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The American Taxpayer Relief Act: The Impact on Estate and Business Planning – Part II

I. INTRODUCTION

President Obama recently signed into law the American Taxpayer Relief Act of 2012 ("ATRA" or the "Act") which creates "permanency" in the estate planning area for the first time since the passage of the Economic Growth and Tax Relief Act of 2001 (EGTRRA). Of course, the use of the term "permanent" in the context of estate tax laws does not mean permanent as that term is used by most individuals. However, it is permanent in the sense that it will not sunset and that it will take an affirmative act of Congress to alter the law as it currently exists. Nonetheless, ATRA does provide a degree of certainty that has been missing and it may be the impetus needed to motivate clients to update their estate plan in order to protect their family and to minimize taxes.

Our analysis of ATRA is addressed in a two-part *Legal & Tax Trends*. The first part, which discusses the impact of ATRA on income tax and investment planning, was distributed earlier this month. The second part, which is the focus of this article, analyzes the impact of the new law on estate and business planning.

II. An Overview of the Transfer Tax Changes

In the transfer tax area, ATRA permanently establishes the same high exemption amount for gift tax, estate tax, and generation-skipping transfer tax purposes, and indexes this amount for future inflation.

ATRA also permanently extends "portability", one of the key features of the Tax Relief act of 2010 and sets the highest marginal estate/gift tax rate at 40%.[1] Under ATRA, each taxpayer has available a unified gift and estate tax exemption of $5,250,000 in 2013. Importantly, this exemption (also referred to as the Basic Exclusion Amount) is permanent, unified, indexed for inflation, and portable.

Permanent. The exemption amount is not scheduled to sunset or be reduced, as had been the case since 2001. As a result, taxpayers should be able to better estimate their long-term estate tax exposure.[2] Permanence also eliminates concern over taxes caused under an estate tax "claw back" since the applicable exclusion amount will not be less at death than during life.[3]

Unified. There was considerable uncertainty in 2012 as to whether the gift tax exemption amount would revert back to $1.0 million or some amount less than $5.25 million. ATRA unifies the gift tax exemption with the estate tax exemption and creates tremendous gifting opportunities. Clients can now fully use their gift and GST tax exemption during life, taking full advantage of the absence of state gift taxes, the benefits of a grantor trust, and valuation discounts.

Indexed. The unified exemption amount is indexed for inflation, based on a $5,000,000 exemption amount in 2011.[4] It increased by $120,000 in 2012 and by $130,000 in 2013. Scheduled future increases will give taxpayers significant additional lifetime giving capacity (the equivalent to nine additional annual exclusions in 2013). Indexing should also reduce pressure on legislators to address the exemption amount, since automatic exemption increases will help prevent the number of taxpayers subject to the estate tax from increasing over time. Long term, this indexing feature of the exemption amount will have a significant financial impact on future planning.

Portable. The exemption is portable between spouses, meaning that under certain conditions, a surviving spouse may use not only his or her own basic exclusion amount ($5,250,000 in 2013) but also any unused applicable exclusion amount of his/her last deceased spouse.[5] For many taxpayers, exemption portability will simplify planning since it will obviate the need for each spouse to create a traditional bypass trust and have separate property to fund this trust at the first death.

[1] See also the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act ("TRUIRJCA") of 2010.
[2] Of course, as with all tax provisions that may be changed. We must keep in mind that the definition of "permanent" in Washington really means "current," as future legislation could rewrite the rules.
[3] See IRC § 2001(g) and 2505(a)(2).
[4] In 2012, the exemption amount of $5,120,000 was an increase of 2.4% over the prior year. The 2013 exemption amount of $5,250,000 is an increase of approximately 2.5%
[5] For these purposes, the marriage must be one recognized under federal law. The portable portion of the deceased spouse's exemption is known as the Deceased Spousal Unused Exclusion Amount ("DSUE Amount"). This provision is retroactive only to 2010 – there is no DSUE Amount for a spouse who died prior to 2010.

ATRA retains the estate/gift rate brackets and rates of the 2010 tax act, but with the highest marginal rate of 40% instead of 35%.[6] The 40% bracket takes effect on values of $1,000,000 or more.

> Example: The tentative tax for a gross estate of $2,500,000 is $905,800. This amount equals the tax on the first $1,000,000 ($345,800) added to the tax on excess of $1,500,000 (i.e., 40% x $1.5million, or $560,000).

The generation skipping transfer tax ("GSTT") tax exemption is set at the same level as the estate and gift tax exemption, $5,250,000 (in 2013). Since the estate exemption increases with inflation, so too will the GSTT exemption amount. A number of GSTT provisions in ATRA permanently extend the prior law. These provisions will simplify the GSTT exemption allocation process when planning with multi-generational irrevocable trusts:

- ATRA continues the prior law's automatic allocation of GSTT exemption to indirect skips (e.g., gifts to trusts);
- ATRA extends the retroactive allocation of GSTT exemption, relating to situations when a member of a younger generation predeceases the transferor;
- ATRA also provides for division of trusts to fix inclusions ratio problems;[7]
- Finally, ATRA sets the date for valuation for GSTT gifts and bequests, including transfers subject to an estate tax inclusion period ("ETIP").

The Act preserves the deduction for state death taxes. For estate planning purposes, the use of the deduction (instead of the state death tax credit last available in 2005) means that states using a "pick-up" or "sponge" tax tied to current federal system will not collect any state estate tax. This may encourage other states to decouple from the federal system and establish their own state death tax structure. Currently 15 states and the District of Columbia have decoupled.[8]

Also made permanent are certain provisions of §6166, relating to the extension of time to pay estate tax where the estate consists largely of interests in a closely held business. In a sense, ATRA "merely" extends most of the provisions of the 2010 TRA legislation. Importantly, however, the permanent extension of these provisions has provided a certainty that will help clients plan more effectively.

III. Portability

ATRA makes portability permanent. Portability attempts to simplify estate tax planning by avoiding the need for married couples to undertake trust planning to fully utilize the

[6] It represents a compromise between the 45% of the President's position (as in 2009) and the 35% applicable in 2010-2012.
[7] IRC §2642(a)(3) allows for the division of trusts with an inclusion ratio between zero and one, as well as the division of trusts with an inclusion ratio of zero.
[8] For states decoupled from the federal estate tax, the combined maximum marginal estate tax rate (after considering the tax benefit of the deduction) could reach close to 50% (e.g., 49.6% in NY).

basic exclusion amount at the first death. Unfortunately, portability is not simple, nor does it always assure the intended results. For a spouse who dies after December 31, 2010, the Act allows the surviving spouse to use the deceased spouse's unused exclusion amount in addition to the surviving spouse's own basic exclusion amount. The executor of the deceased spouse's estate can transfer this remaining amount to the surviving spouse by making an election on a timely filed estate tax return for the deceased spouse. Therefore, even relatively small estates of married persons must consider whether to file an estate tax return for the first deceased spouse's estate.[9]

This carryover amount is referred to as the Deceased Spousal Unused Exclusion (DSUE) Amount.[10] If the surviving spouse has more than one predeceased spouse, then the surviving spouse may only use the lesser of (A) the applicable exclusion amount, or (B) the excess of (i) the basic exclusion amount of the last deceased spouse of the surviving spouse, over (ii) the taxable estate.[11]

The following examples will illustrate how portability works.

> *Example: 1: Josephine dies in January of 2011 having previously made taxable gifts totaling $1 million. The entire estate is left to Napoleon and the executor files an election to allow Napoleon to use Josephine's deceased spousal unused exclusion (DSUE) amount of $4 million. Napoleon can now use his basic exclusion amount of $5.25 million in 2013 plus Josephine's DSUE amount of $4 million for a total of $9.25 million in transfers during his lifetime, or his executor can use the $9.25 million at his death.*
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> *Example: 2: Same facts as above except Napoleon marries again. His second wife, Marie Louise, predeceases Napoleon in 2013 having made taxable gifts totaling $3 million and does not have a taxable estate. An election is made on Marie Louise's estate tax return to permit Napoleon to use Marie Louise's deceased spousal unused exclusion amount. Napoleon cannot combine the deceased spousal unused exclusion amount for each of his deceased wives. Instead, he may only use Marie Louise's $2.25 million deceased spousal unused exclusion amount since she was the last spouse to die, along with his own $5.25 million basic exclusion amount for a total of $7.5 million. This amount may be used during lifetime or at death.*

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[9] Temporary Regulations T.D. 9593 77 Fed. Reg. 36150 (June 18, 2012) and identical proposed regulations (REG-141832-11) simplify some of the information that must be included on the estate tax return.

[10] This does not include any unused generation skipping transfer tax amount. Under the Act, "Applicable Exclusion Amount" is now defined as the "Basic Exclusion Amount" (e.g., $5,250,000 in 2013) plus the "Deceased Spousal Unused Exclusion Amount."

[11] Section 2010 (c)(4)(B) (ii) originally stated that the DSUE amount is limited to the lesser of "the basic exclusion amount of the last deceased spouse…." ATRA changes this reference from "basic exclusion amount" of the last deceased spouse to "the applicable exclusion amount" of such last deceased spouse so that the statute reflects intent. This difference is critical because an individual's applicable exclusion amount includes his or her basic exclusion amount plus DSUE amount. This adopts the position taken in Example 3 of page 53 of the Joint Committee on Taxation Technical Explanation of TRA 2010.

Suppose Napoleon had predeceased Marie Louise, his executor could have used Napoleon's $5.25 million basic exclusion amount and Josephine's deceased spousal unused exclusion amount of $4.0 million because Josephine was the last deceased spouse of Napoleon. If an election was made on his estate tax return, Marie Louise would be able to use Napoleon's deceased spousal unused exclusion amount of $5.25 million.

Benefits of Portability: Portability was originally thought to be a stopgap planning measure primarily beneficial to married taxpayers who failed to create an estate plan to take advantage of the basic exclusion amount at the first death. However, now that portability has been made a permanent part of the law and can be safely relied upon; it has become a legitimate planning concept. For many of our clients it will no longer be an easy decision as to whether to create an estate plan using a bypass trust or to rely upon portability. This is true even for an individual with a substantial estate. A number of factors will need to be weighed in order to determine whether it is in the client's best interests to take advantage of portability:

<u>Simplicity</u> Leaving everything to the surviving spouse and relying on portability offers the advantages of simplicity and a greater sense of security for the surviving spouse. In deciding whether to rely on portability, one should consider not only the cost of filing the estate tax return to elect portability but also the cost of maintaining a bypass trust for future years, including fiduciary fees and bookkeeping and tax return preparation costs.

<u>Step Up in Basis</u> The assets which pass to the surviving spouse outright (and which benefit from portability) will receive a step up in basis at the surviving spouse's death, while assets passing to a credit shelter trust will not. This income tax benefit will be important for many married couples with less than a $10 million estate.

<u>Qualified Retirement Plans</u> Portability will be helpful where one spouse has an unusually large asset and it cannot be easily divided (e.g., a client who has a large qualified plan or IRA and few other assets to fund the credit shelter trust). In this situation there is a tension between leaving the IRA directly to the surviving spouse to benefit from income tax deferral and foregoing the estate tax benefits of utilizing the exemption ***versus*** leaving the IRA to a credit shelter trust to realize the estate tax benefits, but consequently losing the income tax benefits of a spousal rollover. Portability largely solves this problem by leaving the retirement and IRA benefits directly to the surviving spouse and relying on portability to use the deceased spouse's unused estate tax exclusion amount at the surviving spouse's subsequent death.

<u>Retitling Assets</u> Traditionally, if one spouse owned most of the marital assets, in order to utilize the estate exemption amount of the less-propertied spouse if he or she died first, the wealthier spouse would have to retitle assets into the name of the less wealthy spouse or fund an inter vivos QTIP trust for that spouse, often unpopular with the wealthier spouse. This reluctance will be even greater with a $5.25 million exemption since a very large amount might need to be transferred to the poorer spouse. Transferring assets can be avoided if the spouses are willing to rely on portability to

take advantage of the less wealthy spouse's exclusion amount. Furthermore, where the assets are owned jointly, retitling the assets into individual names may result in the loss of creditor protection.

Save State Estate Taxes Fully funding a credit shelter trust at the first spouse's death might generate significant state estate taxes when the couple lives in a state where the state death tax exemption is significantly lower than the federal exemption.[12] This tax at the first death could be avoided by relying on portability.[13] For example, if a deceased NY resident fully funds the $5,250,000 bypass trust at the first death, then that would generate more than $390,000 of NY state estate tax. On the other hand, by relying on portability this NY estate tax could have been avoided. The surviving spouse (who would have both his or her basic exclusion amount and the DSUE amount of his or her deceased spouse) could then make gifts that would not be subject to state transfer taxes.[14]

Creating Grantor Trust as to Surviving Spouse Leaving assets to the surviving spouse and electing portability permits the surviving spouse to makes gifts to his or her grantor trust.[15] The "tax burn "of a grantor trust creates significant transfer tax benefits over time and may prove more financially beneficial than a credit shelter trust.

Consumption Exceeding Growth Portability may be preferable if the assets in the bypass trust decline in value during the surviving spouse's lifetime. In this situation, portability is preferable to using a bypass trust since with portability the surviving spouse has the full unused exemption amount available in addition to his or her own estate tax exemption amount. If a bypass trust had been used, no unused exclusion amount would exist and the bypass trust assets would have declined in value.

Benefits of Using a Bypass Trust:

Whether or not to elect portability, however, will not be an easy decision as there are substantial tax and non-tax benefits available in funding a bypass trust at the first spouse's death:

[12] This is true where the QTIP election, or nonelection for federal estate tax purposes, is binding for state estate tax purposes (e.g., NY, NJ). In these states, if a QTIP trust is created and the executor decides to fully fund the exemption for federal estate tax purposes, the estate would be precluded from electing the marital deduction for state estate tax purposes, triggering a state estate tax on the federal exemption amount. This unsatisfactory result can be largely avoided in states where the QTIP election for federal estate tax purposes is not binding for state estate tax purposes. For example, in MA the executor can make separate QTIP elections for federal and state tax purposes and thereby utilize the full federal exemption but still avoid the state estate tax at the first death.

[13] Relying on portability, however, may result in unnecessary state death taxes being paid at the second death because of the failure to take advantage of the state death tax exclusion of the first spouse to die. One possibility is to leave the state exemption amount to a bypass trust and rely on portability for the balance of the first decedent spouse's estate, which would have the effect of deferring all state taxes until the second spouse's death.

[14] Only one state, Connecticut, has a gift tax.

[15] In most states, however, the surviving spouse could not be a discretionary beneficiary of this trust without subjecting the trust assets to inclusion in the surviving spouse's estate.

Non-Tax Benefits There are the obvious non-tax benefits of using a trust – creditor protection, professional management, and the ability to restrict distributions by the surviving spouse.

Provides Income Tax Planning Opportunities If the bypass trust contains a sprinkle provision that permits the trustee to distribute income to the spouse and children, then there is an opportunity to shift income to the various family members who are in a lower tax bracket.[16] This may be especially attractive with ATRA's higher rates and the new 3.8% surtax. Portability, on the other hand, does not provide any opportunity to shift income to family members in lower tax brackets.

Removes Future Appreciation from Surviving Spouse's Estate The appreciation of the property after it is transferred to the credit shelter trust will not be included in the surviving spouse's estate. Contrast this with the fact that the portable portion of the exclusion amount is frozen at its date of death value and does not receive the benefit of future inflation indexing. This benefit is especially important with younger clients and for clients with appreciating assets.[17]

Attractive with Blended Families A credit shelter trust is attractive in that a person can use a portion, or all, of their exemption amount at his or her death to benefit children from a previous marriage by leaving assets in trust. Similarly, use of a trust can ensure what happens to the property after the death of the surviving spouse. In other words Mother does not have to worry about Father remarrying and leaving the property to his new family and thereby, disinheriting her own children.

Avoids Risk of Losing the DSUE Amount The unused exclusion from a particular predeceased spouse may be lost if the surviving spouse remarries and survives his or her next spouse. This risk is avoided by funding a bypass trust.[18]

Loss of the GST Exemption If one relies on portability the GST exemption of the first spouse to die will have been wasted as there is no portability of the GST exemption. This will be especially troublesome in larger estates.[19]

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[16] The Trustee has 65 days after the end of the tax year to determine which beneficiaries are in a lower tax bracket and make payment to them.

[17] To determine whether to use a bypass trust or not, it will be important to run the numbers to illustrate the estimated estate tax savings of each strategy and allow the client and his or her tax advisors to ultimately decide which strategy to implement.

[18] For example, assume wife passes all of her assets to a QTIP trust with remainder to her children from a prior marriage. Husband, as executor, can elect QTIP, obtain the wife's DSUE amount, and then make gifts of his property to his children from a prior marriage using up both the DSUE amount and his applicable exclusion. On his death, the QTIP trust will bear the tax burden it would not have otherwise had. Husband's children from his prior marriage will benefit at the expense of Wife's children from her prior marriage. This issue could be addressed in a prenuptial agreement.

[19] If the client wants to rely on portability and still use his or her GST exemption at the first death, consider funding a QTIP trust where the executor can elect the marital deduction and still make a reverse QTIP election under Section 2652(a)(3) to enable the use of the decedent's GST exemption. The income that must be paid to the spouse in a QTIP trust will result in some leakage for GST tax purposes and will not be as tax-efficient as a bypass trust.

No Statute of Limitations with Portability There is no running of the statute of limitations from the first deceased spouse's estate tax return for purposes of determining the unused exclusion amount. Conversely, the statute of limitations does run from the time of the filing of the estate tax return for federal estate tax purposes if a bypass trust is funded at the first spouse's death.

Avoids Tax Risk to First Decedent's Spouse's Family Use of credit shelter trust avoids the risk that the QTIP trust for the benefit of the first decedent spouse's family will pay large estate taxes without any benefit of the first decedent spouse's estate tax exemption.

Avoids Risk of Losing Survivorship Presumption It is not clear that survivorship, and thus eligibility to use the DSUE amount, is governed by a survivorship presumption in the wills or other governing instruments of spouses who die "simultaneously," as the creation of a credit shelter trust would be.

IV. Life Insurance Funding May Change

The key to planning with life insurance will be flexibility. Even with so-called permanency, one cannot truly know what the estate tax exemption amount will be when he or she dies. While many of the same needs and objectives for clients will still apply regardless of the level of the exemption amount, some needs are clearly the result of the estate tax. Many clients may be reluctant to commit to funding for an uncertain estate tax need. However, a properly designed irrevocable life insurance trust can still serve as the cornerstone of an effective estate plan.[20] Clients should consider using single life products inside these trusts since the death benefit can help meet a myriad of needs such as support for the surviving spouse, family protection, education funding, business continuity and estate equalization.

In light of the increased estate tax exemption, life insurance funding may change over time. Traditionally, advisors have made certain assumptions regarding the client's projected estate settlement costs and then recommended that the client purchase the maximum amount of death benefit to meet that projected need. Often, the goal was to minimize the premiums paid for a set amount of life insurance, given that the policy was often placed in an irrevocable trust, outside the direct reach of the insured(s). This emphasis on maximizing death benefit coverage for a given premium favored purchasing guaranteed products.

There are several shortcomings with this traditional approach. First, it will continue to be extremely difficult to accurately predict the amount of estate settlement costs. Given the uncertainty regarding the future estate tax laws, the future growth in the estate, the year of death, and how effective estate tax planning techniques will be in reducing these projected costs, the initial amount of life insurance purchased will often be far more or

[20] An irrevocable trust can not only remove the trust assets from estate taxation, it can also protect assets from creditors and failed marriages, maximize the transfer tax deferral by making the trust GST exempt, and provide assurance that the right people will receive the assets at the right time with the right amount of supervision.

far less than the client's actual need. This uncertainty is even greater with younger clients. A second disadvantage in this approach is that in funding for the maximum death benefit, the client is sacrificing cash value buildup and may be jeopardizing the underlying viability of the policy. This emphasis on death benefit will often result in the underfunding of the policy and the policy's early termination. These policy lapses have led some prospective clients and their advisors to perceive life insurance as a poor investment. For instance, many attorneys are reluctant to allocate the client's GST exemption to contributions to a life insurance trust in the fear that this GST amount will have been wasted if the policy lapses.

Rather than minimally funding the policy, an alternative approach is to heavily fund the policy and enable the cash values to grow more quickly in the early years and permit the death benefit to grow in later years when compared to a guaranteed product.[21] Even though it may be counter traditional thinking, a life insurance with a lower face amount and higher living values may prove more attractive over the long term. The most efficient cash value policy, if there is a significant chance that the insured will live beyond life expectancy, is generally one that provides the minimum initial death benefit, but the maximum cash value. While this policy will provide a lower death benefit initially, it will ultimately provide a greater death benefit at older ages and a better return on investment. If the insured lives to his/her normal life expectancy, the policy's death benefit will often return the premiums with an attractive, compounded tax-free return. This is especially true when compared to guaranteed products.[22]

The higher cash value policy will also provide more flexibility to alter the amount of coverage, to make changes in the event the policy is no longer performing, or to re-allocate resources if the insured's needs change. This increased flexibility, of course, will need to be weighed against a lower death benefit in the event that the inured should die prematurely.

This alternative approach views the life insurance cash values as a tax-advantaged sinking fund. With the increase in income tax rates and the new 3.8% Medicare tax, there will be a shift in focus to the income tax benefits of life insurance. Clients will be motivated to increase their exposure to a tax-deferred vehicle such as life insurance by transferring large deposits into such policies to help manage today's high tax rates. This is especially true for non-grantor trusts as the threshold for application of the 39.6% rate and the Medicare surtax is only $11,950. The high gift tax exemption should assist with this strategy as it will now be easier to fund insurance premiums by making larger gifts to an irrevocable trust.

This substantial funding approach works well with a type of irrevocable trust known as a spousal lifetime access trust (SLAT). These trusts address two primary concerns; one, given the uncertainty of projecting future estate tax liabilities, SLATS exclude the death

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[21] In order to maintain the definition of "life insurance," these ever-growing cash values will generally force an increase in the death benefit over time.
[22] With the recently increased reserve requirements under AG 38 and the continued low interest rate environment, guaranteed products will continue to experience price increases and a reduced projected rate of return on death proceeds.

proceeds from both the insured's and the insured's spouse's estates and two, given the uncertainty of whether the insured and his or her spouse during the insured's life and the surviving spouse after the insured's death will have sufficient income, SLATs permit the trustee to make distributions of trust principal and income to the insured's spouse not only after the insured dies, but also while the insured is alive.

To this end, while the insured is alive, it is possible for the trustee to access the cash values without tax by taking withdrawals up to the policy's basis and/or policy loans from the life insurance policy to make distributions to the spouse.[23] At the insured's death, the proceeds are received income tax-free and can provide continuing spousal survivor income. The fact that the proceeds are in a trust, rather than paid outright to the spouse, will be consistent with the objectives of many clients.

While the trust assets may not be reached by the insured grantor, the trust can provide income or principal distributions to the grantor's spouse. A SLAT will also allow the spouse – in his or her capacity as trustee – to access policy values subject to an ascertainable standard, to increase or decrease the insurance coverage, or to make other changes to the policy as new legislation alters tax law or as the couple's circumstances change.

V. Impact of ATRA on Various-Sized Estates

Having permanency in the estate and gift tax area enables individuals to implement an estate plan with some degree of certainty that the assumptions for which the plan is predicated will not change in the near future. Those who have delayed addressing their estate plans can now move forward with the security of knowing that their planning will not "sunset". The increased exemption for gift tax, estate tax, and generation skipping tax, and the indexing of these exemptions for inflation, will facilitate planning in many ways. The impact, however, will differ markedly depending upon the size of one's estate. For purposes of our analysis, we will offer planning suggestions and ideas for (i) Estates under $5.25 million, (ii) Estates between $5.25 million and $10.5 million, and (iii) Estates over $10.5 million.

Estates of Single Individuals and Married Couples under $5.25 Million

- For these estates, planning will primarily focus on (i) proper disposition - making sure that the "right" people get the "right" assets with the "right" amount of supervision; (ii) income tax planning (e.g., obtaining the step up in basis at death), and (iii) preservation and management of assets. In this regard, one of the key decisions will be whether or not to use trusts as part of the estate plan for non-tax reasons.

- Everyone will need to have their existing estate planning documents reviewed in light of the higher exemptions which are now indexed for inflation.

[23] This assumes that the policy is not a Modified Endowment Contract or MEC.

- Asset Protection planning will be important. Clients may wish to consider holding assets by tenant by the entireties, filing a homestead exemption, funding qualified plans, and creating/funding an inter vivos QTIP trust. For clients under $1 million planning for long-term care will be important.

- Taxpayers at all levels still need planning for insurance ownership, beneficiary designations, asset protection, guardianships, powers of attorney, children with special needs, medical directives, business succession, income tax issues, state death taxes, and many other matters.

- The higher exemptions will permit clients with under $5.25 million to own their own life insurance policies. This will enable the insured to have ready access to the cash values and to rely on the higher estate tax exemption instead of the irrevocable trust to shelter the death proceeds from estate tax. Clients should still consider naming their revocable trust the beneficiary of the policy to still obtain the benefits of a trust.

- Estates of less than $5.25 million will still need liquidity for any one or more of the following:
  - To create survivor income,
  - To meet educational expenses for the children and grandchildren,
  - To pay probate fees and possible state death taxes,
  - To provide for estate equalization,
  - To pay income taxes on income in respect of a decedent assets (e.g., IRAs, 401(k) plans, nonqualified deferred compensation),
  - To better assure the tax benefits of a “stretch” IRA,
  - To provide a legacy for family members or for a favorite charity (“live better and leave more”), and
  - To fund a business succession plan.

Estates between $5.25 million and $10.5 Million (Married Couple)

- Many of the strategies and opportunities for estates under $5.25 million will still be applicable to these larger estates.

- A married couple may wish to rely upon the simplicity of portability and do away with the additional expense of drafting and administering a bypass trust. Filing an estate tax return and making the election may be preferable in many cases. At the death of the first spouse, all of the decedent’s property would pass to the surviving spouse who would then have an opportunity to make gifts to his or her children or to his or her grantor trust for the benefit of the family. (With this ability to make additional gifts to a grantor trust, portability may even be desirable for large estates).

- An optimal approach may be to leave the surviving spouse with the decision of whether or not to utilize portability. For example, a married couple may wish to consider using disclaimer wills to retain flexibility. At the death of the first spouse, all of the decedent's property would pass to the surviving spouse (who with full knowledge of all relevant factors) would have an opportunity to disclaim all or a portion of the bequest with any disclaimed property passing to a credit shelter trust for the benefit of the family. Another alternative would be to leave assets to a QTIP trust and either make a full QTIP election (and rely on portability) or make a partial QTIP election with a provision that the unelected portion would pass to a trust with more flexible dispositive provisions (e.g., a trust which looks more like a standard bypass trust).

- While state death taxes and income taxes may be a more immediate concern, particularly since the federal estate tax exemption is indexed for inflation, future growth of these estates may still necessitate tax planning that is both flexible and economical. Clients residing in states which have decoupled from the federal tax system may fail to realize the state estate tax exposure and thereby fail to provide the necessary liquidity to pay the tax. Life insurance planning should address this potential need for liquidity.

- Individuals whose taxable estate exceeds the state estate tax exemption amount should also consider making lifetime gifts in order to minimize the future state death tax costs. Gifts, however, can be disadvantageous if the loss of the step up more than offsets the state estate tax savings or if the gift asset declines in value after making the gift.

- Clients may decide to use the higher gift tax exemption to simplify their estate planning (e.g., revisit the use of Crummey powers to fund an existing life insurance trust). Not using Crummey powers will permit the settlor/donor to make gifts in trust without having to notify the trust beneficiaries of the gift. This provides the settlor with some assurance that their estate plan will not be derailed by a spendthrift who exercises his or her withdrawal right.

- Clients may also wish to consider creating and funding a life insurance trust with specially designed flexibility to distribute principal and income to the spouse during grantor's life – a so-called spousal lifetime access trust (SLAT). Large gifts of income-producing assets which, depending upon circumstances may possibly be discounted for both lack of control and lack of marketability, can now be made to fund these trusts. The trust income could then be used to (i) fund life insurance premiums, (ii) pay interest on an installment note under a sale to a defective trust, (iii) and distribute excess income to the spouse or children, if needed.

- Consider leveraging the gift to the SLAT with an individual life insurance policy. Gifts to a SLAT or the income from assets placed in the SLAT can be used to purchase insurance on the grantor's life.
- This insurance will be helpful in offsetting the cost of losing the step up in basis on the property transferred to the SLAT.
- If the SLAT is respected, the life insurance proceeds may generally be received both income tax-free and estate tax-free.
- Provided the trust is properly established and operated, all post-transfer appreciation on the gifted assets will be removed from both spouses' estates.

Estates over $10.5 Million (Married Couple)

- Many of the strategies and opportunities that may apply to an under $5.25 million estate or an estate of between $5.25 million and $10 million could also apply to these larger estates.

- Advisors should follow-up with clients who made substantial gifts to irrevocable trusts in 2011 and 2012 to review the benefits of leveraging those gifts. For example, clients might use the gifted funds as "seed money" to facilitate the trust purchasing an appreciating asset from the client on an installment basis. Alternatively, these gifted assets (or the income from the gifted assets) could be used to purchase life insurance on the grantor and/or the grantor's spouse.

- In light of the time crunch at the end of 2012, some clients made gifts of cash or cash equivalents. Clients may now wish to consider exercising a substitution power or structuring a sale to the grantor trust in order to exchange assets with more appreciation potential and/or take advantage of valuation discounts.

- Clients who made large gifts in 2011 or 2012 should also review their estate planning documents to determine whether these documents should be revised in light of these large gifts. Cash flow projections may also be appropriate in order to demonstrate that the client's cash flow after the 2012 gifts will remain adequate to support his or her life style.

- The permanency of the estate and gift tax exemption presents a tremendous opportunity for wealthy individuals to make gifts. The benefits of making a gift include (i) removing future appreciation from the estate, taking advantage of today's low interest rates and valuation discounts, avoiding state transfer taxes as no state other than Connecticut has a gift tax, and for clients who have already used their gift tax exemption, the benefit of the tax exclusive nature of a gift versus the tax inclusive nature of a testamentary bequest. This higher gift tax exemption will lead to an increase in planning which will inevitably lead to increased opportunities to use life insurance to solve estate and business planning problems.

- All of the traditional estate planning ideas (e.g., grantor retained annuity trusts, family limited partnerships, irrevocable life insurance trusts, charitable remainder trusts) will still be useful for high net worth individuals. Since the new law did not restrict use of discounts for lack of control and lack of marketability, these discounts will still be available at least in the near term.

- Clients should consider using the $5.25 million gift tax exemption to simplify their planning. For example, the increased exemption could be used:
  - to give a high cash value life insurance policy to an irrevocable trust; (This gift may have been previously impractical due to the prior law's $1 million gift tax exemption);
  - to forgive a family loan;
  - to exit from an economically inefficient split dollar arrangement;
  - to give assets to a non U.S. citizen spouse;
  - to transfer assets between same sex partners where the gift or estate tax marital deduction is not available; and
  - to exit a failed estate planning transaction.[24]

- The Act presents a unique opportunity to review your client's business succession plan and to consider using some or all of his or her $5.25 million gift tax exemption to transfer an interest in the family business (or family real estate) to his or her children who are active in the business: Gifting can permit the client to take advantage of the discount for lack of control and the discount for lack of marketability; By recapitalizing into voting and non-voting interests and gifting the non-voting interests, your client can still retain control of the business; Gifting also removes the future appreciation from both spouse's estates and shifts the income to the next generation; A grantor trust can maximize the tax benefits (i.e., the grantor can pay the taxes on the trust income so that the trust property grows free of tax).

- Qualified Personal Residence Trusts (QPRTs) may become more attractive under the Act as the increased gift tax exemption will permit very valuable residences to be transferred at a substantial discount. Clients may elect to purchase insurance on the life of the grantor in order to insure against the possibility of death during the term.

- With the higher gift tax exemption and the ability to increase the "seed money," the sale to a grantor trust will become more attractive in larger estates. The ability to exempt the property given to the trust from the estate tax as well as the generation-skipping tax is an important benefit which favors use of this

[24] This may be applicable, for example, in an asset sale to an irrevocable trust where the asset has substantially declined in value, leaving little probability of successfully transferring wealth.

technique. The sale to a defective trust is also attractive as it removes all appreciation after the sale regardless of when death occurs. [25]

- While GRATs may not be as favored as sales to a defective grantor trusts under the Act, GRATs remain a viable strategy, especially longer term GRATs which can leverage today's low interest rates. GRATs will also remain attractive for clients who wish to make a gift and still retain an income interest. Clients can purchase insurance on the grantor's life in order to insure against the possibility of death during the term.

> ***Example:*** *Ken, age 55, is the sole shareholder of Acme Widgets, Inc., an S Corporation. Ken's two children, Michele and Tom, are both active in the business. Ken would like to transfer some interest in the business to the children yet still retain control of the business. Ken could create voting and non-voting stock and transfer the non-voting stock to a 10-year GRAT. Assume the non-voting shares have a value of $2 million and a discounted value of $1.5 million. With a 5% payout rate and a 7520 rate of 2.4% the value of the gift of non-voting stock is approximately $840,000.*

- The ability to make taxable lifetime gifts and generation skipping transfers of up to $5.25 million in 2013 ($10.5 million for a married couple) will make it easier and simpler to fund a dynasty trust. For example, a married couple can use their combined $10.5 million gift tax and GSTT exemption to fund a generation-skipping trust. This amount can then be leveraged by using a portion of this gift to purchase a life insurance policy. Clients with illiquid estates may now be able to solve their liquidity problem by making one substantial gift to an irrevocable trust, assuming the trustee then elects to purchase life insurance with the gift.

- ATRA did not address many of the Administration's tax proposals including (i) requiring a minimum ten-year term for a GRAT, (ii) restricting the use of valuation discounts, (iii) limiting the duration of dynasty trusts to 90 years, and (iv) requiring inclusion in the estate for assets held in a grantor trust. These proposals, if enacted, would adversely impact many of the more effective estate planning techniques. Clients with large estates who could benefit from these strategies should use this window of opportunity to act sooner rather than later.

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[25] Only the remaining balance on the note is includable in the estate. The increase in income tax rates, plus the Medicare 3.8% increase, may cause some individuals, however, to reconsider the creation and funding of grantor trusts.

VI. Conclusion

The estate planning environment is dramatically different today than at any other time in our recent past. That is, for the first time there is a permanent, unified, historically high, inflation-adjusted, and portable exemption amount that effectively excludes all but the wealthiest 1% from gift, estate, and GST tax. While only a small segment of the population will have a federal estate tax liability, it does not eliminate the need to plan. Planning will remain important so that the right people receive the right assets at the right time with the right amount of supervision. Since the threat of the federal estate tax will no longer be the catalyst to motivate clients to take action, it will become critical to educate clients on the continuing need to plan. Non-estate tax planning such as business continuation planning, retirement planning, asset protection planning and legacy planning will move to the forefront. Planning will become more income tax driven and many of the reliable techniques which worked well in the past will need to be reevaluated in light of this new environment.

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