



Recent Developments

Spokane Estate Planning Counsel
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Agenda

- ▶ **American Taxpayer Relief Act of 2012**
- ▶ Net Investment Income Tax (NIIT)
- ▶ President's Budget
- ▶ Portability
- ▶ Formula Clauses
- ▶ Beneficiary-Owned Trusts
- ▶ Delaware Incomplete Non-Grantor (DING) Trusts

American Taxpayer Relief Act of 2012

- ▶ Gift Tax
- ▶ Estate Tax
- ▶ GST Tax
- ▶ Planning Considerations
- ▶ Estate Tax Repeal

Gift Tax

- ▶ Permanently **reunifies** gift tax with estate tax
 - ▶ 2001 Tax Act “decoupled” gift tax from estate tax capping gift tax exemption at \$1 million while allowing estate tax exemption to increase to \$3.5 million
 - ▶ 2010 Tax Act reunified gift and estate tax after 2011
- ▶ Amount exempt from gift tax is **\$5 million** indexed for inflation after 2011
- ▶ Top marginal gift tax rate increases from 35% to **40%**

Estate Tax

- ▶ Amount exempt from estate tax is **\$5 million** indexed for inflation after 2011 (to extent not used during decedent's life to make gifts)
- ▶ Top marginal estate tax rate is **40%**
- ▶ Estate tax exemption is **portable** between spouses
 - ▶ Applicable exclusion amount is sum of basic exclusion amount and deceased spousal unused exclusion (DSUE) amount
 - ▶ Basic exclusion amount is \$5 million (indexed for inflation)
 - ▶ DSUE amount is essentially deceased spouse's unused basic exclusion amount
 - ▶ Surviving spouse may use DSUE amount to make gifts

Generation-Skipping Transfer (GST) Tax

- ▶ Amount exempt from GST tax is **\$5 million** indexed for inflation after 2011
- ▶ Tax rate is **40%**
- ▶ GST exemption is **not portable** between spouses
- ▶ Taxpayer-favorable 2001 Tax Act GST tax provisions made permanent
 - ▶ Automatic allocations to indirect skips
 - ▶ 9100 relief for missed allocations and elections
 - ▶ Substantial compliance for allocations of GST exemptions
 - ▶ Retroactive allocations for unnatural orders of death
 - ▶ Trust severances for GST tax purposes

Overview

Estate, gift and GST tax rates and exemptions

	Estate tax		Gift tax		GST tax	
	Exemption	Top rate	Exemption	Top rate	Exemption	Top rate
2009	\$3,500,000	45%	\$1,000,000	45%	\$3,500,000	45%
2010	\$5,000,000*	35%*	\$1,000,000	35%	\$5,000,000	0%
2011	\$5,000,000 (portable)	35%	\$5,000,000	35%	\$5,000,000	35%
2012	\$5,120,000 (portable)	35%	\$5,120,000	35%	\$5,120,000	35%
2013	\$5,250,000** (portable)	40%	\$5,250,000	40%	\$5,250,000	40%

*May elect to apply law under 2001 Tax Act (i.e., no estate tax in 2010, carryover basis)

Planning Considerations

▶ Gifts made in 2012

- ▶ Clean them up, file appropriate gift tax returns and obtain proper appraisals
- ▶ Determine whether certain elections should be made (QTIP, gift-splitting, GST tax, 529 plans)
- ▶ Additional planning for gifts in trust
 - ▶ Swap assets gifted to trust with discounted assets and assets that have greater appreciation potential
 - ▶ Leverage equity in trust to execute installment sales
- ▶ Additional planning for outright gifts
 - ▶ If gift of cash, have heirs purchase assets that have greater appreciation potential from donor
 - ▶ Consider using gifts to form a family limited partnership for future estate planning purposes

Planning Considerations

▶ Planning going forward

- ▶ Traditional estate planning techniques will continue to be important
 - ▶ Family limited partnerships/limited liability companies
 - ▶ Grantor retained annuity trusts
 - ▶ Sales to intentionally defective grantor trusts
 - ▶ Irrevocable life insurance trusts
 - ▶ Charitable lead trusts
 - ▶ Qualified personal residence trusts
 - ▶ Qualified interest in property trusts/credit shelter trusts
- ▶ Techniques that leverage unified credit will continue to provide greatest estate planning benefit (FLPs, Sales to IDGTs, GRATs, CLTs)

Planning Considerations

▶ Planning going forward

- ▶ Benefits of making gifts during life continue to be smart
 - ▶ Removes appreciation of gifted assets from taxable estate
 - ▶ Tax exclusive
- ▶ Portability of unified credit between spouses is permanent and will add complexity to estate planning process especially since it does not apply for GST tax purposes
- ▶ Annual gifting will need to take into consideration inflation adjustments for gift tax annual exclusion and unified credit
- ▶ Clients who receive a DSUE amount from their deceased spouses should take advantage of this amount by making gifts
 - ▶ DSUE amount applied to gifts before basic exclusion amount
 - ▶ Clients who intend to remarry should use DSUE amount before they remarry as this amount will be lost if new spouse dies before client

Planning Considerations

▶ Planning going forward

- ▶ Analysis involving a gift now, as opposed to a basis step-up of assets at decedent's death, more important especially for decedent's with modestly-wealthy estates (\$5M - \$15M)
 - ▶ 40% estate tax rate versus 23.8% capital gains rate
 - ▶ Assets will have to appreciate substantially in order for 40% estate tax savings on appreciation to offset loss of basis step-up
 - ▶ **Example:** Donor makes a gift of \$1M of stock with a zero basis. Assume stock is sold shortly after Donor's death. If the stock has not appreciated, Donees will receive proceeds of \$762,000. If the asset is not gifted, estate tax consequences are the same; however, Donees will receive proceeds of \$1M – a difference of \$238,000 (the capital gain tax).

In order for the gift to make sense, the asset will have to appreciate \$1,469,136 to \$2,469,136 or 147%.

Planning Considerations

$(y - \text{amount gifted}) \times \text{estate tax rate} = (y - \text{basis}) \times \text{capital gain rate}$

$$(y - \$1,000,000) \times .40 = (y - \$0) \times .238$$

$$.4y - \$400,000 = .238y$$

$$.4y - .238y = \$400,000$$

$$.162y = \$400,000$$

$$y = \$400,000 / .162$$

$$y = \$2,469,136$$

$y = \text{appreciated value of gift}$

$$(\$2,469,136 - \$1,000,000) \times .4 = \$2,469,136 \times .238$$

$$\$587,654 = \$587,654$$

Estate Tax Repeal

- ▶ On March 22, 2013, Senate passed by a vote of 80-19 a nonbinding budget amendment (offered by Mark Warner (D-VA)) to support repealing or reducing estate tax
 - ▶ A non-binding budget amendment to repeal estate tax (offered by John Thune (R-SD) failed by a vote of 46-53
 - ▶ Tax must be offset before it can be reduced or repealed
 - ▶ Tax cannot add to deficit
 - ▶ Several Democrats who supported amendment have never supported efforts to repeal estate tax (Pat Murray (D-WA), Barbara Mikulski (D-MD))

Agenda

- ▶ American Taxpayer Relief Act of 2012
- ▶ **Net investment Income Tax (NIIT)**
- ▶ President's Budget
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Net Investment Income Tax

- ▶ Overview
- ▶ Types
- ▶ Category 1 – Ordinary Course of a Trade or Business Exception
- ▶ Category 2 – Trades or Businesses
- ▶ Category 3 – Net Gains
- ▶ Allocable Deductions
- ▶ Trusts and Estates

Overview

- ▶ The Medicare Contribution tax has **two** major components:
 - ▶ **Additional Medicare Tax** on earned income which is a 0.9% tax on wages and self-employment (SE) income – rules contained in sections 1401(b)(2), 3101(b)(2) and 3102(f)
 - ▶ **Net Investment Income Tax (NIIT)** on unearned income which is a 3.8% tax on net investment income (NII) – rules contained in section 1411
- ▶ **Effective date:** January 1, 2013 (proposed regulations issued November 30, 2012 – generally effective for tax years after December 31, 2013, although proposed regulations state that you may rely upon them without penalty until final regulations are issued)

Overview

- ▶ New **3.8%** tax imposed on NII
- ▶ For individuals, tax is 3.8% of **lesser of**
 - ▶ NII
 - or
 - ▶ Excess of modified adjusted gross income (MAGI) over
 - ▶ \$200,000 if single
 - ▶ \$250,000 if married, filing jointly
 - ▶ Thresholds not indexed for inflation
 - ▶ MAGI generally defined as adjusted gross income (AGI), plus amounts excluded by foreign earned income exclusion under section 911 and certain inclusions related to controlled foreign corporations (CFCs) and personal foreign investment companies (PFICs)

Types

- ▶ NII generally includes **three** categories of income
 - ▶ (Category 1) Income not derived in ordinary course of business
 - ▶ Interest
 - ▶ Dividends
 - ▶ Income from non-qualified annuities
 - ▶ Rents and royalties
 - ▶ As included by Prop. Regs., substitute interest and dividend payments
 - ▶ (Category 2) Other gross income derived from a trade or business that is a
 - ▶ Passive activity
 - ▶ Trading financial instruments or commodities
 - ▶ (Category 3) Net gains from disposition of property produces Category 1 and Category 2 income

Types

▶ **NII does not include**

- ▶ Amounts subject to Additional Medicare Tax on earned income
- ▶ Distributions from an IRA or qualified retirement plan
- ▶ Income of tax-exempt trusts
- ▶ Income earned by a non-resident alien
- ▶ Items of income that are excluded from federal tax base
 - ▶ Interest on tax-exempt bonds
 - ▶ Life insurance proceeds

Category 1 – Ordinary Course of a Trade or Business Exception

▶ Two-part test

- ▶ Must be “derived in” a trade or business that is not
 - ▶ A passive activity
 - or
 - ▶ Trading in financial instruments or commodities
- ▶ Must be derived in “ordinary course” of a trade or business
- ▶ Proposed regulations look to definition of “trade or business” under section 162 and body of law thereunder
- ▶ Proposed regulations look to definition of “ordinary course” in other regulations and case law
 - ▶ *Lilly v. Commissioner*, 343 U.S. 90 (Mar. 10, 1952)
 - ▶ Treas. Reg. section 1.469-2T(c)(3)

Category 1 – Ordinary Course of a Trade or Business Exception

- ▶ In case of an individual engaged in conduct of a trade or business **directly** (or through a disregarded entity), determination of whether a Category 1 item is derived in a trade or business is made at **individual** level
- ▶ In case of an individual engaged in conduct of a trade or business through a **pass-through** entity, determination of whether a Category 1 item is derived in a trade or business is made
 - ▶ At individual level for a passive activity (however, passive activity must still rise to level of constituting a trade or business)
 - ▶ At entity level for trading in financial instruments or commodities

Category 2 – Trades or Businesses

- ▶ Category 2 includes “**other gross income**” derived in a trade or business that is a passive activity or trading in financial instruments or commodities
- ▶ Items of income from a passive activity or trading in financial instruments that would be classified in Category 1 or Category 3 are **not** included in Category 2 – all other gross income from these trades or businesses are Category 2 items

Category 3 – Net Gains

- ▶ Net gain may not be less than **zero**
- ▶ **Income tax** rules determine when there has been a **disposition** for NII purposes
- ▶ Special rules for determining NIIT in case of a **disposition** of an interest in an S corporation or partnership
 - ▶ In general, net gains subject to NIIT only to extent gains would have been subject to NIIT to seller if partnership or S corporation had instead sold all of its assets immediately before partner or shareholder's disposition
 - ▶ Proposed regulations set forth a four-step process for determining net gains subject to NIIT

Allocable Deductions

▶ NII is reduced by allocable deductions

- ▶ Principles applied in determining amount and timing of a deduction for income tax purposes generally apply for purposes of determining a deduction for NII purposes
- ▶ Only amounts paid or incurred to produce gross income or net gains that are part of NII may be deducted in determining NII
- ▶ Net operating losses are not taken into account in determining NII
- ▶ Deductions cannot exceed NII, but deductions allowed to be carried over for income tax purposes may be carried over for NIIT purposes
- ▶ Deductions that are subject to limitation under section 67 (2% AGI floor on miscellaneous itemized deductions) or section 68 (overall limitation on itemized deductions) are allowed in determining NII only to extent they are allowed for income tax purposes

Trusts and Estates

- ▶ NIIT provisions applicable to individuals are also applicable to estates and trusts unless otherwise provided
- ▶ NIIT imposed on estates and trusts on **lesser of**
 - ▶ Undistributed net investment income (UNII) or
 - ▶ Excess of AGI over dollar amount at which highest income tax bracket begins (currently \$11,950)
- ▶ UNII of estate and trust is **reduced** by
 - ▶ NII included in income distribution deduction (picked up by beneficiaries to whom a distribution was made)
 - ▶ NII included in charitable contribution deduction allowed under section 642(c) – a give away by IRS in proposed regulations as a charitable deduction would not be an allowable deduction in case of an individual

Trusts and Estates

- ▶ **Tax-exempt trusts** are exempt from NIIT
- ▶ **Grantor trusts** or portions of a grantor trust are not subject to NIIT, but as is case for income tax purposes, grantor will pick up items passed through trust in his or her calculation of NII
- ▶ **Charitable remainder trusts (CRTs)** are not subject to NIIT, but annuity or unitrust recipients may be
- ▶ **Foreign estates and trusts** are not subject to NIIT, but US beneficiaries receiving distributions may be
- ▶ **Electing small business trusts (ESBTs)** are required to go through a three-step process for determining NII

Trusts and Estates

▶ Who should pay tax

- ▶ Tax on trust income could be 43.4% if income in excess of \$11,650
- ▶ Trustees of discretionary trusts will need to consider triggering thresholds for trusts/estates and their beneficiaries
 - ▶ NIIT on NII triggered when a trust or estate has income in excess of \$11,650
 - ▶ NIIT on NII triggered when an individual has income in excess of \$200,000 if single and \$250,000 if married, filing jointly

Trusts and Estates

▶ Investments to minimize NIIT

- ▶ Tax-exempt investments (e.g., municipal bonds)
- ▶ Tax-deferred investments (e.g., life insurance, annuities)
- ▶ Investments in assets that can be depreciated, depleted or amortized
- ▶ Defer recognition or timing of gains (e.g., tax-free exchanges, installment sales, charitable remainder trusts)
- ▶ Manage portfolio of assets that require a low turnover
- ▶ Manage portfolio that does not pay (or minimizes) dividends

Trusts and Estates

▶ Passive activities

- ▶ In determining whether a trust or estate meets active participation requirements in section 469, there is uncertainty as to participation of which parties is considered
 - ▶ Look to trustees, employees and third-party agents – *Mattie K. Carter Trust v. United States*, 256 F.Supp.2d 536 (N.D. Tex. Apr. 11, 2003)
 - ▶ Look only to trustees who are considered fiduciaries – Tech. Adv. Memo. 2007-33-023 (Aug. 17, 2008) and Priv. Ltr. Rul. 2010-29-014 (Apr. 7, 2010)
- ▶ *Carter Trust* is still valid law and may support filing position
- ▶ If grantor or beneficiary participates in activity, consider whether they should be added as a trustee or whether trust should be a grantor trust

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President's Budget

▶ **Maintain estate tax at 2009 levels**

- ▶ Exemption
 - ▶ \$3,500,000 exemption for estate and GST tax
 - ▶ \$1,000,000 exemption for estate tax
 - ▶ No indexing for inflation
- ▶ 45 percent estate tax rate
- ▶ No clawback for decreases in exemption
- ▶ Portability allowed
- ▶ Effective for decedents dying, and for transfers made, after December 31, 2017

President's Budget

▶ **Require consistency in value**

- ▶ Value reported for estate tax purposes would be required basis of property for income tax purposes in hands of beneficiary
- ▶ Donor's basis of gifted property would be donee's basis in property
- ▶ In no event would basis of property in hands of recipient be greater than value of property as determined for gift or estate tax purposes
- ▶ Requirement to furnish basis information to recipient and to IRS by donor for gifts and executor for estates
- ▶ IRS would be granted regulatory authority to address implementation
- ▶ Effective for transfers on or after date of enactment

President's Budget

- ▶ **10-year minimum annuity term for GRATs**
 - ▶ Maximum term of life expectancy of grantor, plus 10 years
 - ▶ Remainder interest cannot be zero
 - ▶ Prohibit any decrease in annuity during annuity term
 - ▶ Effect
 - ▶ Increases possibility that grantor will die during annuity term
 - ▶ Creates more downside risk by eliminating any transfer tax benefit for those GRATs in which grantor dies within term
 - ▶ Substantially reduces annual annuity payment that may be rolled over into another GRAT and term of each new GRAT would have to be a new 10-year term
 - ▶ Effective for trusts created after date of enactment

President's Budget

- ▶ **Limit duration of GST exemption to 90 years**
 - ▶ GST exclusion would terminate on 90th anniversary of creation of trust
 - ▶ Inclusion ratio of trust becomes one (1) on 90th anniversary
 - ▶ Separate transferors to same trust create separate trusts for GST tax purposes – rule would apply to each separate trust
 - ▶ Applies to pour-over trusts and decanted trusts – use anniversary date of original trust
 - ▶ Effective for trusts created, and for transfers made to existing trusts, after date of enactment

President's Budget

- ▶ **Coordinate income and transfer tax rules applicable to grantor trusts**
 - ▶ If a grantor engages in a transaction that constitutes a sale or exchange that is disregarded for income tax purposes, portion of trust attributable to property received in transaction (including all retained income, appreciation and reinvestment net of amount of consideration received by grantor) will be subject to gift or estate tax when property is no longer subject to grantor trust rules
 - ▶ Gift or estate tax imposed would be payable by trust
 - ▶ Much more narrow than last year's proposal which would not subject a transfer to a grantor trust to gift tax until there was a distribution from trust or until trust ceased to be grantor
 - ▶ Effectively negates transfer tax benefit of sales to IDGTs
 - ▶ Effective for transactions executed after date of enactment

President's Budget

- ▶ **Extend estate tax lien on deferrals provided under section 6166**
 - ▶ Estate tax lien under section 6324(a) would be extended throughout section 6166 deferral period
 - ▶ *Estate of Roski v. Commissioner*, 128 T.C. 113 (Apr. 12, 2007)
 - ▶ Tax Court held that IRS had abused its discretion by requiring that all estates electing to pay estate in installments under section 6166 must provide a bond or lien
 - ▶ Court ruled that it was Congress's intent that IRS determine, on a case-by-case basis, whether government's interest is at risk prior to requiring security from an estate making an election under section 6166
 - ▶ Effective for estate of decedents dying on or after date of enactment

President's Budget

- ▶ **Clarify GST tax treatment of health and education exclusion trusts (HEETs) (new)**
 - ▶ Section 2503(e) excludes from gift tax
 - ▶ Payments made directly to provider of medical care
 - ▶ Payments made directly to a school for tuition
 - ▶ Section 2611(b)(1) excludes from GST tax any transfer made pursuant to section 2503(e)
 - ▶ HEETs provide for medical and tuition expenses of multiple generations and distributions from them for these purposes are excluded from GST tax
 - ▶ Provision would *clarify* that section 2611(b)(1) only applies to a payment by a living donor
 - ▶ Effective for trusts created after introduction of bill proposing change

President's Budget

- ▶ **Missing from this year's budget – Valuation proposal**
 - ▶ Previous proposals would have added an additional category of disregarded restrictions to section 2704 that would be ignored in valuing transferred interests
 - ▶ Limitations on right to liquidate interest if more restrictive than standard set forth in regulations
 - ▶ Any restriction on transferee's ability to be admitted as a full partner or a holder of an equity interest in entity
 - ▶ Restriction would have been ignored if, after transfer, restriction may lapse or may be removed by transferor or transferor's family
 - ▶ In determining whether family members may remove restrictions, certain interests held by charities and other non-family members would be considered held by family members

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- ▶ **Portability**
- ▶ Formula Clauses
- ▶ Beneficiary-Owned Trusts
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Portability

- ▶ Overview
- ▶ Election
- ▶ DSUE Amount
- ▶ Last Deceased Spouse
- ▶ IRS Examination

Overview

$$\text{Applicable exclusion amount} = \text{basic exclusion amount} + \text{deceased spousal unused exclusion amount}$$

- ▶ Basic exclusion amount is currently \$5,125,000 million
- ▶ DSUE amount is lesser of
 - ▶ Basic exclusion amount
 - or
 - ▶ Excess of
 - ▶ Basic exclusion amount of last deceased spouse over
 - ▶ Amount with respect to which tentative estate tax is determined on estate of that spouse
- ▶ Portability does not apply for GST tax purposes

Election

- ▶ Must be made on **timely** filed estate tax return even if estate would not otherwise be required to file return
- ▶ If executor chooses **not** to make election
 - ▶ Executor must make affirmative statement on estate tax return
 - ▶ If no estate tax return required to be filed, not filing return is considered an affirmative statement not to make election
- ▶ Once made, election is **irrevocable**
- ▶ **Executor** of deceased spouse's estate makes election
 - ▶ If no executor, any person in actual or constructive possession of decedent's property may make election
 - ▶ Election by a non-appointed executor cannot be superseded by a contrary election by another non-appointed executor

Election

- ▶ Estate tax return must be **complete** and **properly** prepared
- ▶ If estate **not** otherwise required to file a return, return does not have to report value of property that qualifies for marital or charitable deduction
 - ▶ Executor required to report only description, ownership and/or beneficiary of such property
 - ▶ Executor must provide information necessary to establish right of estate to marital or charitable deduction for property
- ▶ Executor must estimate total value of estate in **good faith**
 - ▶ Executor must identify particular range applicable to gross estate from ranges provided in instructions of estate tax return
 - ▶ Ranges in instructions are \$250,000 ranges

DSUE Amount

- ▶ **Executor** must compute DSUE amount (Part 6 of estate tax return)
- ▶ DSUE amount based on basic exclusion amount in effect in **year of death** of decedent
- ▶ If decedent paid gift tax, gifts that were taxed are **excluded** from adjusted taxable gifts for purposes of determining DSUE amount
- ▶ Regulations **reserve** on issue of how DSUE amount interfaces with other available estate tax credits (e.g., tax on prior transfers under section 2013, foreign estate taxes under section 2014)

Last Deceased Spouse

- ▶ **Most recently** deceased individual who was married to surviving spouse at that individual's death (provided individual died after December 31, 2010)
- ▶ **Remarriage or divorce** by surviving spouse
 - ▶ Does not affect who will be considered last deceased spouse
 - ▶ Does not prevent surviving spouse from including in surviving spouse's applicable exclusion amount DESU amount of deceased spouse who most recently preceded surviving spouse in death
- ▶ Identity of last deceased spouse **not** affected by whether
 - ▶ Estate of last deceased spouse makes portability election
 - or
 - ▶ Last deceased spouse has any DSUE amount available

Last Deceased Spouse

- ▶ When surviving spouse has more than one deceased spouse, regulations apply an **ordering rule**
- ▶ Any gifts made by a surviving spouse use up DSUE amount of last deceased spouse **before** using surviving spouse's basic exclusion amount
- ▶ Surviving spouse's DSUE amount then becomes DSUE amount of last deceased spouse, **plus** any DSUE amount actually applied to surviving spouse's taxable gift to extent it was from a decedent who is no longer last deceased spouse
- ▶ Regulations provide examples that illustrate application of rules

IRS Examination

- ▶ IRS may examine returns of each deceased spouse of surviving spouse in order to **eliminate** DSUE amount
- ▶ IRS may assess **additional** estate tax on deceased spouse's returns only if period of limitations on assessments is still open

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Formula Clauses

- ▶ Overview
- ▶ Types
- ▶ Cases
- ▶ *Wandry*
- ▶ Summary

Overview

- ▶ Uncertainties in **valuation** can lead to gift tax GST tax consequences unintended by a transferor
- ▶ Formula clauses address **uncertainties** in valuation when transferring assets that do not have a readily ascertainable value by gift or sale
- ▶ Courts have respected formula clauses that **define amount** of assets intended to be transferred

Types

- ▶ **Adjustment clause** retroactively adjusts value of transfer due to a subsequent valuation determination
- ▶ **Definition clause** defines a transfer by reference to value of a possibly larger, identified property interest
 - ▶ Defined transfer clause – defines amount of transfer with any excess property resulting from a revaluation returning to transferor
 - ▶ Defined allocation clause – defines amount of transfer with any excess property resulting from a revaluation being reallocated among transferees

Cases

- ▶ ***Procter v. Commissioner***, 142 F.2d 824 (4th Cir. 4/11/44) – adjustment clause – against public policy
 - ▶ Has tendency to **discourage** collection of tax by public officials charged with its collection since only effect of an attempt to enforce tax would be to defeat gift
 - ▶ Would **obstruct** administration of justice by requiring courts to pass upon a moot case
 - ▶ Final judgment of a court would be held for **naught** – condition would not become operative until there has been a judgment, but after judgment has been rendered, it cannot become operative because matter involved is concluded by judgment

Cases

- ▶ ***Estate of Christiansen v. Commissioner***, 130 T.C. 1 (1/24/08), *aff'd* 586 F.3d 1061 (8th Cir. 11/13/09) – reallocation clause for an estate tax disclaimer – court approved
- ▶ ***Estate of Petter v. Commissioner***, T.C. Memo. 2009-280 (12/7/09), *aff'd* 653 F3d 1012 (9th Cir. 8/4/11) – reallocation clause in gift tax context (sale to IDGT – clauses used in gift and sale transactions) – court approved
- ▶ ***Hendrix v. Commissioner***, T.C. Memo. 2011-133 (6/15/11) – reallocation clause – court approved

- ▶ **Wandry v. Commissioner**, T.C. Memo 2012-88 (3/26/12)
 - Tax court approves defined transfer clause for first time

Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service (IRS). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. *Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.*

- ▶ Tax court reviewed opinions in *Christensen*, *Petter* and *McCord* noting that definitional clauses as opposed to adjustment clauses were valid because they merely transferred a **fixed set of rights** with uncertain value
- ▶ It further agreed with Ninth Circuit in *Christensen* that although value of a membership unit in LLC was unknown on date of gift, value on any given date was **constant**
- ▶ Tax court reasoned that it was **inconsequential** that formula clause reallocates membership units among donors and donees rather than a charity because reallocations do not alter transfers

- ▶ **Public policy** concerns in *Procter*
 - ▶ No well-established public policy against formula clauses
 - ▶ IRS's role is to enforce tax laws, not merely maximize tax receipts
 - ▶ Mechanisms outside IRS audit exist to confirm accurate valuation reporting – most significant of which is that members of FLP had an interest in confirming that they were allocated their fair share of profits
 - ▶ Judgment in favor of donees would not undo gift as they transferred a fixed set of interests and neither they nor transfer documents contained power to undo transfers

Summary

- ▶ **Defined allocation clauses** – *Petter, Christiansen and Hendrix*
 - ▶ Donor is transferring property with a defined value
 - ▶ Clause merely serves to reallocate property among two or more donees if assets transfers exceed defined value
 - ▶ No property returns to donor, as was case in *Procter*
 - ▶ Safe bet – involve charity as it creates fiduciary duties and penalties for failure to adhere to those duties

- ▶ **Defined transfer clauses** – *Wandry*
 - ▶ Donor is transferring property with a defined value
 - ▶ Transfer of rights has value on date of transfer which is constant although value of rights may be unknown
 - ▶ Property transferred in excess of defined value returned to donor

Agenda

- ▶ American Taxpayer Relief Act of 2012
- ▶ Net Investment Income Tax (NIIT)
- ▶ President's Budget
- ▶ Portability
- ▶ Formula Clauses
- ▶ **Beneficiary-Owned Trusts**
- ▶ Delaware Incomplete Non-Grantor (DING) Trusts

Beneficiary-Owned Trusts

- ▶ Beneficiary-owned trusts are trusts that are treated as owned by **beneficiary** under section 678
- ▶ Under section 678, a person **other than grantor** may be treated as owner to which such person
 - ▶ Has a power exercisable solely by himself to vest trust property in himself
 - ▶ Has previously partially released a power and after release retains such control as would, within the grantor rules, subject a grantor of a trust to treatment as owner
- ▶ In most instances, trust is created by a senior family member for benefit of junior family members using a **lapsing** withdrawal power to create grantor trust status

Beneficiary-Owned Trusts

- ▶ Beneficiary-owned trusts have historically been used most often when senior family members donate **S corporation stock** to a trust for benefit of junior family members
- ▶ Of late, beneficiary-owned trusts have been used by family members to permit a beneficiary to **swap** assets into trust tax-free or **sell** assets to trust in a highly leveraged sale
 - ▶ Removes assets and future appreciation from beneficiary's gross estate
 - ▶ Beneficiary can retain a potential beneficial interest in trust, as well as some control

Beneficiary-Owned Trusts

- ▶ **Facts** of PLR 2012-16-034 (Jan. 11, 2012)
 - ▶ Grantor created a trust for benefit of an individual
 - ▶ Beneficiary had power following a contribution to trust to withdraw entire contribution
 - ▶ Power to withdraw was cumulative
 - ▶ Each year amount beneficiary could withdraw was reduced by greater of \$5,000 or 5 percent of value of trust principal
 - ▶ Beneficiary, as trustee, could distribute income and principal to himself subject to an ascertainable standard
 - ▶ Beneficiary had power, in a non-fiduciary capacity, to acquire trust property by substituting property of equivalent value
 - ▶ Grantor intended to transfer S corporation stock to trust

Beneficiary-Owned Trusts

▶ Grantor trust status

- ▶ As to portion of trust over which beneficiary's withdrawal power had not lapsed, beneficiary would be treated as owner of such portion under section 678(a)(1)
- ▶ As to portion of trust over which beneficiary's withdrawal power lapses, beneficiary would be treated as having released a power while retaining grantor trust power under section 675(c)(4) (a power of administration to acquire trust property by substituting property of equivalent value); therefore, triggering section 678(a)(2)
- ▶ IRS reserved ruling on section 678(a)(2) as issue whether someone exercises a power in a non-fiduciary capacity is a question of fact to be determined when income tax returns of parties involved are examined by IRS

Beneficiary-Owned Trusts

- ▶ Totally lapsed power as “**partially released**” for section 678(a)(2) purposes
 - ▶ IRS has ruled this way in a number of letter rulings
 - ▶ Rationale
 - ▶ When unlimited power lapsed and a power limited by an ascertainable standard continued, it was same as a partial lapse in powers before lapse and after lapse
 - ▶ Because powerholder could have withdrawn amount but did not, it is essentially a release of power
 - ▶ It should be noted, however, that after lapse of power, beneficiary only had power as **trustee** to make distributions to himself subject to an ascertainable standard

Beneficiary-Owned Trusts

- ▶ **Beneficiary's** power of substitution to make grantor still owner of trust after lapse
 - ▶ Power to substitute assets under section 675(4)(C) makes a trust grantor as to someone who makes a gratuitous transfer to a trust
 - ▶ It makes no difference who holds power – IRS has ruled as such on a number of occasions

Agenda

- ▶ American Taxpayer Relief Act of 2012
- ▶ Net Investment Income Tax (NIIT)
- ▶ President's Budget
- ▶ Portability
- ▶ Formula Clauses
- ▶ Beneficiary-Owned Trusts
- ▶ **Delaware Incomplete Non-Grantor (DING) Trusts**

DING Trusts

- ▶ DING trusts are **complex** trusts to which transfers are **incomplete** for gift tax purposes
- ▶ DING trusts are designed as a way to minimize or eliminate **state** income tax (may also offer asset protection)
- ▶ In a typical arrangement, a person in a state that **imposes** an income tax will transfer assets to a trust situated in a state that **does not** impose a state income tax or that does not tax accumulation of income in a trust
- ▶ To extent no distributions are made to beneficiaries of trust (which generally include grantor), no **current** state income tax will be payable on income earned by trust

DING Trusts

- ▶ Non-grantor trust status is generally achieved by requiring **adverse parties** (i.e., beneficiaries) consent to discretionary distributions to grantor during his or her life
- ▶ Incomplete gift status is generally achieved by giving grantor ability to have **some control** over distributions and/or a testamentary **limited** power of appointment
- ▶ IRS issued nine **favorable** PLRs regarding DING trusts – PLRs 200148028 (Aug. 27, 2001); 200247013 (Aug. 14, 2002); 200502014 (Sept. 17, 2004); 200612002 (Nov. 23, 2005); 200637025 (June 5, 2006); 200647001 (Aug. 7, 2006); 200715005 (Jan. 3, 2007); 200729025 (Apr. 10, 2007); and 200731019 (May 1, 2007)

DING Trusts

- ▶ On July 9, 2007, IRS released **IR 2007-127** stating
 - ▶ It was reconsidering a series of letter rulings as to whether beneficiaries of a trust who direct distributions of a trust had general powers of appointment
 - ▶ It was considering whether its rulings regarding application of section 2514 were consistent with Rev. Rul. 76-503 and Rev. Rul. 77-158 which indicate that because committee members are replaced if they resign or die, they would be treated as possessing general powers of appointment over trust corpus
 - ▶ IRS invited comments but has not resolved issue

DING Trusts

▶ **CCA 201208026 (Sept. 28, 2011)**

- ▶ IRS ruled that a limited testamentary power of appointment did not render a transfer to trust incomplete for gift tax purposes
- ▶ Donors were not permissible recipients of distributions from trust

▶ **PLR 201310002 (Nov. 7, 2012)**

- ▶ IRS ruled transfers to trust were incomplete gifts due to
 - ▶ Grantor's sole power over principal
 - ▶ Grantor's consent power over income and principal
 - ▶ Grantor's testamentary limited power to appoint trust property
- ▶ Decisions of beneficiaries as distribution committee members did not constitute gifts with regard to grantor or other beneficiaries

DING Trusts

▶ Planning considerations

- ▶ DING trusts continue to be a viable state income tax and asset protection strategy
- ▶ Be cognizant of issues raised by IRS in IR 2007-127 and CCA 201208026
- ▶ Possible use in minimizing net investment income tax
 - ▶ Where a grantor trust owns an interest in a trade or business activity, material participation will be determined by reference to grantor
 - ▶ Using a DING trust would shift determination of material participation away from grantor to activities of trustees where material participation threshold might be met

Thank You