**Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2027**

**Date:** 12-Nov-12
**From:** Steve Leimberg's Estate Planning Newsletter
**Subject:** **Marty Shenkman & Bob Keebler: The Election is Over- Now What?**

*"President Obama has been reelected to a second term. The Senate remains in democratic control with 53 seats and possibly Bernie Sanders from Vermont and Angus King in Maine, may both caucus with the Democrats. So the Democrats have retained their majority position, and the Republicans lost 2 seats. In the House the Republicans have retained their majority, although they lost 5 seats. There are now, post-election, more Democrats in both the House and Senate. Speaker John Boehner remains in control of the House and Senate Majority Leader Harry Reid remains in control of the Senate Clearly, the election was a victory for the Democrats, but not a sufficient mandate to assure that the President's tax and spending agenda will be enacted.*

*From one perspective this looks quite similar to the political landscape that we have had for the past few years. If that proves to be the case, the results could be a continuing impasse or band-aids instead of comprehensive tax legislation. But the political landscape may prove different than the superficial view suggests. President Obama made it clear during his campaign that the election was one of "choice." His campaign made it quite clear that he expects the wealthiest taxpayers to shoulder more tax burden and that he views his reelection as a mandate for that platform."*

Now, **Marty Shenkman** and **Bob Keebler** provide members with their commentary on the question that's on everyone's mind now that the national elections are over: what happens next?

**Robert S. Keebler, CPA, MST, AEP** (Distinguished) is a partner with **Keebler & Associates, LLP** and is a 2007 recipient of the prestigious Accredited Estate Planners (Distinguished) award from the National Association of Estate Planning Counsels. He has been named by CPA Magazine as one of the Top 100 Most Influential Practitioners in the United States and one of the Top 40 Tax Advisors to Know During a Recession. His practice includes family wealth transfer and preservation planning, charitable giving, retirement distribution planning, and estate administration. Mr. Keebler frequently represents clients before the National Office of the Internal Revenue Service (IRS) in the private letter ruling process and in estate, gift and income tax examinations and appeals, and he has received more than 150 favorable private letter rulings including several key rulings of "first impression". He is the author of over 100 articles and columns and is the editor, author or co-author of many books and treatises on wealth transfer and taxation. For information about Bob's tapes, seminars on tape, or speaking engagements, please contact Bonnie Lamirande at Bonnie.Lamirande@keeblerandassociates.com

**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.

As we said in a previous newsletter, this is – literally – THE Estate Planning Book of the Year. You can get it as an e-book at www.amazon.com, or if you prefer a download of a PDF instead of an e-book on www.amazon.com, **Phil Kavesh** is selling PDFs from his www.ultimateestateplanner.com. For hard copy, call **Bob Keebler's** office: office 920-593-1701, ask for Emily.

Here is their commentary:

## EXECUTIVE SUMMARY:

President Obama has been reelected to a second term. The Senate remains in democratic control with 53 seats and possibly Bernie Sanders from Vermont and Angus King in Maine, may both caucus with the Democrats. So the Democrats have retained their majority position, and the Republicans lost 2 seats. In the House the Republicans have retained their majority, although they lost 5 seats. There are now, post-election, more Democrats in both the House and Senate. Speaker John Boehner remains in control of the House and Senate Majority Leader Harry Reid remains in control of the Senate Clearly, the election was a victory for the Democrats, but not a sufficient mandate to assure that the President's tax and spending agenda will be enacted.

From one perspective this looks quite similar to the political landscape that we have had for the past few years. If that proves to be the case, the results could be a continuing impasse or band-aids instead of comprehensive tax legislation. But the political landscape may prove different than the superficial view suggests. President Obama made it clear during his campaign that the election was one of "choice." His campaign made it quite clear that he expects the wealthiest taxpayers to shoulder more tax burden and that he views his reelection as a mandate for that platform.

As every adviser knows, the fiscal cliff is looming. The Busch era tax cuts could expire if there is no action. Should that occur, capital gain rates could jump from 15% to 20%, and qualified dividend advantages will disappear. The estate exemption drops to $1 million from $5.12 million and the estate tax rate rises from 35% to 55%. Inaction in Congress could result in what might prove to be the largest tax increase in history. Cuts, related to the debt ceiling deal of 2011, could affect over a thousand government programs including Medicare and defense.

But it is not only the end of the Bush Era tax cuts that may create harsh tax increases. The temporary payroll taxes are not part of the fiscal cliff but they end at the same time. This will take a small 2% bite out of the average American's paycheck. For lower income earners this will hurt. For those Americans living paycheck to paycheck, any increase in taxes will cut spending and consumption. For wealthier taxpayers the 3.8% Surtax on Net Investment Income (passive income) which takes effect in 2013 will exacerbate all the other possible tax increases.

## COMMENT:

**Mirror Mirror on the Wall**

What will happen yet remains anyone's guess:

- Might we end up with a compromise that maintains the current tax status for another year or two? I Wish I could get a buck for every politician that said that they did not want to "kick the can down the road."

- Might the current tax status remain for all those earning under $250,000 and rates rise for the highest earners, along with some increase in estate taxation, perhaps reducing the exemption to $3.5 million, and increasing the rate to 45% that President Obama has proposed?.
- There could be comprehensive tax reform. The pieces are in place for everyone to come together and have striking tax reform. But it is certainly not clear if this can happen in the remaining days of this year.

If the Washington “machine” remains fractured what can be done? The budget situation and the fiscal cliff are huge issues and the Speaker must put forth a plan. There is some hope that there will be an improved sense of cooperation but that remains to be seen. The ultimate issue remains whether President Obama and the Speaker will be able to work out a deal to avoid the country going over the fiscal cliff.

As the fiscal cliff approaches there are a host of challenges. How flexible law makers will be no one knows. The other half of the fiscal cliff “coin” is cuts to military and Medicare spending. These could have a significant negative impact on the economy. With this coin, tails you lose, heads you lose. This all may trigger more volatility in the markets, which will only serve to make clients more skittish about planning.

Where does this leave practitioners? What do we advise clients to do in the waning days of 2012?

This election may prove to be one of the most important elections in U.S. history, at least from a tax perspective. Apart from the fact that President Obama won the Presidency, and apart from who now controls the House and Senate, we are likely to see the first major changes to the tax code in over ten years.

Accordingly, there is no better time than now, immediately after the election, to advise your clients and prospects on what important steps to take before the tax law changes in 2013.

**"I've got the pen" - Tax Increases the Administration Would Like to See**

When might change occur? When might tax legislation be enacted? If President Obama has his way, tax changes might happen rather soon. The yearend deadline we’ve all assumed may turn out to be only fanciful thinking.

The administration would like to see top income tax brackets jump to 36%+. Adding the so called “Buffet Rule” could affect capital gains, qualified dividends, and carried interest from hedge fund advisers. Raising capital gains rates to 20%, and taxing dividends and carried interests at ordinary income rates over a certain threshold, could change the face of income tax planning and investing for high earning taxpayers. The estate and gift tax exemption will drop to $1 million and the rate would rise to 55%.

**Medicare Tax on High Earners Increases in 2013**

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 current 2012 law only wages/earnings are 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.

The new Medicare tax will apply to the unearned income of individuals, and to estates and trusts as well. IRC Sec. 1411(a)(2). Estates and trusts will pay the Medicare tax on investment income based on the lesser of: (1) The estate or trust's undistributed net investment income; or (2) The excess of the estate or trust's net investment income over the threshold at which the estate or trust is taxed at the highest marginal tax rate.

The calculations for an estate or trust will be complicated by having to determine expenses that can offset investment income with consideration to the rules under Code Section 67(e) and the special rules for applying the 2%-of-AGI floor on miscellaneous itemized deductions to estates and trusts

If an estate or trust earns $30,000 it will face the additional Medicare tax but a beneficiary may not have, even with the full distribution of his or her share of the estate or trust, enough income above the threshold to trigger the Medicare investment tax. This will raise additional complications in planning distributions from trusts, for example, that carry out distributable net income ("DNI") to be taxed to the beneficiary. There may be increased pressure on trustees to distribute to lower bracket beneficiaries, using the potential Medicare tax savings, as the excuse.

Might investment assets, and the income they generate trapped inside a business entity, avoid the Medicare tax? This is unlikely unless the business can justify a business purpose for this. The body of tax law from old personal holding company days justifying retention of liquid assets inside a corporation might provide a guideline. Although there are no rules or guidance yet, creating minutes documenting the business purpose of retaining investment assets in the business might be one of the steps to take to support this type of action. However, one downside for this type of planning will be exposing liquid assets to business creditors and claimants.

Consider possibly related impact of curtailing deductions also encouraging taxpayers to structure formerly personal or investment activities inside an entity. As noted elsewhere, consider the increased use of entities to capture deductions and possibly income that can avoid the Medicare tax.

Will trustees be at risk for challenges from beneficiaries if they don't distribute? Charitable remainder trusts ("CRTs") are exempt from this tax. This, when combined with the potential for higher income taxes on capital gains, may lead to an increased popularity of CRTs.

**Checklist of Likely Changes to Current Tax Laws**

The scope of income tax law changes could be substantial. Almost no area may be left unaffected:

- Ordinary income tax rates may be raised by increasing the top two tax brackets to 36% and 39.6% respectively. This may only apply for adjusted gross income ("AGI") of $200,000 or more for single taxpayers and $250,000 or more for married taxpayers, filing jointly. The Republicans, controlling the House and having the filibuster have in the Senate, continue to voice objections to rate increases, while President Obama has reminded them of the "mandate" he received from America to proceed to tax wealthier taxpayers at a higher rate. When this possible higher marginal income tax rate is combined with the Medicare surtax of 3.8% the maximum rate would rise to 43.4%.
- The "Buffett Rule" may mandate a 30% minimum tax on high earners. The income level that this rule might apply to is for those making more than $1 million of investment income. The interaction of such a rule and the many other possible increases remains unclear.
- Capital gains tax rates increased for high-earners to 20%, plus the 3.8%

surtax. While charitable remainder trusts have become less popular in recent years, in part as a result of the lower capital gains tax rates, this increase, possibly along with the Buffet Rule and other changes may invigorate the use of CRTs again in the future. An 18% rate is provided for property purchased after December 31, 2000 and held more than five years at the time of sale. For lower bracket taxpayers an 8% rate will apply.

- Dividends will be taxed as ordinary income for individuals with AGI of $200,000 or more for single taxpayers, and $250,000 or more for those married filing jointly.
- Carried interests will be taxed as ordinary income instead of capital gains. This is discussed in more detail below.
- The tax benefit of certain deductions, including the PEAS amendment 3% scale back on itemized deductions is back. This is discussed in more detail below.
- New taxes related to the affordable care act may be enacted.
- The impact of the Alternative Minimum Tax (AMT) may be changed.

**Example**: How significant might these changes be to a client? We calculated the estimated tax impact of the conversion of dividends from a tax favored form of income, to ordinary income tax rates. One client will face an estimated increase from $30,000 in tax under the current law, to over $80,000 in income tax.

**Likely Changes to the Current Estate and Gift Tax Laws:**

- The estate and gift tax exemption may decline. While the law provides for a $1 million exemption in 2013, President Obama has proposed a $3.5 million exemption. However, the gift tax exemption is unsettled and may be only $1,000,000.
- The generation-skipping transfer (GST) tax exemption is scheduled to decline to $1 million inflation indexed in 2013, but again President Obama has proposed a $3.5 million exemption.
- The estate, gift and GST rate is scheduled to increase from the current 35% to 55%, but President Obama has proposed a 45% rate.
- Grantor retained annuity trusts (“GRATs”) may be required to use a 10 year minimum term. This will substantially increase the mortality risk for using GRATs making the technique ineffectual for older taxpayers. Numerous bills to restrict GRATs were proposed previously. For example, the House of Representatives passed the Small Business and Infrastructure Jobs Tax Act of 2010 on March 24 (H.R. 4849). Changes may be patterned after this or other prior proposals.
- Grantor trusts have been proposed to be included in the grantor’s estate; however existing grantor trusts will be grandfathered in.
- Portability of the estate tax exemption is set to expire in 2013. However, President Obama has proposed that it be made permanent. Regardless of what happens to portability it seems to be the consensus of most tax advisers that the shortcomings of portability generally make it only a technique to rely upon when better proactive planning was not pursued, or in a limited number of other circumstances.
- Valuation discounts have been proposed for restriction or repeal numerous times. This may be another avenue of raising revenues on the wealthy. For example, Code Section 2704(b) provides that valuation restrictions which are more restrictive than state law should be ignored. State laws have been intentionally changed, e.g. Nevada, undermining the intent of this provision by incorporating into state law the restrictions that support valuation discounts. This might be viewed as a loophole appropriate to close. Other anti-FLP provisions might mandate that

certain restrictions be ignored. This could include certain categories of restrictions, such as the lack of a definite term in an agreement, the creation by transfer of only an assignee interest, inability to withdraw capital, and so forth. Lock in features might be ignored

- Restrictions to multi-generational dynasty trusts could be significant if President Obama's proposal to limit the allocation of GST exemption to 90years is enacted.
- Other restrictions to intra-family transfers may be proposed.

The collective effect of several, or perhaps all of these types of changes, could change the face of estate planning in a profound manner. The effective date could wreak havoc with 2012 planning that may still be in process if changes are enacted before year end. We may wake-up on January 1, 2013 to find an empty estate planners toolbox.

**Possible Restrictions on Itemized Deductions**

CNN reported that "Boehner, R-Ohio, signaled a willingness to deal on Friday but also maintained hard-line GOP opposition to any tax increase." http://www.cnn.com/2012/11/09/politics/obama-fiscal-cliff/index.html?hpt=hp_t2

The Republican position that rates should not be raised, even on the wealthiest taxpayers, might, to some extent depending on the shape of tax negotiations, morph into tighter restrictions on a range of deductions. The impact of this could be harsher, far more complex to evaluate, and result in significant variation in the impact on different taxpayers. These changes might occur regardless of marginal rate increases.

A new deduction tax paradigm might mean higher actual tax costs for many taxpayers, even higher than the rate increases proposed by President Obama. Slashing deductions will have a widely disparate effect on different taxpayers, different industries and different states. Disruptions may be mollified by phasing out tax benefits over time, but it is not clear whether this will occur. Within these possible changes exists potential tax planning opportunities for the proactive forward thinking adviser and client.

Restrictions on deductions might include the full laundry list of common tax deductions. Changes may spur taxpayers to restructure transactions and the manner in which they handle their affairs. A family limited partnership ("FLP") formed to take advantage of gift and estate discounts may morph into a new purpose if discounts are restricted or repealed and income tax rates rise and deductions are restricted. FLPs instead of being dissolved (which for asset protection reasons alone most should not) may be one of the few techniques remaining to secure deductions as itemized deductions are limited.

- Home mortgage interest deductions could be restricted. The concept is not new. Previously deductions were capped so that only interest on mortgages up to $1 million generally used to purchase or improve a home, plus interest on a qualified home equity line, could be deducted. The sacred home mortgage interest deduction may be up for consideration of further restrictions. This could impact the cost of home ownership and the rent versus buy analysis. Even if the home mortgage deduction is not directly restricted, restricting itemized deductions generally, and other broader changes, may indirectly have a depressing impact on the value of the home mortgage deduction even if it is retained.

- Charitable contribution deductions may be restricted. One proposal previously discussed which might resurface was to limit the charitable deduction for individuals to amounts over two percent of adjusted gross income ("AGI"). If this type of change is proposed before year end then taxpayers should evaluate whether contributions should be made before

year end before the restrictions take effect, or deferred until next year when higher tax rates on income and capital gains for wealthy taxpayers may become effective. The Medicare tax on passive income might not apply to charitable remainder trusts. Therefore, using charitable remainder trusts (CRTs) and non-grantor charitable lead trusts (CLTs) might shift investment income to the trust and avoid the new Medicare investment income tax, generate a deduction of some benefit and defer higher capital gains.

- The state and local tax deduction for individuals has been talked about as a target. If this tax deduction is restricted or eliminated the disparate impact on taxpayers would be significant. If the Republican position against raising marginal tax rates is translated into restrictions on deductions, it could have this type of impact that will barely affect some and be terribly unfair to others.

**Example**: A 50 something socialite-executive in New York earning a very high salary may lose a substantial charitable contribution deduction for the myriad local charities she supports, a significant state and local tax deduction, and have to add to income the cost of a health insurance plan if a new cap is enacted. The new Medicare tax on earnings and investment income may be triggered. Contrast this with a retiree living in Florida with a comparable income, but no income tax. This taxpayer might face a lower marginal income tax rate, even if the Medicare Tax on investment income is added. The bottom line difference on these two taxpayers could be dramatic.

**Carried Interest Tax Changes**

Carried interests are a right that entitles the general partner ("GP") of a private or public investment fund to a share of profits as compensation for managing the fund's assets. These can be vested or unvested. For example, a GP might earn 2% of assets and 20% of profits. Management fees are taxed at ordinary income tax rates, while carried interests are taxed as capital gains and are exempt from employment tax. Thus a GP receives income for services rendered at capital gain rates. There have been a number of proposals, e.g. 2007 HR 2834, introduced to tax carried interests as ordinary income regardless of the character of the item at the partnership level. These changes, depending on how crafted, could affect a larger swath of taxpayers than only hedge fund managers. Carried interests can also be used as an estate planning technique for a family business. If the estate plan provides for giving a profits interest to a child to avoid income and gift tax, this could get pulled into the new paradigm. Carried interests are a common approach to compensation in real estate transactions as well. Most carried interest "fees" are presently taxed at capital gains tax rates. This contrasts with management fees which are taxed as ordinary income.

The proposals provide that these types of economic interests will be taxed as ordinary income without regard to the normal flow through rules of partnership taxation. Further, if you later sell these interests even the gain on the sale will be taxed as ordinary income instead of capital gains. Finally, Code Section 1402 may be amended to make carried interests subject to employment taxes as well.

**Income Tax Actions To Take Before Year-end**

There is a host of income tax planning steps that might be worth discussing with clients. Consider the following:

- Analyzing when to take deductions and losses. Although the general rule of thumb is to accelerate tax deductions and losses, because of the possible tax rate rise, the opposite approach might sometimes be advisable. Thus, many taxpayers will benefit from deferring income tax deductions and losses until 2013 when higher marginal tax rates will

make these deductions and losses more valuable. But will they? If restrictions on specific deductions are enacted, then it may only prove worthwhile deferring deductions that themselves are not restricted or eliminated. The reinstatement of the 3% AGI phase out of itemized deductions may make many deductions of little or no value next year regardless of changes in marginal tax rates. Thus, the calculus of what to defer and what to accelerate could make this the most uncertain and/or complex year-end tax planning environment ever.

- When to recognize income and harvest capital gains will thus be a significant issue for many taxpayers. This is discussed in more detail below.
- Bonus depreciation and Section 179 deductions are important to consider as clients plan asset acquisitions near year end. If your client buys a new car should they buy it now or in January 2013 when income tax rates are higher and they may qualify for a Section 179 deduction?
- Income shifting to junior generations may be advantageous.
- If you can get paid this year the income may be taxed at a lower rate than next year.
- If you have a bond paying interest on January 1, sell that bond in December. The income will be taxed at 35% now, instead of at a 43.8% marginal tax rate in 2013. There is also an arbitrage that you can take advantage of on bonds. Your client might benefit from selling a bond trading at a premium in 2012, and repurchasing the bond later. The market premium is capital gain taxed at 15% and the purchased premium can be amortized over the life of the bond.
- Some of these strategies provide a large deduction up front but you have to be careful. There are significant environmental issues on some gas deals, for example. Some of the alternative investments, such as oil and gas, gold, foreign currency and index options may also offer an income shifting benefit.
- If a client has an existing installment note, gift it to a non-grantor trust under Lucas v. Earl, and trigger the income tax now.
- Use derivative strategies and straddles to take gain in 2012. The straddle rules prevent you from taking loss early, not gain early.

**Gain Harvesting**

If rates will be higher next year, then accelerating income into 2012 by harvesting gains, will prove advantageous. This could avoid the income tax at higher rates in 2013 as well as the Medicare surtax. Avoiding the increase in long-term capital gains and the health care surtax by harvesting gains this year will sound appealing, but it will not always prove advantageous. You must evaluate the trade-off between paying lower taxes and the loss of tax deferral by trigging the gain.

If you sell this year and pay tax of $15,000 versus selling in January and paying tax of $23,800 the decision is easy. But as the time goes on, and your holding period for the asset involved lengthens, the analysis is different. You have to consider time value of money, cost of sale, etc. The analysis will often be more complicated, consider:

- One construct to use in this type of evaluation is a return on investment (“ROI") approach. What is the ROI? At 4 years the ROI is 9.21% after tax for a risk free rate of return. That is still an incredible annual return.
- The gains triggered by gain harvesting in 2012 may impact the taxation of Social Security benefits for some taxpayers, so for them a broader analysis must be considered.
- If the taxpayer is elderly or terminally ill, loss harvesting may never make sense as it may be more advantageous to simply hold the securities until death and achieve a step up in income tax basis for heirs.

- When the US Treasury issues regulations concerning the new Medicare surtax they may provide that loss carry forwards pre-dating the 3.8% surtax on net investment income cannot offset the surtax. If that is the case then it will be quite advantageous to harvest these losses this year. The IRS has indicated that these Regulations should come out soon.
- Asset location considerations should be evaluated. If the marginal tax rate on dividend paying stocks increases, for example, it may prove advantageous to hold those stocks in qualified plans. If so, then even if a client's asset allocation remains constant, the location of those assets, as between qualified and non-qualified buckets may change. This may provide another reason to liquidate certain positions before year end.

**Roth Conversion Planning**

Roth IRA conversions have been hot, but depending on the tax law changes they could become red hot. Watch the deadlines for when these conversions can be processed. At some point on the calendar investment companies will refuse to process conversions before year end.

Conversions should not be evaluated in a vacuum. You must also consider asset protection and estate planning considerations.

The reason we want to convert to a Roth IRA is that rates are lower today. Generally convert by asset class to take advantage of market conditions and volatility. A carefully designed conversion can lower the overall tax paid in the long term. Roth IRAs are not subject to the required minimum distribution (RMD) rules that regular IRAs are subject to at age 70.5. Beneficiaries can realize tax free withdrawals from Roth IRAs, but not from regular IRAs. From an estate tax planning perspective, funding a bypass or applicable exclusion trust with a Roth IRA is much more efficient since they are full dollars, whereas funding with a regular IRA is not only more complex but it underutilizes the benefit because the dollars involved are partial or pre-tax dollars. The market is down now about 300-400 points so this may be an opportune time to do this.

- Strategic conversions take advantage of the client's long term wealth transfer objectives. For example, it may in some circumstances actually be advantageous for an elderly or terminally ill client to convert, or even just cash in a regular IRA and use the net of tax proceeds to fund gifts.
- Tactical conversions take advantage of NOL carry forwards, charitable contribution carryovers, and other special circumstances to offset the income tax cost of the Roth conversion. The presence of these special conditions might trump the rest of the analysis and make conversion advantageous.
- Opportunistic conversions take advantage of changes in different asset classes. Reid introduced a 5% surtax if you had over $1 million of income. If this occurs you want to be in a Roth. So getting into a Roth if you can re-characterize could prove particularly advantageous.
- Hedging conversions – take advantage of current lower rates.

**Estate Planning Actions To Take Before Year-end**

There is a host of income tax planning steps that might be worth discussing with clients. Consider the following:

- Annual exclusion gifts always provide a year-end advantage because they are a "use it or lose it" benefit. However, in 2012 the focus for almost all taxpayers is maximizing the benefit of the current large exemption to the point that this may be one of the few year-ends where annual gifts are not part of most tax planning conversations.

- Lifetime gift exemption gifts are really the focus of planning. Wealthy taxpayers by the droves are rushing to get last minute planning completed before the exemption declines.
- Taxable gifts make theoretical sense if the tax rate does in fact increase from 35% to 55%, but given the uncertainty it is likely that few taxpayers will intentionally incur gift tax this year.
- Grantor Retained Annuity Trusts (GRATs) could be subject to restriction as described earlier, so many advisers and taxpayers are implementing GRATs now. While GRATs are a great tool, especially with the current low interest rate environment, in some instances clients or their advisers are misdirecting precious planning time and effort on GRATs when the client has substantial unused exemption amounts. For many, this will prove to be a less then optimal focus. Why use a GRAT to transfer what a completed gift to a grantor trust can directly accomplish without mortality risk.
- Dynasty trusts should be the norm of planning in all years. Why have a trust ever end before it has to and expose assets to future estate taxation, divorce and malpractice risk, and so on. However, in 2012 the importance of completing dynastic trusts has special meaning as this may prove the last period during which GST exemption can be allocated without limit given the proposals of President Obama to limit the duration of GST exemption allocations to 90years.
- Installment sales to dynasty trusts have been a popular technique for large wealth transfers. But with perpetual allocation of GST exemption, grantor trusts and discounts potentially all on the chopping block, the incentives for ultra-high net worth clients to implement note sale transactions to freeze business and real estate interests, is especially great.
- Family limited partnerships (“FLPs”) and limited liability companies (“LLCs”) have been nearly ubiquitous in estate planning. While they remain incredibly powerful tools for a host of reasons a number of particular considerations demand attention so late in the year. Funding a new FLP or LLC with assets and consummating a gift of those entity interests at a discount may leave precious little time for the assets to “cure” or “age” inside the entity before the gift of entity interests. The shorter the time frame between the different steps or components of the plan the more likely it is that the IRS will assert a step transaction challenge to it. With the recent Rush University case in Illinois some practitioners are reconsidering how self-settled trusts are utilized. Certainly FLPs and LLCs can be used to own assets in a non-DAPT state to avoid any real or tangible property interests being held outside of the DAPT state where the self-settled trust was formed and administered. Others establish LLCs in the DAPT state to further enhance the connections to that state to support the position that there is sufficient nexus to take advantage of the DAPT state laws. There has of late been some increasing discussion of housing trust protectors, investment advisers and similar roles inside a special purpose LLC to arguably further minimize connections to non-DAPT jurisdictions. With the pressure on many mid-wealth range clients to make large gifts to utilize their exemptions, the pressure or need to use self-settled trusts as the receptacle for those gifts is substantial. All of these applications of FLPs and LLCs can be incorporated into such planning.
- Spousal Lifetime Access Trusts (SLATs) have become the hot planning technique of 2012. What remains to be seen in the post-game analysis, is how well these trust plans will fare. The potential bumps in these plans are not insignificant. While several well respected practitioners believe the reciprocal trust doctrine risks are overstated, most planners take some steps to differentiate the trusts when each spouse or partner establishes a trust for the other. How much distinction will prove necessary with hindsight to win the day is unknown. As clients rush to

complete non-reciprocal SLATs closer and closer to the end of the year the time pressure may make the planning less focused on this issue. If non-reciprocal SLATs are established but one spouse appears to have access to the trust, might the IRS simply argue for estate inclusion on the basis of an "understanding" or "implied agreement" that the transferor spouse would have benefit? Even articles appearing in Leimberg Services have touted the ability of the transferor/grantor spouse to "indirectly" benefit from the trust for the other spouse. Some cautious practitioners have opted to establish the SLATs in DAPT jurisdictions so even such an argument should fail because if the implied agreement in fact occurred, at worst the client has established a self-settled trust in a jurisdiction that permits them. However, the reality is that most clients' appetite for complexity and legal fees keeps that prudent step off the menu. There is also the Achilles heel to SLATs – what the clients do to mismanage the trusts after they are established. Just like the scores of bad-fact FLP cases, it doesn't take Carnac the Magnificent to envision a proliferation of bad-fact SLAT cases down the line. While most if not all practitioners will caution clients to return for periodic reviews of how the trusts should be operated, most clients won't follow that advice.

- Front-end loading irrevocable life insurance trusts (ILITs) can be a valuable step for clients unwilling to establish new trusts or more sophisticated planning, and for any client with a robust life insurance plan. This can provide not only a means to utilize the currently available exemption that might decline but to secure and hopefully grandfather long term GST exemption allocation and grantor trust status. With today's super-low interest rates split-dollar life insurance should also be explored.
- Forgiving intra-family installment notes has proven another popular 2012 planning technique. For clients this has the substantial emotional benefit in many cases of enabling a child or other heir to own a home debt free, and so on. However, many of the debt forgiveness "plans" are really not planned and will prove problematic in future years. Forgiving a loan is often accomplished outside the protective envelope of a trust. Thus, if a parent had loaned a child several hundred thousand dollars to buy a house forgives that loan, and perhaps even gifts the child additional money to pay off a mortgage, when that child is sued or divorces in a future year, all may be lost. A better way to structure this type of transaction, for the occasional client willing to listen to the recommendation, is to have the parent gift the funds to a trust (and preferably a GST exempt, grantor dynasty trust in a DAPT jurisdiction). The trust can then loan money to the child so that the economic value stays protected inside the envelope of the trust.

**Insurance Considerations**

Many of the potential changes, both income and estate tax, favor insurance products and insurance planning. There can be significant advantages to incorporating insurance into 2012 planning, as well as in establishing and/or funding irrevocable life insurance trusts ("ILITs") this year. Higher income tax rates and lower deductions may make life insurance one of the most attractive investment formats since the economic value can grow inside the income tax advantageous envelope of the life insurance policy. The large current exemptions make shifting wealth into a properly structured life insurance trust an incredibly powerful wealth shifting tool.

If the common tax planning approach of maximizing the number of acronyms for each component of planning is adhered to, try a SLAT-ILIT. The client can create a SLAT as the receptacle for investment assets, interests in a family business, or a rental real estate property. That SLAT could be structured with insurance provisions, perhaps a special life insurance trustee, and the cash flow from the business, real estate interests or investments could be used to cover insurance premiums, all inside the same trust. If you grew up on Alphabet

cereal that SLAT-ILIT could be an IDIT or grantor trust too.

**Clawback**

Clawback is the possibility that the calculation of the estate tax in future years when the exemption is lower could result in the 2012 gift being pulled back into the estate tax calculation in a later year. Even if this were to occur, and it does seem most commentators believe it should not (with some notable exceptions) most believe that it is still advisable to gift as future appreciation will be removed, grantor trust and GST benefits perhaps grandfathered, discounts obtained, etc. But given the potential for costly adverse tax increases for the wealthy, perhaps the better question is why put off planning in light of a risk that cannot be quantified? Yet, regardless of what appears to be the better argument of proceeding with planning it seems that hardly an estate planning discussion can be had without "clawback" being raised. It would seem at this stage of the discussion that any client sophisticated enough to understand 2012 wealth transfers that they might make, has likely been exposed to media discussions of this issue a sufficient number of times that no practitioner should really have to be obligated to explain the possible risk again. Yet many of us continue to do so.

A significant issue should clawback become a reality, is who will pay the tax if it occurs? For example, if a large gift is made to the client's son, and the remaining estate is left to the client's daughter, then the daughter may lose much of her inheritance if the clawback cost consumes a significant portion of the remaining estate. This is similarly an issue with a second or later marriage where your client makes a large gift to children from a prior marriage, and then leaves the estate to the spouse, who may bear the brunt of the "clawback tax."

**Can Defined Value Clauses Address the Inability To Get an Appraisal**?

No discussion of 2012 last minute gift planning seems complete without a discussion of defined value clauses. Some practitioners use Wandry clauses in every transaction. Some practitioners use a Wandry clause in every gift and a Petter/Christiansen type defined value clause in every sale transaction (the porridge is too cold). Some practitioners or clients will undoubtedly abuse defined value clauses to mask aggressive appraisals, or in lieu of getting proper appraisals. Also the language in Wandry very clearly contemplates an independent qualified appraisal. Just like the bad-fact FLP cases they'll likely muddy the waters for all. Some practitioners rarely use a defined value clause believing that they are ineffectual unless to a charity (which many clients will not consider), and assert that such clauses are merely audit red flags that increase the risk to the client (the porridge is too hot).

Other practitioners do not uniformly use either a Wandry or other type of valuation clause in every transaction. These practitioners believe that they should consider the audit exposure the clauses might create, the cost and complexity of creating some of these mechanisms (e.g., if the excess is to be paid over to a GRAT, a GRAT needs to be created and according to some, funded), etc. While these practitioners believe that their Wandry porridge is just right, practitioners in the other camps undoubtedly disagree.

There are lots of interesting questions as to what should be done on a gift tax and income tax return for a Wandry or other defined value transfer. If your client consummated a gift/sale of an LLC what should appear on the K-1 for the years while the Wandry clause keeps equity in limbo? Should you report the estimated ownership percentage with an asterisk * that refers to a footnote or should you attach a schedule that explains the Wandry clause and makes the percentage ownership interest a mere estimate until the clause resolves? Should the members of the LLC sign agreements to adjust their personal tax returns and refund any excess distributions if the Wandry clause retroactively adjusts their ownership percentages? What must be done post-transfer so that the Wandry clause, in the words of the well known tax adviser Dr. Phil, can "keep

it real."

**Swap Powers as the Last Ditch Effort**

If your client cannot complete the appropriate appraisals, lender or franchisor or other third party approvals, in time to consummate a gift of equity interests or real estate, then many advisers are suggesting transferring cash into the trust in 2012 and using the swap power next year to transfer the hard to value or contractually restricted assets into the trust. While there is certainly merit to this approach it too is not without risk. Depending on the changes made to the grantor trust rules a 2013 swap transactions may have undesired consequences of increasing risk. If grantor trusts are in fact restricted, what effect might a swap power have on the ability of that trust to be grandfathered? If the trust would be grandfathered, but that grandfathering will be lost if any additional assets are given to the trust, the valuation risk with exercising the swap power to complete the plan in 2013 could be rather monumental.

**Conclusion**

Jim Croce might be able to make days last forever but the planning days left in 2012 are waning. New tax legislation could cut the time period to implement planning, or make planning incredibly more complex, or both.

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

Marty Shenkman
Bob Keebler

**CITE AS:**

**LISI** Estate Planning Newsletter #2027 (November 12, 2012) at http://www.leimbergservices.com Copyright 2012 Leimberg Information Services, Inc. (**LISI**). Reproduction in Any Form or Forwarding to Any Person Prohibited – Without Express Permission

1 Comment Posted re. *Marty Shenkman & Bob Keebler: The Election is Over- Now What?*

Bernie Kent 12-Nov-12 11:13 PM

In this very comprehensive article, there is one point that I do not understand: · " When the US Treasury issues regulations concerning the new Medicare surtax they may provide that loss carry forwards pre-dating the 3.8% surtax on net investment income cannot offset the surtax. If that is the case then it will be quite advantageous to harvest these losses this year. The IRS has indicated that these Regulations should come out soon."

If the 2012 capital losses do not offset the 3.8% surtax, you would want to save your losses to next year when they can be used to offset the 3.8% surtax (as well as the potential 20% rate on long-term capital gains) rather than harvest the losses this year.

Post a comment on this newsletter:

Submit comment by Inell Lester

Copyright © 2012 Leimberg Information Services Inc.