
<td>55%</td>
</tr>
<tr>
<td>GST Lifetime Exemption</td>
<td>$5,000,000</td>
<td>$5,000,000*</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

*Adjusted by inflation

### Table 2: States That Levy Additional Estate or Inheritance Tax

<table>
<thead>
<tr>
<th>State</th>
<th>State</th>
</tr>
</thead>
<tbody>
<tr>
<td>Connecticut†</td>
<td>Nebraska***</td>
</tr>
<tr>
<td>Delaware</td>
<td>New Jersey</td>
</tr>
<tr>
<td>District of Columbia</td>
<td>New York</td>
</tr>
<tr>
<td>Hawaii</td>
<td>North Carolina</td>
</tr>
<tr>
<td>Illinois</td>
<td>Ohio</td>
</tr>
<tr>
<td>Indiana*</td>
<td>Oregon</td>
</tr>
<tr>
<td>Iowa*</td>
<td>Pennsylvania*</td>
</tr>
<tr>
<td>Maine</td>
<td>Rhode Island</td>
</tr>
<tr>
<td>Maryland**</td>
<td>Tennessee†</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>Vermont</td>
</tr>
<tr>
<td>Minnesota</td>
<td>Washington</td>
</tr>
</tbody>
</table>

* State inheritance tax; taxation based upon the descendent-beneficiary relationship (the closer the relationship, the lower the tax).
**Maryland assesses both estate and inheritance tax.
***Nebraska has a county-based estate tax.
†Connecticut and Tennessee impose state gift tax.

Table 2 lists the states that levy an additional estate or inheritance tax. Many of these states have maximum tax brackets as high as 16 percent. Therefore, gifts made in any state except Connecticut or Tennessee will completely avoid state gift, estate, and inheritance tax.

### Special Gift Planning Issues 2010 Gift Conundrum

Many clients made substantial 2010 year-end gifts to take advantage of the lower 35-percent gift tax. Unfortunately, with the increase of the lifetime exemption from $1 million to $5 million, these 2010 gifts could have been made in early 2011 at no gift tax cost. These 2010 gifts may be undone through the use of qualified disclaimers that meet the following criteria:

- The disclaimer is executed within nine months from date of transfer.
- The disclaimant cannot accept any benefits from the gift. A real problem can arise if the gift has been comingled with the donee’s personal assets or accounts.
- The disclaimant cannot control where the gift passes and is presumed to have predeceased the gift, with the assets passing to the contingent beneficiaries upon disclaimer.
- State law dictates where the asset passes upon disclaimer. In most cases direct gifts (such as personal checks or wire transfers) that are disclaimed by the donee will return to the donor. This would undo the 2010 gifts and the resultant liability. The donor then can re-gift in 2011 and eliminate the 2010 liability.

If the gift was made to a gift trust, then a qualified disclaimer typically will cause the gifted assets to pass to the contingent beneficiaries of the trust rather than back to the grantor. However, this may still provide a tremendous GST opportunity if the gifted trust assets pass to the next generation. For example, many trusts are drafted to pass assets to grandchildren upon the death of a child. The disclaimer creates this “death trigger.” Because the GST rate in 2010 is 0 percent, the assets would pass to the grandchildren free of GST while still allowing the donor to keep his/her $5-million GST exemption for other uses.

Note that using qualified disclaimers requires the guidance of legal counsel.

### “Claw Back” Contingency

Some commentators are concerned that the generous benefits provided by Congress may be rescinded. Specifically, the concern is that Congress may impose the $1-million exemption limit not just on tax years 2013 and thereafter but...
also retroactively on 2011 and 2012. Most experts believe this to be improbable but not impossible. To protect themselves, advisors must explain this contingency to their clients.

Should clients still pursue a strong gifting strategy? The answer is an unqualified “yes,” for the following reasons:

- It is likely that the 2011 and the 2012 gift tax would remain at the 35-percent rate.
- Appreciation after the date of the gift still would pass to the beneficiaries free of gift tax.
- Aside from Connecticut and Tennessee, no state estate or gift tax would apply.

GST Planning

Any gifts made to grandchildren and their successors can have profound tax savings. Congress addressed this planning loophole by creating a GST on such gifts. The GST is an add-on to the estate or gift tax for transfers made to grandchildren. It can result in a large tax liability unless the transfers are planned carefully. Taxpayers have a $5-million exemption for GST transfers made in 2011 and 2012.

Note that the GST exemption is integrated with the $5-million gift and estate exemptions. For example, a $5-million gift to a grandchild uses both the gift tax and GST exemptions. If a $5-million gift had been made before the gift to the grandchild, then the gift would be subject to a gift tax but not the add-on GST.

GST and Dynasty Trusts

Time can be fully utilized as a planning asset through a dynasty trust. A dynasty trust is drafted to use the $5-million GST exemption and to provide discretionary income and principal for successive generations until the trust is exhausted or until the state statutory limitation of the trust term. No beneficiary is given enough rights to make the trust taxable to his/her estate.

The dynasty trust can run for decades without any estate tax implications.

The state statutory limitation historically had been driven by the common-law Rule Against Perpetuities (RAP). RAP required that all trusts must terminate no later than 21 years after the death of “life in being” that was alive upon the creation of the trust. Many states have replaced this common-law rule with more-favorable statutory language that promotes longer-term trusts. For example, Florida allows trusts to last up to 360 years, while Illinois has a perpetual trust rule. Other states, such as Indiana, still maintain the common-law RAP. Of course, legal counsel must be part of the dynasty trust process.

Multigenerational Planning

The wealth manager is an integral part of the GST planning process. Accounts managed for grandparents will be more risk adverse than those managed for younger generations. In fact, a common mistake is to create a blended “family investment strategy.” The wealth manager must have a candid conversation with family members to determine which accounts are earmarked for future generations. The accounts that children or grandchildren will inherit can adopt a more aggressive investment profile that is centered on growth.

Gift Leverage and Life Insurance

Many wealth managers will use life insurance as a means to maximize the value passing to the family. Properly planned life insurance held in a third-party trust avoids estate tax in the grantor’s estate and, if in a dynasty trust, the beneficiary’s estate as well. Unfortunately, life insurance isn’t always an automatic asset for gift trusts. The medical underwriting of the insured, the investment rate of the underlying cash value, and the actuarial expectancy of the death benefit payment drive this decision. Life insurance must be viewed as an asset class and compared to alternative investments to determine the correct choice. An internal rate of return (IRR) analysis of the life insurance coverage must be provided to ensure its investment suitability.

Planning for the Very Wealthy in the Current Economic Environment

For many high-net-worth clients, the $5-million lifetime exemption is merely a drop in the bucket compared with the value of their overall estate holdings. Aside from the new tax laws, the current low interest rate and depressed economic environment has created additional gift planning opportunities specifically for the high-net-worth client.

Grantor Retained Annuity Trusts (GRATs)

GRATs allow a discount for gifts made to the trust equaling the present value of the grantor’s annuity paid back to him/her from the trust. If the appreciation of the trust assets exceeds the discount rate (the IRS Section 7520 rate was 2.8 percent in June 2011), then this appreciated value passes to the beneficiary free of gift tax. The wealth manager’s obligation is to choose those assets most likely to appreciate in value—at least above the prescribed Section 7520 discount rate. The grantor also must outline the term of the GRAT to complete the gift; otherwise, the assets are brought back into the grantor’s estate.

Qualified Principal Residence Trusts (QPRTs)

With real estate values depressed due to the economy, many clients should consider a QPRT. A properly drafted QPRT can allow the grantor to retain the right to live in the residence for an initial term of years (e.g., 10–20 years). This “right to live” in the residence creates a discount of the gift made into the QPRT. At the end of this initial term, the beneficiaries would become the owners of the residence and the grantor’s interest in the residence would...
Installment Sales

These can be used to spread out net investment income and MAGI in much the same manner as a charitable remainder trust. Installment sales may enable a taxpayer to avoid surtax exposure in the year of sale and in subsequent years.

Above-the-Line Deductions

Deductions that can be claimed on page one of Form 1040 reduce MAGI without necessarily reducing NII. Two of the most important are contributions to qualified plans and traditional IRAs and charitable contributions.

Conclusion

Without planning, the new 3.8-percent surtax could significantly increase the tax payable by high-income individuals and trusts beginning with the 2013 tax year. Fortunately, a number of effective tax strategies can be employed, particularly in 2011 and 2012, that can reduce or eliminate exposure to the surtax.

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terminate. However, the grantor could establish a lease agreement with the beneficiaries and continue to rent the residence at fair market rent. If the house is later sold, the proceeds would be paid to the beneficiaries of the trust. QPRT’s can be established on both a primary residence and a vacation home. If there is an expectation that the residence will appreciate, then this appreciation passes to the beneficiaries free of gift tax.

Many clients have balked at QPRTs because transfers into QPRTs immediately reduce the gift tax exemption; however, with the new $5-million limit, many clients should be more comfortable with QPRT benefits in their gift planning.

Intentionally Defective Grantor Trusts (IDGTs)

In lieu of a gift, assets can be sold to beneficiaries. Simply stated, the exemption limitations for gifts are not relevant to sales. Therefore, sales to beneficiaries can be measured in tens of millions of dollars. Like gifts, the targeted sale assets should have strong appreciation potential. Benefits include the following:

- The transaction avoids any gift tax because it is a sale to the trust rather than an outright gift. The sale moves the real estate interest outside the grantor’s estate and any future appreciation of the asset will pass to the trust’s beneficiaries, estate and gift tax free.
- The value of this planning tool is reflected in the valuation discounts used in these sales. For example, discounts for minority and lack of marketability discounts can pass additional value to the trust beneficiaries of 35 percent or more, which maximizes the amounts passing to the beneficiaries.
- The grantor trust will be structured as a defective trust for income tax purposes, so that it avoids any capital gains tax recognition. If the trust stays defective after the sale, any income earned by the IDGT will be reported on the grantor’s income tax return, and the grantor personally will pay the requisite income tax. These income tax payments are not considered gifts and are not subject to gift tax.

GRAT, QPRT, and IDGT planning always should be done with the guidance of legal counsel.

It is important to note that the planning strategies discussed in this article may be adversely impacted by future legislation. Therefore, it may be best for clients to take advantage of these new opportunities sooner rather than later.

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