2012 Estate and Gift Tax Overview

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- Current Estate and Gift Tax Law
- Exclusion Planning for 2012
- Portability Overview
- Impact of Increased Exclusions on Common Estate Plans
- Advanced Planning Ideas
- Miscellaneous Issues and Updates

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Current Estate and Gift Tax Law

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Estate Tax Basics
State Estate Taxes

No South Carolina Estate Tax for Decedents dying after January 1, 2005.

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2010 Tax Act

- Restored Federal Estate Tax
- Increased Exclusion to $5 million with inflation adjustment
- Reduced Tax Rate to 35%
- Made Exclusion Portable
- Sunsets on December 31, 2012

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Estate and Gift Tax for 2012

- $13,000 annual exclusion for gifts
- $5.12 million exclusion
- 35% tax rate

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President's Proposal for 2013

$3.5 million exclusion for estate tax

$1 million exclusion for gift tax

45% rate

Portability

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Default Rules for 2013

$1.0 million exclusion for estate and gift tax

55% maximum tax rate

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2013 Options

Extension of $5 million exclusion

Reduction of exclusion to $3.5 million

Reduction of Exclusion to $1.0 million

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Exclusion Planning for 2012

Assume the exclusion for 2013 is reduced to $3.5 million

This would result in $1,620,000 of "Lost Exclusion"

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Exclusion Planning for 2012

If the estate tax rate is 45%, a reduction in the exclusion **increases** the estate tax by **$729,000** for individual or **$1,458,000** for a couple

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Exclusion Planning for 2012

There are only two ways to capture the Lost Exclusion:

#1 - Die before 12/31/2012

#2 - Gift $5,120,000 before 12/31/2012

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Exclusion Planning for 2012

To use the Lost Exclusion by making gifts, you must give more than $3.5 million this year

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Exclusion Planning for 2012

Client makes a gift of $2 million in 2012

In 2013, the exclusion is reduced to $3.5 million

Client has $1.5 million of exclusion remaining but did not use any of the Lost Exclusion

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Exclusion Planning for 2012

Client makes a gift of $4 million in 2012

In 2013, exclusion is reduced to $3.5 million

Client has NO exclusion remaining but did use $500,000 of the Lost Exclusion

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Exclusion Planning for 2012

Client makes a gift of $5,120,000 million in 2012

In 2013, exclusion is reduced to $3.5 million

Client has NO exclusion remaining and used ALL of the Lost Exclusion

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Exclusion Planning for 2012

Gifts to Trusts for Descendants:

- Management (if needed)
- Creditor Protection
- Spousal Protection
- Estate Tax Protection (GST Trusts)
- Grantor Trusts

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Grantor/GST Trust

- Father establishes Trust for Child with Child as Trustee or with third party as Trustee (on a temporary or permanent basis)
- Trust provides the Trustee can use income and principal for Child and Child's descendants for health care, education, maintenance and support

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Grantor/GST Trust

- Trustee can invest in stocks, bonds, or real estate (including residential or recreational properties)
- At Child's death, Child has the power to direct how trust assets are distributed among determined class of beneficiaries (descendants, spouse, charities)

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Grantor/GST Trust

- Father reserves the right to substitute assets that he owns personally for assets held by the trust as long as they are of equal value

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Grantor/GST Trust

- Trust is not included in Child's estate at Child's death for estate tax purposes
- Trust is not marital property if Child gets a divorce and is not subject to Elective Share claims
- Trust is not subject to claims of Child's creditors

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Grantor/GST Trust

- Trust may use Father's social security number as its tax ID
- All income, deductions, gains, and losses are reported on Father's return and Father's payment of the trust's income tax liability is not considered to be an additional gift

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$10,240,000 Grantor Trust Gift

Years of Growth @ 6%	Future Value
5 years	13,703,429
10 years	18,338,280
15 years	24,540,755
20 years	32,841,067
25 years	43,948,756

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Exclusion Planning for 2012

Gifts to Trust for Spouse (Spousal Access Trust):

- Management (if needed)
- Creditor Protection
- Spousal Protection (remarriage)
- Estate Tax Protection
- Grantor Trust

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Spousal Access Trust

- Husband establishes Trust for Wife with Wife as Trustee or with third party as Trustee
- Trust provides the Trustee can use income and principal for Wife or descendants for health care, education, maintenance and support

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Spousal Access Trusts

- Trustee can invest in stocks, bonds, or real estate (including residential or recreational properties)
- At Wife's death, Wife has the power to direct how trust assets are distributed among a class of beneficiaries (descendants or charities)

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Spousal Access Trust

- Default provision at Wife's death is for trust to continue as GST Trust for children/descendants
- Husband reserves the right to substitute assets that he owns personally for assets held by the trust as long as they are of equal value

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Spousal Access Trust

- Trust is not included in Wife's estate at Wife's death for estate tax purposes
- Trust is not marital property if Wife remarries after Husband's death and is not subject to Elective Share claims
- Trust is not subject to claims of Wife's creditors

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Spousal Access Trust

- Trust may use Husband's social security number as its tax ID
- All income, deductions, gains, and losses are reported on Husband's return and Husband's payment of the trust's income tax liability is not considered to be an additional gift

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$5,120,000 Gift to Spousal Access Trust

Years of Growth @ 6%	Future Value
5 years	6,851,714
10 years	9,169,140
15 years	12,270,377
20 years	16,440,533
25 years	21,974,378

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Spousal Access Trust

Reciprocal trusts <u>are not</u> permitted

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Formula Gifting

Proctor Case (1944 – 4th Circuit) - Gift Adjustment Clause violates public policy and is invalid

If it is determined that any part of this transfer is subject to gift tax, the portion subject to gift tax shall be deemed not to be included in the transfer and shall remain the property of the donor.

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Formula Gifting

McCord (2006), Christensen (2008), Petter (2009) and Hendrix (2011) – *Formula <u>Allocation</u> Clause* is valid

Donor transfers asset to a trust that includes a formula allocating the gift tax exclusion amount to descendants and any excess to a non-taxable beneficiary (charity or a QTIP Trust)

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Formula Gifting

Wandry (2012) (U.S. Tax Court) – *Formula Transfer Clause* is valid

I transfer a fixed number of units with a value equal to $_____. If it is later determined for gift tax purposes that the number of units transferred exceeds this value, the number of units shall be reduced accordingly

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Formula Gifting

Tips for Using Formula Gifts:

1. Prepare Appraisal Immediately
2. Properly describe the gift and make clear that the number of units is based upon a formula that assumes a particular value
3. Use grantor trusts as donees to avoid income tax issues if there is an adjustment

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Portability of Exclusions

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Estate Tax Basics
2012 Estate Planning Options
Simple Will with No Portability

Husband	Wife
$6,000,000	$ 3,000,000
	$ 6,000,000
	$ 9,000,000
	- $ 5,120,000 Exempt
	$ 3,880,000 Taxable

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Basic Estate Tax Planning

Decedent's Estate

Family Trust
$5.12 million
Estate and GST Tax Exempt

Marital Trust
Excess Assets
Estate Tax Deferred

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Estate Tax Basics
2012 Estate Planning Options
Will with Family Trust

Husband	Wife
$6,000,000	$ 3,000,000
	$ 880,000
	$ 3,880,000
$5,120,000 Trust	-$ 5,120,000 Exempt
-$5,120,000 Exempt	$0 Taxable
$ 0 Taxable	

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Portability
The DSUE Amount

Generally, if the first spouse to die does not use all of his or her exclusion, the **D**eceased **S**pouse's **U**nused **E**xclusion ("**DSUE**") Amount is available for the surviving spouse.

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Portability – Election Required

Deceased spouse's exclusion is not portable unless:

- First Spouse dies **after 12/31/10**
- First Spouse's PR has **timely filed a complete and properly prepared estate tax return**
- First Spouse's PR **elects portability** on the estate tax return

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Portability Election – IRS Notice 2011-82

- Must file a **complete and properly prepared estate** tax return to make the election – regardless of the size of the estate
- Must be made on a timely filed return

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Portability
Last Deceased Spouse

- Aggregation from multiple spouses not allowed. Only the exclusion from your **last deceased spouse** is portable

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Portability
Last Deceased Spouse

- Some commentators have suggested including language in a prenuptial agreement to require the first deceased spouse to make the portability election

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Portability – Basic Rules

- Husband I and Wife are married
- Husband I dies first leaving all assets to Wife

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Portability – Basic Rules

Husband I dies first and leaves all to Wife.

Husband I → Wife

$5.0 Basic Exclusion
$5.0 DSUEA
*$10.0 Total Exclusion

*May be used for lifetime gifts or at death

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Portability – Basic Rules

Husband I dies first and leaves $2 million his children.

Husband I → Wife

$5.0 Basic Exclusion
$3.0 DSUEA
$8.0 Total

$2.0 to Children

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Portability
Impact of Remarriage

Wife marries Husband II

Wife dies first and leaves all assets to Husband II

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Portability
Impact of Remarriage

Wife dies first and leaves all assets to Husband II

Wife	Husband II
	$5.0 Basic Exclusion
→	$5.0 Wife's DSUEA
	*$10.0 Total

*Husband I's DSUEA is not transferrable to Husband II

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Portability

Proposed Regulations provide that if a surviving spouse makes a lifetime gift the DSUE Amount is applied **BEFORE** her own exclusion amount.

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Portability

Wife make $5 million gift to children before her death.

Wife	Husband II
	$5.0 Basic Exclusion
→	$3.0 Wife's DSUEA

$5 million – lifetime gift
$3 million - Husband I's DSUEA
$2 million – Wife's Exclusion

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Portability

Wife dies before Husband II and leaves $5 million to her children.

Wife — Husband II

$5.0 Basic Exclusion

$3.0 Wife's DSUEA

$5 million

$3 million - Husband I's DSUEA

$2 million – Wife's Exclusion

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Portability

Wife has $8 million exclusion (her own plus Husband I) but Husband II dies first and leaves his $7.5 million estate to his children.

Husband II — Wife

$5.0 Basic Exclusion

*$0 DSUEA

*Last Deceased Spouse is Husband II and he used all of his exclusion

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Portability

Reasons to continue to use trusts for planning:

- GST exemption is not portable.
- Trusts protect growth in assets.
- Use of exclusion at death by establishing a trust cannot be impacted by spouse's subsequent remarriage.
- Sunset Provision
- State Law Concerns

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Estates Less than $1 million

- Estate Tax Planning Probably Not Needed
- Reassess Need for Trusts
  - Asset Protection
  - Management/Tax Planning for children
  - Management for spouse
  - Protection of Plan of Distribution
  - Protection from Remarriage of Surviving Spouse

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Estates Greater than $1 million but Less than $5 million

- Tax Planning May Be Needed
- Design Plan with optional or required use of exclusions for husband and wife
- Consider non-tax reasons for including trusts in the plan

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Estates Greater than $5 million

- Tax Planning Probably Needed
- Design Plan to require use of exclusions for husband and wife
- Look at advanced planning options if estate is greater than $5 million

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Advanced Planning Option #1
Insurance Planning

- Transfer existing policies to an Irrevocable Life Insurance Trust (ILIT) to remove policy proceeds from estate - potential three year rule
- Use Irrevocable Insurance Trust to purchase a new single life or second-to-die policy to provide liquidity for estate taxes

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Advanced Planning Option #2
Using Generation-Skipping Trusts

- $5.12 million limit per transferor (2012)
- Avoids estate tax in child's estate
- Added protection from creditors' claims
- Added protection in divorce

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Advanced Planning Option #3
Annual Exclusion Gifts

- You may gift $13,000 per year to as many individuals as you like without gift tax consequences – estimated to be $14,000 in 2013
- Husband and Wife may gift $26,000 together – Split Gift Election

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Advanced Planning Option #4
Tuition Payment Options

- Direct payment of tuition to educational institution is not a gift
- Some institutions will allow you to pre-pay all future years (non-refundable)
- Gifts to Section 529 Plans are subject to the annual exclusion limits ($13,000). Five-year option available.

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Advanced Planning Option #5
Creating Discounts

- Generally, a minority interest in a family business is entitled to a discount for estate and gift tax valuation purposes.
- A 40% interest in business is not valued at 40% of the value of the entire company.
- Lack of control and lack of marketability are two factors used by appraisers to determine the amount of the discount.

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Advanced Planning Option #5
Creating Discounts

- Divide ownership of beach houses, recreational property or business property to create discount opportunities
- Consider recapitalizing company to voting and non-voting stock as a way to divide control of a company
- Don't put surviving spouse back in control with an outright bequest - use a marital trust instead

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Advanced Planning Option #6
Intra-Family Loans

- Short-Term Rate (less than 3 years) – 0.23% (October 2012)
- Mid-Term Rate (between 3 and 9 years) – 0.93% (October 2012)
- Long-Term Rate (greater than 9 years) – 2.36% (October 2012)

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Advanced Planning Option #7
Using Lifetime Exclusion

Planning Opportunities

- Couples can transfer $10,240,000 without gift taxes.
- Consider Grantor Trusts.
- Consider GST Trusts for long-term protection from estate taxes, creditors, and spousal claims.

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Advanced Planning Option #8
Grantor Retained Annuity Trusts

- Grantor transfers substantial assets to irrevocable trust
- Trust provides for payment of some assets back to Grantor during trust term
- At the end of the term - remaining trust assets pass to children

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Advanced Planning Using GRATs

- Assume $2 million of stock transferred to Trust.
- Trust provides that $1,018,018 of value is to be returned to Grantor at end of year 1 and $1,018,018 at the end of year 2
- Taxable Gift is zero as present value of payments using 7520 rate (1.2% - October) rate is equal to $2 million

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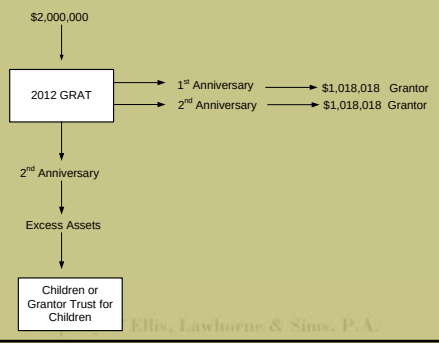
Advanced Planning Using GRATs



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Advanced Planning Using GRATs

- If growth of stock plus dividends is equal to or less than 7520 rate (1.2% per annum in this example) all assets are returned to Grantor
- If growth exceeds 7520 rate, all excess growth passes to children without gift tax
- If growth is 8% per year, in this example, children receive $215,320

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Advanced Planning
Using GRATs – Sale of Business

- Family S Corporation is valued at $10 million
- Shareholder gifts 25% interest to GRAT (Undiscounted - $2,500,000)
- Value of 25% interest is discounted by 30% ($1,750,000 total value)
- Present value of payments to be returned to Grantor is $1,750,000

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Advanced Planning Option #9
Family Partnerships & LLCs

- Management of Family Assets
- Asset Protection from LLC Activities
- Asset Protection for LLC Assets
- Create Discounts

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Family Partnerships & LLCs

- Must have legitimate non-tax purposes
- Death bed and securities only entities will be audited
- Don't leave founder in control
- Consider Hackl case for annual gifts

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Miscellaneous Recent Developments

- IRA Protection from Creditor's Claims enhanced – South Carolina Code Section 15-41-30(A)(13)
- LLC does not protect individual member from his own negligent acts (*16 Jade Street LLC v. R. Design Construction Co., LLC* – SC Supreme April 2012)

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Miscellaneous Recent Developments

- Single Member LLC qualifies for 4% Personal Residence rate – *CFRE, LLC v. Greenville County Assessor* (SC Supreme Court August 2011)
- *Ford v. Beaufort County Assessor* (SC Court of Appeals June 2012) – Primary residence rented for more than 14 days does not qualify for 4% assessment

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Miscellaneous Recent Developments

4% Assessment (SC Code Section 12-43-220(c)) for primary residence is not available for the ***entire*** residence unless:

- Owner-occupant owns at least 50% or
- Owner-occupant owns at least 25%, other immediate family members (parent, child, sibling) own the remainder, and the owner-occupant is not a member of a household that receives a 4% assessment on another property

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