THE KIRWAN LAW FIRM

Temporary Estate Tax Fix Creates Golden Opportunity to Permanently Protect Your Assets From Creditors and Estate Taxes

On December 17, 2010, President Obama signed into law H.R. 4853, The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (I'll refer to this as the new "Act"). These new laws make significant changes to the gift, estate and generation skipping transfer tax (GST) laws, but will only be effective for TWO YEARS. They are repealed automatically on December 31, 2012, leaving us with the old estate tax laws with their one million dollar estate tax unified credit and top estate tax rate of 55%. As I will explain below, the vast majority of professionals and business owners have been presented with a limited opportunity to permanently shelter their businesses, future business profits, brokerage accounts, real estate, savings, and other assets from estate taxes and permanently protect those assets from the claims of creditors to boot. It may even offer opportunities to protect your assets if you are already facing a lawsuit.

Brief Summary of the New Estate Tax Laws

In short, the Act made the following changes to the US estate tax laws:

1. The **estate tax** Unified Credit increased to $5,000,000, per person (that means $10,000,000 to a married couple);
2. The **gift tax** Unified Credit increased to $5,000,000, per person (that again means $10,000,000 to a married couple);
3. The generation skipping tax exemption increased to $5,000,000, per person (once more, that means $10,000,000 to a married couple);
4. The top estate and gift tax rate falls to 35%;
5. The estate tax unified credit becomes "*portable*" so a surviving spouse inherits his or her spouse's estate tax unified credit. However, to prohibit "serial" marriages, only the most recent deceased spouse's unused exemption may be transferred by the surviving spouse (see warning below before relying on spousal portability); and
6. The ability to use family limited partnerships and limited liability companies ("LLCs") to shrink the value of your assets for estate and gift tax purposes was not destroyed (something many of us estate tax attorneys feared might be in the new Act).

Brief Summary of Estate Tax Concepts.

Before forging ahead with the opportunities provided with the Act, I want to go over a few of the basics of estate and gift tax planning so that you will fully appreciate the planning strategies explained below.

<u>The Unlimited Marital Deduction</u>. As a general rule, the tax law allows people to give unlimited amounts of cash and property to his or her spouse without triggering the imposition of estate or gift tax (this is often referred to as the "unlimited marital deduction"). This results in married individuals being treated as a single taxable unit for estate tax purposes because the payment of any estate tax is deferred until the surviving spouse's death.

<u>Your Unified Credit</u>. Every person has a "unified credit" which permits him or her to make gifts during life or at death up to a certain amount. This is a single, one time credit; not a person or per year credit. In 2009 this amount was $3,500,000; in 2011 it rose to $5,000,000; under the new Act, and in 2013 the amount drops to $1,000,000. For purposes of the estate tax, this means that if you and your spouse <u>both</u> die before January 1, 2013, you would not pay estate taxes if your estate was $10,000,000 or less. Note, however, that if one of you dies in 2013, you would pay estate taxes on everything over $1,000,000 (or $2,000,000 if you have properly funded wills and trusts.) Hopefully, all of you reading this article will still be among the living in 2010, so the unified credit's ability to shelter lifetime gifts from gift taxes will be more relevant.

The reason the unified credit is called the **<u>unified</u>** credit, is because it shelters (i) assets left to your heirs at death from the estate tax, **and** (ii) assets gifted to people and trusts during your lifetime from the gift tax, but (ii) is reduced for both estate and gift taxes to the extent it is used during your life. For example, if the unified credit was $1,000,000 and you made a gift to your children (or a trust for their benefit) of $600,000, then you could only shelter $400,000 from estate taxes when you died. The gift of $600,000 is made free of gift taxes and is now forever removed from your estate. Note that you could also make a gift to a trust for the benefit of your spouse, as well, and the assets in the trust are also forever sheltered from estate tax even though your spouse can use, invest, and spend the money in the trust. You could even have a trust for both your spouse and your children. If you made a $1,000,000 gift to a trust like this, you lived for another 30 years, and the assets grew at an average annual rate of 5%, you would have removed over $4,300,000 from your estate. If you made a gift of $5,000,000 to the same trust before 2013 (while the Act has given us a $5,000,000 unified credit), you would permanently remove over $21,600,000 from your estate without paying any gift taxes even if the estate laws change for the worse in the future.[1]

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[1] When I say that assets can be permanently removed from your estate, I do want to make clear that due to the way the estate tax is computed on Form 706 (the IRS Estate Tax Return), there is a small chance that some of the transferred assets could be "clawed back" into your estate if the unified credit drops in the future. While I do not think this is likely, it is not impossible. But consider this. Even if that did happen, (a) all the future income and appreciation on those transferred assets are protected from estate tax, (b) all the transferred assets are protected from creditors, and (c) you still are no worse off than if you hadn't engaged in planning. So gifting assets to a trust really is a "no harm, no foul" proposition.

The reason why the increase in the unified credit under the new Act is so important stems from the fact that it increases this important credit for BOTH estate and GIFT tax purposes. Under President Bush's tax act, the unified credit was increased to $3,500,000 in 2009; BUT ONLY FOR ESTATE TAX PURPOSES. The unified credit for GIFT TAX purposes was only $1,000,000. This means that if you made a gift of $2,500,000 in 2009 (assuming you made no previous gifts that used part of your credit), you would have paid gift tax on a full $1,500,000. This would have resulted in your cutting a check to the IRS for $675,000. Under the new Act, you can now make a gift of a full $5,000,000 and not pay a nickle of gift tax. Since gifted property can be permanently protected from both the estate tax and the claims of creditors, I hope you can start to see the long term, *permanent* benefits of the *temporary* increase in the unified credit under the Act and why you need to act sooner rather than later.

Additional Advantages of Gifting. Gifts made during life also trigger less tax than gifts made at death. As strange as it sounds, the estate and gift tax is imposed on "the privilege" of being able to give your assets away. But even the the tax rate is the same for both the estate and gift tax, making lifetime gifts is cheaper than leaving assets to your heirs at death. Assume you made a gift of $100,000 to your child. Your child receives the entire $100,000 and you pay the gift tax out of your other assets. Let's assume for simplicity's sake that the tax rate for both the gift and estate tax is 50%. The cost to you of giving away $100,000 is $50,000 ($100,000 x 50%) so it cost you a total of $150,000 to give your child $100,000. If you left the same $100,000 to your child at death, however, you must have an estate of at least $200,000 in order for your kid to receive the same $100,000. This stems from the fact that if your entire estate (all the assets you own at death) are taxed at 50%, you need an estate of $200,000 to leave your child with $100,000 ($200,000 estate LESS 50% tax of $100,000 leaves $100,000 for your heirs). Note that the money that is used to pay the estate tax is itself subject to estate tax.

Since less taxes are paid with respect to gifts made during your life (I'll call this the "Gift's Are Cheaper" advantage), there are more assets left to gift and grow outside your estate. For example, if you made a lifetime gift of roughly $133,333 to a trust for the benefit of your spouse and children, the full $133,333 would be forever removed from your estate and would also be forever protected from the reach of creditors. Since the gift tax on your $133,333 gift would be roughly $66,667 the total transaction cost you $200,000. But since you made a gift during your life (rather than at death), you now have an additional $33,333 growing outside your estate that is permanently protected from creditors and the estate tax.

The Generation Skipping Tax Exemption. In addition to the estate and gift tax unified credit, each person also has something called a "generation-skipping tax exemption" (or "GST Exemption" for short). One of the things this exemption can be used for is to shelter assets gifted to a trust from **ever** being subject to estate taxation not only when you die but also when the assets pass from your children and grandchildren to their children and grandchildren. This can drastically increase the amount future generations will receive since the assets are not being taxed at each generational level. Because the new Act also increases the GST Exemption to $5,000,000, a married couple can not only shelter $10,000,000 (and the future growth on that $10,000,000) from estate taxes when they die, but can also ensure that their children, grandchildren, and future progeny never pay estate taxes on those assets either. This advantage can only be achieved, however, if assets are left to children in properly drafted trusts.

Shrinking or "Discounting" Your Assets. As mentioned above, the new Act is also significant for what it didn't do; namely destroy your ability to shrink or "discount" your assets for estate and gift tax purposes. For example, assume you and your spouse owned $15,000,000 in real estate, businesses, investments, and other assets. Even if both of you were "lucky" enough to die in the next two years and fully used the new Act's new $5,000,000 per person unified credit, you would still have to pay estate taxes on $5,000,000. This would result in an estate tax bill of $1,750,000. Now assume you and your spouse implemented a family limited partnership or LLC to "discount" those assets. If a discount of one-third (1/3) was obtained (discounts tend to range between 30 and 40 percent), your $15,000,000 estate would be reduced to only $10,000,000 ($15,000,000 less 33.33% equals $10,000,000) which could be transferred outside your estate with no tax cost at all.

To better understand how discounts work, suppose that I have two shares of publically traded stock (i.e., GE, Microsoft, etc) each trading at $100 per share. If I asked how much you would pay for one of these two shares the answer would probably be $100 since you could easily turn around and recoup your $100 immediately after the sale by selling it. Now suppose I place the same two shares inside a partnership and ask you how much you would pay for a one-half interest in the partnership (which, remember, represents the same underlying one share of stock). You would probably say "Tell me a little more about this partnership." I would respond by explaining that among other things (i) I was going to be the General Partner (the partner with voting control) and would, therefore, control how the partnership assets are invested and if and when distributions to the partners would be made, (ii) you would be a Limited Partner with no voting control, (iii) restrictions in the partnership agreement prevent you from selling or gifting your interest in the partnership without first gaining my approval, (iv) you are not permitted to withdraw as a Limited Partner, and (v) even if no distributions are made from the partnership (i.e., you receive no cash from the partnership) you still have to pay 50% of the taxes generated by the partnership assets. With all these restrictions, the likelihood of your paying me the same $100 is slim to none. Therefore, you would only pay me a price "discounted" from the underlying asset value, perhaps, only $65 (which would reflect a 35% discount).

Now think back to the discussion on your unified credit. If you make a gift of $100,000 to a child, you pay $50,000 in gift taxes (assuming a 50% tax rate) making the total cost to you $150,000. Now assume that you contributed the same $100,000 to a family limited partnership and could obtain a 35% discount. You would give the non-voting, limited partnership interests to your child and your child would still receive the same $100,000 in value (albeit in the form of a partnership interest). But since you were able to obtain a 35% discount, the value of the limited partnership gifted by you to your child would only be $65,000 for gift tax purposes. This results in a gift tax of $32,500 meaning you saved $17,500 in gift taxes ($50,000 gift tax with no discount LESS $32,500 gift taxes with discount saves $17,500). I hope you can now see how helpful "discounting can be in moving assets to trusts that can protect assets from both creditors and estate taxes.

Our Poor Economy Also Provides Incredible Planning Opportunities. Now that you have a basic understanding of the benefits provided by your unified credit, GST exemption, and the ability to discount assets, you should also be able to see why our poor economy adds to making this an excellent time to shelter assets from creditors and estate taxation. We are presently experiencing historically low property values due to the recent crash of the US real estate. Huge inventories coupled with a record number of foreclosures and properties being sold at rock bottom prices in "short sales" means that you can presently value your real estate at very low values for gift tax purposes as well. Many medical practices and other businesses are also experiencing decreased revenues which also means that their value for gift tax purposes have dropped; sometimes considerably. Finally, there are certain estate planning techniques that work especially well when the interests rates published by the IRS are low. The current IRS interest rates are also at historic lows.

While the estate and gift tax benefits of a depressed economy can be significant, there are also advantages from an asset protection perspective. First, when times get tough and people lose money, law suits abound as they look to place blame and seek sources to replace their lost assets. In fact, the latest Litigation Trends Survey issued by the law firm, Fulbright & Jaworski, predicts a continued upswing in the number of lawsuits. This means that asset protection will likely be more important over the next few years. Second, every time someone transfers an asset into a trust, they need to be concerned about violating Florida's Fraudulent Transfer Act. Although a complete discussion of the topic is beyond the scope of this article, if a creditor can show that you gifted an asset with the intent to "frustrate, hinder, or delay" their ability to collect against you, then the transfer can be "unwound" leaving the asset subject to being seized. If you could show, however, all the estate and gift tax benefits associated with the transfer and how you only had a limited period of time to make these before the new Act expired, you would have a far greater chance of getting a judge to agree that your motive was "pure" and the gift should be allowed to stand.

I think we all know somebody who purchased property in 2005, 2006, or 2007, at the height of the real estate bubble, who now owes significantly more to the bank than the property is worth. These people already have creditor problems and could benefit greatly from removing the assets they have left from the reach of the bank. The new Act could give them a better chance of doing just that.

Trusts and Asset Protection. Without delving into all the details on how trusts are used to protect assets from creditors' claims, I want to point out that a well drafted trust can do just that. For example, a husband can create a trust for his wife and children and the assets transferred to that trust will be forever protected from the creditors of the husband, wife, and children. It is even possible for a married couple to create trusts for each other and achieve similar asset protection benefits. Please note that the trusts I am describing need to be carefully drafted to avoid something called the "reciprocal trust doctrine," but if done properly a married couple can permanently protect all their assets while continuing to be able to control the assets and spend them as they see fit. Trusts can also be created for children both during your life and when you pass on that not only give your children total use and control over the assets (subject to certain restrictions, if you deem appropriate), but also the ability to protect those assets from divorcing spouses and other creditors. You need to understand that Revocable Trusts, like the ones you use to avoid probate, generally do not provide you with any asset protection and should not give you a false sense of security that the assets held within them are protected.

The topic of asset protection is complicated and needs to take your personal circumstances into account to be truly effective. If you are interested in learning more about this interesting and important topic, I suggest you read my book, *The Asset Protection Guide for Florida Residents*, or a book I have written specifically for physicians, *The Asset Protection Guide for Florida Physicians*. The later book can be read online at my website, http://www.KirwanLawFirm.com.

Why You Should Engage in Planning Even If Your Assets Are Under $1,000,000. After reading the article up to this point, many of you may already see the benefits of planning even your net worth is well under $1,000,000. Let me list some of the more important reasons, however, to make sure you haven't missed any:

1. Taxes Are Almost Sure to Rise. The U.S. is not in a sound financial state. In a recent article at Bloomberg.com, Douglas Elmendorf, director of the congressional office that estimates the impact of legislation on the federal budget said "[Changes to U.S. fiscal policy] need to be large, need to affect programs that are popular and tax payments that people make, and it will need to be enacted fairly soon." Remember that only four short years ago Americans lined up at the polls in record numbers to fill congress with Democrats. Just a couple months ago, we showed up to cast out votes to vote in a record number of Republicans. We are now experiencing a level political volatility that makes it hard to know who will be in office over the next decade and what our tax laws will look like. But we do know this; given our present poor economy, the enormous U.S. deficit ($1.42 trillion in 2009, a $960 billion increase from the 2008 deficit), and the record levels of spending by both the Bush and Obama administrations, our country needs to

raise money. This will mean increasing taxes which could include estate and gift taxes.

Understand that it is no coincidence that the new Act expires in 2013; an election year. Therefore, relying on our future lawmakers to keep taxes low may result in your paying more than your fair share of them.

2. <u>You May Be Worth More Than You Think</u>. Even if your assets are not substantial today, they will most likely increase over time. Many people get caught up in our present "bad times" and can't imagine that they might be solvent, let alone, wealthy in the future. Boom times and bust times come and go, and thankfully we live in a country that allows anyone to make their fortune. Proper planning done today can help remove future appreciation and even future income from your estate forever. If you miss the golden opportunity offered by the new act, you may regret it in the future. In addition, many people do not factor in the effect that life insurance has on estate taxes. If you and/or your spouse have $1,000,000 or more in life insurance, you may already have an estate that could trigger estate taxes in 2013.

3. <u>Trusts Provide Creditor Protection</u>. As mentioned above, if you leave assets to a surviving spouse and / or your children in trust, you can not only give them those assets in a manner that they can use, enjoy, and control, and spend, but also give them an asset protected "envelope" to keep those assets safe from creditors (including divorcing spouses).

4. <u>Trusts Avoid Probate and Provide Numerous Other Benefits to Your Children</u>. If you use trusts (revocable or irrevocable) to pass assets to your spouse and/or children, not only do you avoid the timely and costly probate process, but you also have the ability to (a) remove those assets from your spouse and children's estate (so they do not get taxed again at their death), (b) dictate who the trustee is (i.e., the person that will manage the money and decide when assets are distributed to the beneficiary pursuant to the rules established under the trust agreement), and (c) establish rules for when your spouse and/or children can receive trust assets. This can be used to provide children with incentives to be self-sufficient (e.g., matching their income), perform academically, save their money rather than being a spendthrift, and a host of other qualities you would encourage if you were living. For a more complete discussion of this topic, see my article on this important subject at <u>http://www.KirwanLawFirm.com</u> (click the tab labeled "Your #1 Asset").

Now that I have gone over the benefits of (i) a high unified credit, (ii) a high GST exemption, (iii) the benefits of gifting over leaving assets at death, (iv) using family limited partnerships and LLCs to obtain discounts, (v) our presently depressed economy, and (vi) the asset protection and other benefits provided by trusts, I now want to provide you with some concrete examples of certain planning strategies you can employ to permanently protect your assets from both creditors and estate taxes.

<u>Planning Opportunities to Permanently Eliminate Estate Taxes</u>.
Everyone (especially those individuals with businesses and sizeable estates) should consider the planning strategies set forth below to permanently remove assets from their estate and provide themselves with ongoing asset protection. I want to stress, however, that the following summaries are just that; summaries. Many of the planning strategies have traps for the unwary so it is crucial that you work with an attorney that thoroughly understands them AND can explain potential pitfalls and downsides to you so you can decide whether it is right for you given your assets and personal objectives.

<u>Make Simple Gifts</u>.
The first and most straight forward suggestion is simply to make gifts to children, family members, and friends. This results in decreasing your estate for estate tax purposes and gaining the additional Gift's Are Cheaper advantage mentioned earlier in this article. If the gifted funds will be used by the donor to pay debt or are spent on expenses that will not increase their net worth, then outright gifting can make sense. If the gift will increase their wealth, then it will be best to make the gift to a trust to gain the estate tax and asset protection benefits mentioned above. Since gifts aggregating up to $5,000,000 can be made under the new Act for the next two years ($10,000,000 for a married couple), gifts can substantially reduce your estate.

<u>Make Gifts to IDITs</u>.
If you plan to make large gifts during the next two years, consider making it to a special type of trust called an IDIT. IDIT stands for **<u>I</u>**ntentionally **<u>D</u>**efective **<u>I</u>**rrevocable **<u>T</u>**rust and is also called a "Grantor Trust." Like non-grantor trusts, gifts made to an IDIT (i) are removed from your estate, (ii) protect the assets from the beneficiary's creditors (and your creditors), and (iii) allow all or some of the assets to escape taxation when the beneficiary (and their descendants) ultimately die. IDITs also offer an additional advantage.

IDITs (or Grantor Trusts) are different terms to describe a trust that is ignored for <u>Income Tax</u> purposes. This means that the person who creates the trust is taxed ***personally*** for all income generated inside the trust). Remember, however, that for <u>Estate Tax</u> purposes, the trust is not ignored and that assets properly transferred to the trust will be removed from your taxable estate.

Understand that when income and/or capital gains are realized by the IDIT, whoever established the trust is responsible for paying the income taxes. This is not a bad thing, however. First, if you pay the taxes from your own pocket (i.e., assets that will be included in your estate) the assets in the IDIT (i.e., assets that will NOT be included in your estate) will grow at a faster rate (this is sometimes called the "Burn Effect"). Second, even if you do not wish to gain the additional leverage by paying the taxes from your personal assets, the IDIT can be drafted in a manner that permits the trustee to reimburse you for any tax liability you incur with respect to trust assets.

To clarify the advantage of the Burn Effect, consider the following example:

> Emmett and Ruby-Mae have two children, Thurman and Medora. Emmet establishes and IDIT with Ruby-Mae as the trustee (the person who controls the trust assets) and which names Ruby-Mae, Thurman and Medora as the beneficiaries (the people who can use and benefit from the trust assets). Emmett then transfers $5,000,000 to the trust. This leaves him with savings (i.e., money that he doesn't spend on living expenses) of $2,000,000.
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> Assume the trust assets grow at the rate of 6% per year and the trust pays income taxes on those earnings at the rate of 35% . In twenty years, the assets in the trust grow to over $10,700,000; all of it sheltered from estate taxation and protected from creditors. If Emmett's remaining $2,000,000 grew (and were taxed) at the same rate as the trust, his personal estate would grow to almost $4,300,000. This would result in an estate tax of $2,150,000 if taxed at the rate of 50%. So in summary, if Emmett dies twenty years after creating the trust, Thurman and Medora receive roughly $12,900,000 ($10,700,000 from the trust and $2,150,000 remaining after estate taxes are paid.)
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> But now consider the effect of Emmet's using an IDIT. Since Emmett will now be personally paying the income taxes on the income earned by the IDIT, in twenty years the $5,000,000 gift will have grown to over $16,000,000, which again is sheltered from estate taxation and protected from creditors. In addition, since Emmett paid all the income taxes for the trust income personally, the savings in his estate ran out in the year of his death so Emmett paid no estate taxes. In summary, the Burn Effect of the IDIT resulted in (i) Thurman and Medora receiving roughly $16,000,000; or $3,100,000 more than with the non-Grantor Trust (this is an almost ***25%*** increase in the amount of assets received by the kids), and (ii) Emmett's paying no estate taxes. Note also that if Emmett had not died 20 years after setting up the trust and/or didn't want to reduce his savings to zero, the trust could have started paying its share of the income taxes at any time.

Using IDITS gives you all the benefits of trusts in general (e.g., asset protection, control, removing assets from being taxed in future generations, etc.), and allows you to further reduce the assets in your estate as well. Keep this concept in mind as I will be building on it.

Use a Family Limited Partnership or LLC to Discount Assets.
As mentioned earlier in this article, you can use a Family Limited Partnership or LLC to discount assets before making a gift. Assume that Emmett from the last example, had used a Family Limited Partnership ("FLP"). He first transferred roughly $7,200,000 to the FLP. He kept the general partnership interest (giving him control), and gifted the non-voting, limited partnership interests to an IDIT. If the discount he received by using the FLP was 30%, then the value of the limited partnership interests (and the amount of the gift to the IDIT), would only be $5,000,000. But don't forget, there are $7,200,000 of assets growing outside his estate. This means more appreciation, income, and income taxes (i.e., an increased "Burn Effect").

By adding an FLP to his planning, the IDIT created by Emmett would have almost $23,000,000 in it in twenty years assuming the same facts as in the previous example. That's an over 65% increase in the assets received by the children (over $9,000,000 more) compared to what the children would have received had Emmett not used an IDIT and an FLP. Plus Emmett maintains more control over the gifted assets. The addition of an FLP can be significant especially combined with other strategies.

Businesses and Real Estate Can Be Transferred
to Trusts to Protect Future Income and Appreciation.
You can also make a gift of real estate or an existing business to an IDIT. Think of the benefits doing so would achieve. Since the present value of real estate is at all time lows and many businesses are experiencing reduced revenue given the poor economy, you already have a built in discount even before using a FLP or LLC. Lets assume the following:

> Emmett is the owner of a business which pays him a salary, and which makes corporate distributions (or dividends) of $500,000 per year. The business was worth $10,000,000 but, because of the poor economy, is now only worth $7,200,000. Emmett is able to discount the stock in his business another 30% using some of the discount methods discussed above, so the value of the stock is now only worth $5,000,000 for gift tax purposes. Emmett then gifts the non-voting stock to an IDIT.
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> If the business appreciates in value at the rate of 4% per year, the value of the stock in twenty years will be roughly $11,000,000. The corporate distributions or dividends are now paid to the trust which now shelters them from the reach of creditors and removes them from his estate. If the dividends grow at the rate of 6%

> per year, in twenty years, they will have grown to over $19,000,000. This results in roughly $30,000,000 passing to Emmett's children free of estate tax.

In addition, this planning cures another problem faced by many business owners and real estate investors. Many times a real estate or business owner wants his or her business (or land) to pass to children so that they can continue to run it and benefit from it, but the estate tax causes problems. If a $10,000,000 business is subject to a 50% estate tax, $5,000,000 in cash needs to be available to pay the estate tax. Sometimes the tax can be paid over a 10 year span of time, but (i) the outstanding tax also accrues interest (albeit at a low rate), and (ii) the tax payments can place a huge burden on the business. If sufficient cash is not available to pay the estate tax, the kids either have to borrow the money (which may be hard), or they have to sell business (or real estate) to raise money to pay the taxes. Since the taxes have to be paid within 9 months of death, the business or real estate is sometimes sold for "fire sale" prices.

Note that because Emmett (i) transferred his business when values were low, (ii) used discounts to lower the value further, and (ii) used an IDIT to receive the gift, his children, Thurman and Medora, can now inherit an $11,000,000 family business (plus $19,000,000 in additional assets) and not have to worry about paying a nickle in estate tax.

<u>Consider a Discounted IDIT Sale if Your Estate is Worth More Than $10,000,000</u>.
The Discounted IDIT Sale is a sophisticated technique that can provide substantial estate tax savings and decrease potential creditors' ability to reach your assets. Let me give you a brief overview of how it works, then I'll explain how the new Act makes it more attractive than ever.

> For example, assume the Discounted IDIT Sale technique is established by Rick O'Shea, a 55 year old, using $1,000,000. Further assume the $1,000,000 in assets experience annual growth of 10% and the Discounted IDIT Sale was established in today's low interest rate environment. First, Rick creates an FLP (discussed above) and transfers the $1,000,000 in assets to the FLP. Rick owns a 1% general partnership interest which enables him to control the activities of the FLP. Rick then establishes the IDIT which benefits Rick's wife and kids. A small gift of 10% of the non-voting limited partnership interests is then made to the IDIT and Rick sells the balance of the non-voting, limited partnership interests to the IDIT in exchange for an interest-only promissory note. The promissory note pays a low interest rate and the debt is forgiven if Rick dies during the term of the note (typically something just short of Rick's actuarial life expectancy). Over time, Rick receives interest payments from the IDIT.
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> Lets pause a second to look at the numbers. The total value of the 99% limited partnership interests that have wound up in the trust is **<u>not</u>** $990,000 (i.e., 99% of

$1,000,000) but rather $643,500 (i.e., 99% of $650,000). The $650,000 figure is $1,000,000 less a 35% discount. Therefore, Rick's 10% gift of limited partnership interests is **not** $99,000 (i.e., 10% of $990,000) but rather $64,350 (i.e., 10% of $643,500). The principal balance of the promissory note is not $891,000 (i.e., 90% of $990,000) but rather $579,150 (i.e., 90% of $643,500).

If the promissory note pays Rick 5% (remember this is 5% of $579,150), and the assets in the IDIT/FLP earn 10% (remember that this is 10% of the whole undiscounted $990,000), the difference of $70,043 in the first year alone, accrues to the IDIT. While this may not seem monumental, after 10 years the value of the trust is over $2,000,000; after 20 years, the trusts value is over $5,000,000; and at Rick's life expectancy in year 29, the value of the trust is roughly $11,400,000. Remember that Rick only used $64,350 of his $5,000,000 gift tax credit and an equal amount of his $5,000,000 generation skipping tax exemption. If Rick dies in year 29, then the principal balance of the promissory note (i.e., $579,150) is paid to his estate leaving close to $11,000,000 to pass down to children free of estate tax. The trust assets can pass from generation to generation without ever being subject to estate tax again. If Rick dies before year 29, the note is forgiven and the trust does not have to pay the $579,150. In addition, all of these assets are protected from creditors, Rick's creditors, his wife's creditors, and the creditors of his kids, grandkids, etc. forever.

If Rick or his family needed assets from the trust during Rick's life, the assets in the trust are accessible. Rick has received note interest from the trust over the years, and given the fact that Rick was also required to pay the income tax on trust income, he has probably been able to shrink his taxable estate and the corresponding estate tax.

Again, given the fact the we now have a $5,000,000 gift tax Unified Credit, a business, real estate holdings, and other assets worth over $150,000,000 (assuming a 35% discount) can be transferred to an IDIT using the Discounted IDIT sale by a married couple. This entire amount is asset protected, can be removed from the reach of estate tax, and sheltered from estate tax in future generations. It can also solve the problem of how to transfer an illiquid business or real estate portfolio to children without having to seek loans or sell off assets.

Married Individuals Can Create "Reciprocal" IDITs for Each Other.

Married couples can establish IDITs for each other that remove assets from their estate. Each of these trusts can be funded with up to $5,000,000 (or more if discounting is used). This means that a married couple can permanently remove $10,000,000 from their estate, protect those assets from creditors, and still control and have use of the assets. If this technique is coupled with the other techniques discussed above (e.g., FLPs, transferring low value real estate or businesses, etc.), the savings in estate taxes can be considerable.

These trusts, however, need to be drafted by an estate planner with considerable knowledge in tax planning. "Reciprocal Trusts" (where two people create trusts for one another), can have their tax advantages nullified if certain requirements aren't met. There are also personal considerations that need to be taken into to account, but for the right couple, the benefits can be considerable.

Same Sex Couples Can Create Trusts for Each Other.
Just as married couples can create Reciprocal IDITs for each other, same sex couples can do the same. Since this strategy relies on using one's Unified Credit (and not the Marital Deduction), there is nothing that requires the two people using the technique to be married. Furthermore, the addition of an FLP or LLC can allow the couple to jointly manage their assets.

If You Are Single or Want Greater Asset Protection,
Consider Using A Self-Settled Asset Protection Trust (Onshore or Offshore).
If you decide to take advantage of the many benefits of using an IDIT, you should also consider using a special type of asset protection trust called a "Self-Settled Asset Protection Trust (or "SSAP Trust"). So what is a Self-Settled Asset Protection Trust? In simple terms it is simply a trust that is created by someone (the "Settlor") who is also a beneficiary under the trust (i.e., the person who can receive money from the trust and otherwise benefit from the trust assets). However, in order for it to work, it needs to be created under the laws of certain states (i.e., Delaware, Nevada, South Dakota, etc.) or foreign countries (e.g., The Cook Islands, Nevis, etc.). Lets examine why.

> Assume that Earl is a neurosurgeon and is concerned about protecting his assets. He decides to create an irrevocable trust (i.e., he is the "Settlor") and he names a third party to act as the Trustee. Earl then transfers $1,000,000 to the trust. *Earl*, his wife, Lucinda, and his kids, Sammy-Joe and Tony, are all beneficiaries. The trust agreement is drafted to give the Trustee absolute discretion when it comes to making distributions to the beneficiaries. In other words, the Trustee could decide to make no distributions at all, to make distributions only to Lucinda and/or the kids, or to make distributions to Earl, the Settlor. The trust also contains a special provision called a "spendthrift clause" to add additional asset protection.

Unfortunately, if this trust is created under Florida law, the trust will NOT (i) protect the trust assets from the claims of Earl's creditors, or (ii) remove the gifted assets from Earl's estate. This stems from the fact that under Florida law (Florida Statutes Section 736.0505 to be exact), a creditor of the Settlor may reach the maximum amount that can be distributed to or for the settlor's benefit (sometimes called the "Maximum Permissible Distribution Rule"). Since the Trustee could distribute all of the trust assets to Earl directly, the assets are not protected from creditors. Furthermore, for reasons beyond the scope of this article, it also means the assets in the trust will be included in Earl's estate and subject to estate tax when he dies.

Fortunately, some states and certain offshore jurisdictions abolished the Maximum Permissible Distribution Rule. If you are married, you and your spouse can create "Reciprocal" SSAP Trusts in lieu of "Reciprocal" IDITs to achieve greater asset protection and eliminate some of the issues raised by using Reciprocal IDITs. If you are single, you may be able to use a SSAP Trust to remove up to $5,000,000 from your estate without losing the ability to get assets back from the trust in the future. Again, married couples can establish SSAP Trusts for each other to permanently remove $10,000,000 from their estate, protect those assets from creditors, and still control and have use of the assets. If this technique is coupled with the other techniques discussed above (e.g., FLPs, transferring low value real estate or businesses, etc.), the savings in estate taxes can be considerable.

Consider a Qualified Personal Residence Trust.
A Qualified Personal Residence Trust ("QPRT") is an estate planning technique that allows you to remove the full value of your primary residence and/or a second residence from your estate for estate tax purposes. A QPRT is a special type of trust designed to hold the residence of the trust's creator (called the "Settlor"). The Settlor makes a gift of his or her residence to the QPRT and retains the right to live in and to use the residence for a specified number of years chosen by the Settlor (the "Retention Term"). The Settlor may even be the Trustee during the Retention Term. At the end of the Retention Term, the property in the QPRT passes to further beneficiaries specified by the Settlor at the time of trust creation. The Settlor may specify that the residence is then held for the benefit of the Settlor's spouse for the rest of his or her life, and is then distributed to (or in trust for the benefit of) the Settlor's children. Because the children (and perhaps surviving spouse) must wait until the end of the term to benefit from the transfer, the present value of the gift is substantially lower than the value of the residence. If the Settlor outlives the Retention Term, the full value of the residence plus all future appreciation thereon is out of the Settlor's estate at a substantially lower gift tax value.

One of the disadvantages of a QPRT) is that there is a significant (though highly discounted) gift element. For example, assume Grelda, a 60 year old woman, transfers her $500,000 home to a QPRT and retains the right to live in the home for 20 years (she can even have the right to continue living in the home thereafter). By using a QPRT, she would have only been considered to have made roughly a $180,000 gift for gift tax purposes rather than the full $500,000 (a 64% discount in value). But now that we have a $5,000,000 Unified Credit under the new Act, a QPRT could be used to either (a) remove a personal residence from your estate while still leaving plenty of remaining unified credit available for other gifts, or (ii) gift a very high value residence from your estate without triggering gift tax (under the facts described above Grelda could gift a $13,000,000 home without triggering gift taxes.

Given the fact that the value of many homes and vacation homes are at all times lows given all the foreclosures and short sales that have occurred after the bursting of the real estate bubble, many homes are undervalued to begin with. This fact coupled with a larger unified credit makes it an excellent time to consider using a QPRT to reduce estate taxes. If the QPRT is established in Delaware, you can also gain additional asset protection benefits.

Planning For Your Life Insurance Policies.
If you die owning a life insurance policy on your life, the entire death benefit is included in your estate for estate tax purposes. If you gift the policy to a trust (like the IDIT or SSAP Trust discussed above), the death benefit can pass to you heirs untouched by the estate tax. One of the downsides of gifting life insurance policies to a trust is that premium payments are considered taxable gifts to the trust. Another is that if the life insurance policy has cash value in it, the gift of the life insurance policy to the trust is considered a gift taxable gift of roughly the policy's cash value. In addition, annual formalities need to maintained, including sending something called "Crummey Letters" to the trust beneficiaries each year.

With a $5,000,000 unified credit, life insurance policies with significant cash value can now be gifted to an IDIT or SSAP Trust thereby removing the cash value and death benefit from your estate without triggering gift taxes. Furthermore, even term policies (policies with no cash value) can be gifted to a trust together with other assets so that annual premiums can be made directly by the trust (as opposed to you, individually), which saves you from having to comply with many of the annual formalities otherwise required. For example, if you transferred a life insurance policy to the same IDIT you used to make a gift of a family business or rental real estate, you could used the income from the business or real estate to pay the premiums. Finally, in the proper circumstances, life insurance can ensure that your beneficiaries receive adequate assets upon your death. Consider that a $2 million premium can often purchase $20,000,000 of second-to-die life insurance coverage all of which would escape estate taxation if held in an IDIT.

Many people, may be inclined to lower their insurance coverage, under the theory that they have no estate tax concerns with a $5,000,000 exclusion from the estate tax. Those people should understand that they may not qualify for insurance if they subsequently find they have a need for it. Remember the new Act expires in two years, the estate tax system is in a state of flux, and anything could happen in 2013 (including going back to a $1,000,000 unified credit and top estate tax rate of 55%).

Many Other Options.
The techniques described above are only some of the options that allow you to take advantage of the laws provided under the new act. Other options (a type of trust called a "GRAT" comes to mind) might also benefit you. The important thing to do is start your planning now while the new Act is still available to you. When I meet with my clients, we go over their personal assets, goals and objectives during their life, and goals and objectives for their children and other heirs. From this foundation, many creative combinations of the techniques discussed above (and others not discussed), can be used to bring them all to fruition. While two years sounds like a long time, some

planning options takes longer than others to implement, so time is of the essence. Remember how much there is to gain.

Do Not Change Your Existing Revocable Trusts to Eliminate Credit Shelter and Marital Trusts.

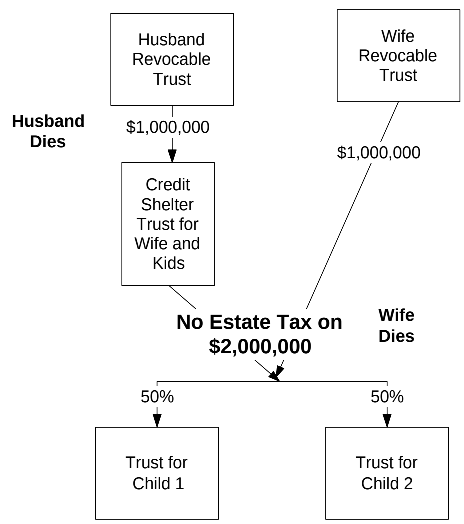
Before I end this article, I want to discuss something that many people already have in place as the base of their estate plan; namely their revocable trusts. Under prior estate tax laws (and the ones that will return in 2013), there were advantages of creating revocable trusts that made sure each spouse's unified credit was fully used. As I will explain below, even though the new Act allows "portability" of your unified credit (i.e., a person can inherit their spouse's unified credit without using revocable trusts), you should not dispense with their use just yet (over maybe ever). Let me start by first showing you what these benefits are and why you still want to use these trusts as part of your estate plan.

The first part of any estate plan is making sure that when the first spouse dies, his or her unified credit is used to the fullest extent possible. When a husband and wife hold assets as tenancy by the entireties ("TBE") or joint tenants with rights of survivorship ("JTWROS"), ownership of those assets automatically pass to the surviving spouse at the death of the first spouse to die. When establishing bank accounts, brokerage accounts, and purchasing certain assets, people are often encouraged to title the accounts or assets in this manner for convenience purposes without considering the often costly estate tax consequences. Married couples also frequently establish wills (sometimes called "I Love You" wills) which leave everything outright to the surviving spouse. In both these common situations, (i.e., the JTWROS scenario and the I Love You will scenario) a significant portion of your assets which could pass to children, grandchildren, and/or other family members can end up going to pay estate tax.

For example, suppose a husband and wife hold joint assets of $2,000,000 so that everything passes outright to the survivor at the death of the first spouse. When the first spouse dies (lets say Husband), no estate tax is paid due to the unlimited marital deduction and the surviving spouse (Wife) ends up owning the full $2,000,000 in her own name. Because the entire amount was sheltered by the marital deduction, the Husband's unified credit was not used and is now lost forever. If the unified credit were $1,000,000 (when Wife subsequently dies owning $2,000,000), she will only be able to shelter half that amount with her $1,000,000 unified credit and the remaining $1,000,000 will subject to estate tax (perhaps at a rate of 55%).

To remedy this problem, estate planning attorneys came up with the "Credit Shelter Trust." Going back to the last example, if Husband and Wife had not owned all their assets jointly, when Husband died, a Credit Shelter Trust could have been used to receive $1,000,000. This trust acts like an IDIT by permanently sheltering those assets (and all the growth on those assets) from estate taxation (and creditors too, if drafted properly). I have provided a flow chart below to graphically depict the flow of assets. The Credit Shelter Trust will provide for Wife's needs during her lifetime, yet is structured to exclude any trust assets from her estate at her death. Wife can even be the sole Trustee. Upon Wife's death, the Credit Shelter Trust will either continue for the benefit of children and/or grandchildren or its assets will be distributed to them outright. Under this structure, when Wife subsequently dies she only owns $1,000,000 in her own name all of which can pass to the children free of estate tax.

Flowchart of Credit Shelter Trust in Action



But now under the new Act, Wife would simple inherit Husband’s unified credit (remember “portability” of the unified credit) making the Credit Shelter Trust obsolete, right? Not so fast. Despite the relative simplicity of portability, there are several reasons for still using credit shelter trusts when the first spouse dies. These include:

1. There is no assurance that portability will apply after 2012.
2. The deceased spouse's unused exemption is not indexed for inflation. Going back to our example, this means that if the assets that would have otherwise gone into a Credit Shelter Trust on Husband’s death grew to $3,000,000 by the time Wife died, the ported unified credit wouldn’t be enough to shelter all the assets from estate taxation. This is prevented by using the Credit Shelter Trust.
3. Under the new Act, if the surviving spouse remarries, the unused exemption from the first deceased spouse could be lost.

4. There is no portability of the GST exemption. This means that half of the assets that are passed to Husband and Wife's kids when they die will be included in the taxable estates of their children to be taxed once again. Since the Credit Shelter Trust can make use of Husband's GST exemption, this problem is avoided by its use.
5. The Credit Shelter Trust allows the deceased spouse to make certain that the assets in the trust are managed and distributed according to his/her wishes (and not those of the surviving spouse).
6. There are other standard benefits of trusts, including asset protection, providing management, and restricting transfers of assets by the surviving spouse that can only be accomplished using a Credit Shelter Trust and a Marital Trust.

For all these reasons, rely on the portability of the unified credit at your own risk. This is one case where simple, simply is not better.

Conclusion:
I hope this article has help you understand the many "golden opportunities" provided to us Americans under the new Act. I also hope you realize the importance of acting quickly. Even though there are 23 months to do planning before the new Act expires, many planning techniques need time to be properly brought to fruition. The longer you wait the fewer your options.

If you have any questions about anything I have written in this article, please feel free to contact me, or visit my website at http://www.KirwanLawFirm.com.