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in this issue

A monthly report for wealth management professionals.

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As part of our ongoing efforts to keep wealth management professionals informed of recent developments related to our practice area, we have summarized below some items we think would be of interest. Please let us know if you have any questions.

We Didn't (Quite) Fall off the Cliff, But We Still Have To Clean up the Mess!

When the clock struck midnight on December 31, 2012, estate planning practitioners said "good night" to an unprecedented period of working with clients to maximize transfer tax planning opportunities. When we awoke on January 1, 2013, we discovered we had only nearly "fallen off the cliff," and, as a result of ATRA, most of the year-end transfers we orchestrated may have been for naught. While the House of Representatives debated ATRA well into the night of January 1, it ultimately approved the bill and sent it to the White House. The President authorized signature remotely via his so-called "autopen" late on January 2, while he vacationed with his family in Hawaii.[i]

The enactment of ATRA means that the three hallmarks of TRA 2010 – namely, (i) the reunification of the estate and gift tax regimes, (ii) the $5 million estate, gift, and GST tax exemptions, as indexed for inflation ($5.25 million for 2013), and (iii) portability – have all become permanent fixtures in federal transfer tax law. ATRA will impose a maximum transfer tax rate of 40 percent, and also has made permanent the following provisions, as introduced by EGTRRA:

i. the deduction for state death taxes under Code Section 2058;

ii. certain provisions related to the extension of time to pay estate tax under Code Section 6166; and

iii. certain GST tax "simplification" provisions, including the automatic allocation of GST tax exemption to "indirect skips" and related elections with respect to "GST trusts" (under Code Section 2632(c)), retroactive allocation of GST tax exemption when there is an "unnatural order of deaths" (under Code Section 2632(d)), the qualified severance rules (under Code Section 2642(a)(3)), modification of certain GST

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[i] *See* Chappell, "With a Swish of His Autopen, Obama Signs Fiscal Cliff Bill, "available at: http://www.npr.org/blogs/thetwo-way/2013/01/02/168477773/how-will-president-obama-sign-the-fiscal-cliff-bill.

valuation rules (under Code Section 2642(b)) and certain relief provisions when there is a failure to allocate GST tax exemption timely or properly (under Code Section 2642(g)).

Additionally, ATRA implements a technical correction to the portability provisions of TRA 2010. In calculating the deceased spousal unused exclusion amount under Code Section 2010(c)(4)(B), TRA 2010 referred to the "basic exclusion amount" of the last deceased spouse of the surviving spouse. Many practitioners thought this reference was erroneous given the now-famous Example 3 of the Joint Committee on Taxation's "Technical Explanation of the Revenue Provisions Contained in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010."[ii] Indeed, in March 2011, the Joint Committee on Taxation issued an errata statement suggesting that a technical correction may be necessary to substitute "applicable exclusion amount" for "basic exclusion amount."[iii] The Treasury Department subsequently confirmed this thinking in promulgating the Temporary Treasury Regulations regarding portability.[iv] ATRA now provides a statutory fix by substituting the term "applicable exclusion amount" for "basic exclusion amount." This provides statutory confirmation of the regulatory fix.

Alas, the better advice of estate planning practitioners "to use or lose" the "expiring" $5 million exemption and 35 percent rate prior to the New Year has now proven unnecessary in many cases. Nonetheless, we need to make sure that the proverbial "i's" are dotted and "t's" are crossed with respect to the transfers that were made hastily at the end of 2012, so that such transfers are respected. We address below "post-2012" transfer tax issues that should be examined by practitioners and clients who made significant gifts before the clock struck midnight on December 31, 2012.

Gift Tax Returns

For gifts made in 2012, federal gift tax returns (Form 709) are due on April 15, 2013. Of course, this date can be automatically extended until October 15, 2013 by filing for an income tax extension on Form 4868. Although many clients made gifts at or below the exemption and will not owe gift tax, some made cumulative gifts in excess of $5.12 million in contemplation of paying gift tax at the historically low rate of 35 percent. Although the due date for the gift tax return can be extended until October 15, 2013, the due date for the payment of gift tax cannot be extended. Thus, clients will need to raise cash to pay such tax on or before April 15. Additionally, if hard-to-value assets have been gifted, which generally requires an appraisal to substantiate the value of the gift, advisors must obtain values from the appraisers so that the gift tax can be computed. Gifts that were made using "defined value" or "formula" clauses also may raise some reporting complexities, as further discussed below. Finally, clients should keep in mind that in the event their planning contemplated gift-splitting, they must elect to gift-split on their gift tax returns.

[ii] JCX-55-10 at pages 51–53.

[iii] JCS-2-11 at pages 554-556.

[iv] *See* Treas. Regulation Section 20.2010-2T(c)(2).

Implementation and Reporting of Defined Value Gifts

Because of timing issues associated with obtaining appraisals and the desire to "hit the nail on the head" in making gifts of exactly $5.12 million, many clients implemented 2012 gifting through the use of "defined value " or "formula" clauses. These gifts were most commonly made of a client's interests in closely held entities, whether corporations, limited liability companies or partnerships. This gifting technique was particularly attractive following the 2012 taxpayer victory in *Wandry v. Commissioner*,[v] notwithstanding the IRS's later non-acquiescence.[vi] Although practitioners carefully navigated *Wandry* and other defined value clause cases[vii] in advising clients with respect to these gifts, it is equally important to implement and report such gifts properly to ensure the benefits of the planning.

From an implementation standpoint, the first step may very well be to obtain appropriate appraisals. In most cases, given the flurry of gifts made at the end of 2012, the appraisals of such gifts were not even started. It is important for practitioners to follow up with the appraisers as soon as possible to determine the interest in the entity (i.e., shares of stock, partnership interests or membership interests) that corresponds with the formula, as based on the appraisal. Once the appraisal is finalized, the transferred interest needs to be properly reflected on the entity's books and records and administered accordingly.

When documenting a specific number of shares of stock, partnership interests or membership interests for transfer on the entity's books and records, our practice is to caveat the transfer appropriately with a footnote or other cross-reference to the defined value or formula clause. Our view is that although it is acceptable to reflect a transfer of a specific interest on the entity's books and records, it must be crystal clear that the specific interest is derivative of the appraisal, and not of the finally determined value used for federal transfer tax purposes, which ultimately controls the specific interest that is transferred pursuant to the clause.

Documenting this transfer as such is particularly important with respect to flow-through entities (i.e., S corporations, partnerships and limited liability companies), as, generally, distributions are made on a pro rata basis and taxable income is allocated on a pro rata basis. S corporations will require this information by the 15th day of the third month following the end of their tax years to file Forms 1120S timely and to provide shareholders with appropriate Forms K-1; partnerships will have until 15th day of the fourth month after the end of their tax years to file Forms 1065 and appropriate Forms K-1. Of course, this issue is mitigated, at least from a tax liability standpoint, to the extent that the defined value or formula gifts were made to grantor trusts.

In addition, when interests are transferred by or to trustees of irrevocable trusts, the trustees will have fiduciary obligations that must be satisfied with respect to such gifts. Translating the formula into a specific interest, even if using the appraised value as an estimate until there is a finally determined value, helps to satisfy the trustees' fiduciary obligations.

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v *Wandry v. Commissioner*, T.C. Memo. 2012-88.

vi A.O.D. 2012-004, 2012-46 IRB.

vii *See Estate of Petter v. Commissioner*, 653 F.3d 1012 (9th Cir. 2011); *Estate of Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009); *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006); *Hendrix v. Commissioner*, T.C. Memo 2011-133.

From a disclosure standpoint, the defined value or formula gift must be properly reported on the client's gift tax return in order to start the running of the statute of limitations. This is not only important from an audit standpoint, but also from the perspective of reaching a finally determined value so that the terms of the formula clause can take effect with finality. The gift should be reported as a specific dollar amount, not as a specific interest in the entity. We then advise clients to disclose the specific interest that equals the defined value based on the appraisal, which should be attached to the gift tax return. Additionally, if the planning involved a sale transaction, our preference is also to disclose the sale so that the statute of limitations can begin running instead of remaining open indefinitely, particularly when the client's estate is required to check "yes" regarding prior sale transactions in answering question 13e of Part 4 of the estate tax return (Form 706).

Clients Want To "Change" the Terms of the Trust

In the mad rush of signing and funding trusts prior to the end of 2012, many clients may not have had ample time to consider fully all the various provisions in quickly drafted trusts to which they made their 2012 gifts. For example, clients may want to consider different dispositive or fiduciary provisions than what were included in the instruments they signed. Indeed, if a trust was signed and funded toward the end of December, many clients may have used a "place holder" trustee to expedite the transaction. A simple "remove and replace" power in the trust instrument may permit flexibility in selecting a successor trustee. However, more significant changes may be in order. Relying on a decanting provision in the trust instrument or under state law can allow the trustee the flexibility to "change" the terms of the trust.

Depending on the terms of the trust instrument or provisions of state law, the "changes" to a trust that can be achieved through a trust decanting can be broad. Under many state statutes the only changes that cannot be achieved through a trust decanting are the reduction or elimination of fixed income or annuity interests, the disqualification from a marital or charitable deduction, and the addition of trust beneficiaries. To the extent that the trust instrument and its governing law do not permit the trustees to decant the trust, the trustees should explore whether the governing law of the trust can be changed to a more favorable jurisdiction so that the decanting can be implemented. Additionally, clients might consider state statutes that provide for judicial or non judicial modification or reformation, but in so doing, they need to be sensitive to possible transfer tax consequences in the event beneficiary consent (or notice) is required.

Planning for Step-up in Basis

In the rush to complete gifts before year-end, many clients may have funded irrevocable trusts with low-basis assets. These clients would do well to consider the income tax consequences to the trust beneficiaries as a result of the loss of a step-up in basis at death. Two possible solutions are available for these clients.

First, if the trust contains a power of substitution, or "swap power," the client can "swap in" assets of equal value with a higher basis and "swap out" the low-basis assets. In executing this "swap," the trustees must ensure that the assets "swapped in" are equal in value to the assets "swapped out." Not only is this part and parcel to the trustees' fiduciary obligations, it is also necessary to avoid the imputation of any deemed gifts. Practitioners may wish to consider using a formula clause as a hedge on the "swap" in a similar manner to the way such clauses are used in gifting transactions. Our preference is to disclose such "swaps" on the client's gift tax return.

Second, even if the trust does not contain a swap power, but is otherwise a grantor trust, the client can purchase assets from the trust. The purchase can even be done with a promissory note. This allows the client to regain the economic benefits of the assets, while still having completed the gift and having an obligation at death that reduces the client's taxable estate. If, in making the gift, the client simply wanted to use the entire gift tax exemption, the note can be structured at the applicable federal rate to allow the client the benefit of any future appreciation. If the gift was intended to allow future appreciation to grow outside of the client's estate, then the note can be structured at a higher rate to result in greater appreciation within the trust.

Lack of GST Exemption

Most clients who used their entire gift tax exemption in 2012 gifting also will allocate GST tax exemption to those transfers. This may cause problems for clients who need to continue to rely on annual exclusion gifts to fund life insurance premiums. If the policy is owned by an "old and cold" life insurance trust, then funding such trust with annual exclusion gifts may result in a mixed GST tax inclusion ratio (meaning that the trust's inclusion ratio is greater than zero but less than one), as the client will no longer have GST exemption to allocate to the annual exclusion gifts. Some relief may be available year-by-year depending on the inflation adjustment of the applicable credit amount. For example, clients who maxed out their GST tax exemptions in 2012 will now have an additional $130,000 to allocate in 2013. This may go a long way for some clients in preserving the GST exempt status of their life insurance trusts.

However, if the additional exemption made available through the inflation adjustment is insufficient, alternatives need to be considered. The most attractive option is likely to make sure that the life insurance policy is owned by the same trust to which the 2012 gifting was made, so that the income from the gift, or a portion of the gift itself, may be used to service the premium payments, thereby preserving the GST exempt status of the trust. If the planning was not structured this way from the outset several options may be available. First, the "old and cold" life insurance trust can be merged into the 2012 gifting trust under the terms of the trust instrument or under state law if such merger is so permitted. Second, the "old and cold" life insurance trust and the 2012 gifting trust can be decanted into a single new trust pursuant to the trust instrument or state decanting statutes. Third, if the prior two options are not available, the "old and cold" life insurance trust can sell the policy to the new trust. It is critical that the purchasing trust be treated as a grantor trust wholly owned by the insured in order to ensure that the transfer falls within the exception to the transfer-for-value rule of Code Section 101(a)(2).

Alternatively, clients can consider lending to life insurance trusts so that the trustees can use the loan proceeds to pay the life insurance premiums. Practitioners should be sensitive to private split-dollar rules in making such loans.

2012 Gifting Results in Mixed Inclusion Ratio

Because ATRA preserves the EGTRRA provisions permitting qualified severances, practitioners and clients can rest assured that even if 2012 gifting (or gifting in 2013 and beyond) results in mixed inclusion ratio trusts, such trusts can be severed.

A qualified severance is a severance of a trust with a mixed inclusion ratio into two or more separate trusts, so that the resulting trusts have an inclusion ratio of one or zero. Generally, the severance must occur on a fractional basis and the terms of the new trusts, in the aggregate, must provide for the same succession of interests of beneficiaries as are provided in the original trust. The severance is reported on Form 706 GS(T) by writing “Qualified Severance” at the top of the form and attaching a statement to the form containing the name of the transferor, the name and date of creation of the original trust, the tax identification number of the original trust, the inclusion ratio before severance, the name and tax identification number of each resulting trust, the date of severance, the fraction of total assets of the original trust received by each resulting trust, the inclusion ratio of each resulting trust, and any other details explaining the basis for funding the resulting trusts.

Reliance on the qualified severance provisions may be a huge relief for clients whose remaining gift tax exemption in 2012 exceeded their remaining GST tax exemption (most often on account of allocation to life insurance trusts or allocation upon the expiration of a GRAT). These clients wanted to max out the amount they could give in 2012 at the higher exemption, but had concerns about the long-term consequences of administering mixed inclusion ratio trusts. Thankfully, it looks like qualified severances are here to stay! Indeed, 2013 may be the “Year of the Qualified Severance.”

Other Lingering Issues

ATRA is welcome legislation in that it provides some long-awaited certainty in the federal transfer tax regime. With that said, we wonder to what extent the administration will continue to focus on prior policy positions advanced in the various Greenbooks over the last several years. Namely, it will be interesting to see whether legislation attacking valuation discounts, GST exempt dynasty trusts, GRATs, and defective grantor trusts will continue to surface in the legislative debate over the course of the coming year. If 2013 proves to be anything like the past decade, your guess is as good as ours!

The Personal Planning Department at Proskauer is one of the largest private wealth management teams in the country and works with high net-worth individuals and families to design customized estate and wealth transfer plans, and with individuals and institutions to assist in the administration of trusts and estates.

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