Estate Planning Under the Tax Relief Act of 2010

Strategic Issues for Financial Planners
Texas A&M University
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Agenda

• TRA 2010 Overview
• Perspectives on planning
• Will planning with uncertain tax law
• Lifetime gifting with TRA 2010
• Life Insurance issues
• Future tax planning landscape
• Conclusions
2010 Tax Act Summary and Key Changes

2010:
- Executors got to choose
  - Carryover basis or estate tax with a $5M exclusion and 35% rate
  - GST tax rate -0-; GST/Estate Exemption $5M; Gift $1M

2011-2012:
- $5M gift, estate and GST exclusion – “reunification”
- 35% gift, estate and GST tax rate
- Portability of estate tax exclusion
- Exclusion indexed beginning in 2012 (from 2010)

2013:
- Sunsets back to the $1 million exclusion; 55% rate for estate and gift tax; $1 million indexed (from 1997) GST exemption
- 55% GST tax rate
- UNLESS …
“Portability” – Fact or Fiction

- “Basic Exclusion Amount” = $5,000,000
- “Applicable Exclusion Amount” = Basic Exclusion Amount + unused Basic Exclusion Amount from the last deceased spouse
  - DSUEA = Deceased Spouse Unused Exclusion Amount
- Requires timely, complete, accurate filing of Form 706 at 1st spouse’s death
  - Deceased spouse’s estate = $3,000,000
  - No 706 required, so no filing
  - No DSUEA for survivor!
**History of Estate Taxes**

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1797</td>
<td>First Tax Repealed 1802</td>
</tr>
<tr>
<td>1802</td>
<td>Spanish American War Repealed 1902</td>
</tr>
<tr>
<td>1898</td>
<td>1862 Civil War Repealed 1870</td>
</tr>
<tr>
<td>1870</td>
<td>1916 Beginning Modern Era Tax</td>
</tr>
<tr>
<td>1898</td>
<td>1918 Charitable Deduction</td>
</tr>
<tr>
<td>1916</td>
<td>Top Rate 40% Gift Tax Added Reintroduced 1932</td>
</tr>
<tr>
<td>1924</td>
<td>1934 Rate 70%</td>
</tr>
<tr>
<td>1940’s</td>
<td>Top Rate 77%</td>
</tr>
<tr>
<td>1948</td>
<td>Partial Marital Deduction</td>
</tr>
<tr>
<td>1981</td>
<td>Unified Marital Deduction</td>
</tr>
<tr>
<td>1981</td>
<td>Unified System 70% Top Rate</td>
</tr>
<tr>
<td>1997</td>
<td>Unified Credit Increases</td>
</tr>
<tr>
<td>2010</td>
<td>TRA</td>
</tr>
</tbody>
</table>

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Client Objectives

3
Social Capital Legacy

2
Family Legacy

1
Financial Independence

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Will Planning With Uncertain Tax law
Contingent Disclaimer Trust

Client  \[\text{Disclaimer}\]  Spouse

Contingent Marital Trust \[\text{Excess of Exclusion Allowance}\] Contingent By-Pass Trust

Spouse  \[\text{Children}\]
“One-Lung” Marital Trust

Client’s Estate

Will/Revocable Trust

QTIP Trust

Election

QTIP

Non Marital

Spouse’s Estate

Children

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Clayton QTIP

Client’s Estate

QTIP

Marital QTIP        Contingent Bypass Trust

Spouse’s Estate     Children

Est. of Clayton, Jr. v. Comm., 70 AFTR 2d 92-6262(976F.2d 1486) 11/17/92
2011-2012 Will Planning

• Deceased spouse’s unused exclusion amount – where should it go?
  • Outright to the surviving spouse?
  • To a Marital Trust for his/her benefit?
  • To a Credit Shelter Trust for his/her benefit?

• There appear to be more questions than answers on that subject!
Lifetime Gift & GST Planning With TRA 2010
Gift Planning Basics

• Starting point is “discretionary assets”
  • Those not needed for lifestyle maintenance
  • Available for family and/or social legacy planning
• TRA 2010 provides unusual opportunity at a very opportune time
  • Relatively low asset values
  • All-time low federal interest rates
  • No restrictions on valuation discounts or GRATs
  • $5 million gift and GST exemption
• Gifting does NOT remove gifted assets from the estate tax calculation – it only removes the appreciation

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Advanced Gift Planning

• Intentionally Defective Grantor Trusts (IDGiT)
  • Good tool for lifetime transfers of vast amounts of wealth
    – Outright gifts of
      – Full value assets up to the combined exclusion
      – Assets that qualify for valuation discounts
        – Leverage the exclusion amount upward
        – 30% discount enables transfer of over $7,000,000 for a gift tax cost of $5,000,000
    – Installment sale of much larger value assets
      – Should seed the trust with +/- 10% of the sale value
      – If seed money = $5,000,000 gift, sale could be for almost $50,000,000!
Advanced Gift Planning

• Intentionally Defective Grantor Trusts (IDGiT)
  – Installment sales continued
    – If the installment sale occurs now (Nov. 2011) and is for 9 years, the interest rate is only 1.2%!
    – The gifted and sold assets are out of the donor’s estate
  – The present value of the remaining payments is an asset in the donor’s estate
    – The “leaky freeze”
Advanced Gift Planning

• Intentionally Defective Grantor Trusts (IDGiT)
  – For donor’s uneasy with complete gift of $5,000,000:
    – Consider part gift & part sale
    – Gift $500,000 (and allocate to GST exclusion)
    – Sell $4,500,000
    – Donor still has $4,500,000 of lifetime gift exclusion + an income stream from the trust
Advanced Gift Planning

- Risk of using the whole $5,000,000 exclusion
  - Gifted asset(s) could become worthless over time
    - The entire $5,000,000 of “prior taxable gifts” comes back into the donor’s estate for estate tax calculation purposes
    - Donor would have wasted the entire $5,000,000 estate tax exemption as well as the entire $5,000,000 lifetime gift tax exemption
  - How to hedge against that downside risk?
Advanced Gift Planning

- **Grantor Retained Annuity Trust (GRAT)**
  - Grantor transfers assets to an irrevocable trust for the benefit of his heirs but retains a fixed annuity interest for a specified number of years.
  - The part subject to gift tax is the “remainder interest” (value of the asset minus the annuity).
  - Many GRATs are designed to generate a very minor gift tax value (short time frame + large annuity payments)
    - If the asset drops in value there has been very little of the lifetime gift or GST exemption lost
    - If the asset doubles or triples in value, the increase in value passes free of estate, gift and GST tax
Future Landscape
For
Transfer Taxes
Future Landscape

- **Revenue Proposals**
  - Require consistency in value for transfer and income tax purposes ($2.1 billion)
    - Valuation discount allowed becomes basis for future capital gains tax purposes
  - Modify rules on valuation discounts ($18.2 billion)
    - Intra family transfers of family controlled entities
  - Require minimum term GRATs ($3 billion)
    - 10 year minimum term
    - Remainder interest greater than zero
    - Annuity amount cannot decrease in any year
Future Landscape

• Treasury’s Fiscal Year 2012 (Oct. 2011-Sept. 2012) Revenue Proposals (cont.)
  • Make “portability” permanent ($3.7 billion)
    • Extend TRA 2010 provisions regarding unused exemption between spouses
  • Limit duration of GST Exemption (Negligible)
    • “Dynasty” trust limited to 90 year duration
    • Subject to transfer tax on 90th anniversary of creation
    • If “pours over” into new trust, starts 2nd 90 year clock

Future Landscape should be highly motivational!!

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Future Landscape

- More motivational “juice”
  - Sept. 2011 Democratic Estate Tax Proposal
    - 2009 Level - $3,500,00 AEA, 45% rate
    - Effective Jan. 1, 2012 !!!!!

- Message for procrastinators: GIT-R-DONE !

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Life Insurance Issues With Uncertain Tax Law
Life Insurance Questions

Will I need life insurance for estate planning purposes if the increased exemption shelters my estate from federal estate taxes?
Life Insurance Questions

It doesn’t look like I’m going to need life insurance to pay Federal Estate Taxes...

...so what do I do about that Irrevocable Life Insurance Trust we created and the big life insurance policy in it?
Life Insurance Questions

• What type of insurance should I purchase if the exposure to federal estate tax is temporary because of the increases in the exclusion amount?
• Is term insurance the answer?
Life Insurance Questions

• Regardless of the type of insurance policy I buy, how should I own my insurance if the estate tax exposure is potentially only for a limited period of time?
Other Life Insurance Issues

- Some will want to cancel policies because they *think* they will no longer face tax liability. Evaluate carefully:
  - Insurance as an asset class
  - 2013 and $1M exclusion
  - State estate tax in decoupled states
  - Liquidity
  - Insurability – client may never be able to replace
  - Use survivorship to cover lost basis step up on $5M bypass

- Restructure existing policies to fit new paradigm

- Gifts to ILITs to unwind split dollar arrangements

- Gift high cash value policies to an ILIT that $1M gift exclusion and limited Crummey powers previously made impractical
Other Life Insurance Issues

• How to plan for new purchases
  – Assume there will be a Federal estate tax
  – Assume it will come close to at least 2009 levels
  – Make sure you take care of survivor income needs
  – Make sure owner & beneficiary designations coordinate with the new / revised estate plan
  – Build in flexibility!
Conclusions
2010 Tax Act packs a lot of punch, surprises, and complexity into a small number of pages.

Clients/Taxpayers view advisers as the little boy that cried wolf – “Oh so in 2013 there will be a $1M exclusion, just like you told me we’d have in 2011?”

Will taxpayers understand the value of proper planning if there is no tax savings golden ring?

Every document and plan must be reviewed and revised. But will clients commit to the effort and cost – especially if 2013 is “Play it Again Sam.” Bypass trusts, revised formula clauses with floors and caps and statements of intent, etc.

Ultra high net worth clients should plan aggressively. Get it while you can.
Creating Comfort for Our Clients in Uncertain Times

- Stay flexible
- **Remember the Pyramid**
  - 1st - Lifestyle maintenance
  - 2nd - Family Legacy
  - 3rd - Social Capital Legacy
- Do no harm
- Protect the plan from the greatest number of life’s contingencies
- **MAKE IT HAPPEN!**
THANK YOU!

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