Insight on Estate Planning

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You're donating real estate to charity

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Conditions favorable for gifts

High exemption amount and low tax rate make 2012 the year to transfer significant wealth

With many provisions of the 2010 Tax Relief act set to expire at the end of 2012, estate tax uncertainty continues. This year, the gift, estate and generation-skipping transfer (GST) tax exemption amounts stand at a record-high $5.12 million. And the top rate for all three taxes is 35%, the lowest it's been in many years. Should you take advantage of this unprecedented opportunity to transfer substantial amounts of wealth to your family tax-free?

No time like the present

It's difficult to predict what will happen in 2013. Lawmakers may do nothing, allowing the exemption amounts and top tax rates to revert to levels prescribed by pre-2001 tax law — $1 million and 55%, respectively (but with the GST tax exemption indexed for inflation). They may extend the current estate tax regime or even make it permanent. Or they may take a middle-ground approach — for instance, a 45% rate and a $3.5 million exemption.

Gifting is particularly attractive today because the value of many assets is depressed, allowing you to transfer a greater amount of wealth within the $5.12 million exemption.

If you're planning to make gifts to (or for the benefit of) your children, grandchildren or other loved ones, it may be a good idea to do so this year, while favorable conditions last. But be aware that, if the exemption is reduced later, the IRS may attempt to "recapture" a portion

of these gifts and subject them to estate taxes. (See "Beware the clawback" on page 3.)

There are a variety of tools for transferring wealth at the lowest possible tax cost. As you weigh your options, keep in mind that gifted assets aren't entitled to a stepped-up basis. So your beneficiaries may be liable for more capital gains taxes if they sell them than they would if they inherited the assets (which would receive a stepped-up basis) and sold them.

Strategies to consider

The simplest way to take advantage of the $5.12 million exemption is to make outright gifts to your children or grandchildren. After you make a gift, the assets are removed from your estate and the recipient enjoys all future appreciation free of gift or estate taxes.

Gifting is particularly attractive today because the value of many assets is depressed, allowing you to transfer a greater amount of wealth (such as more shares of stock or a larger piece of real estate) within the exemption. Even if you've exhausted your exemption, if you believe the top rate will go up next year, it may pay to make taxable gifts this year to take advantage of the 35% rate. (But you still need to be aware of the possibility of clawback, just in a different form. Again, see "Beware the clawback" on page 3.)

If you want to retain some control over your assets — or if you feel that your loved ones aren't ready to handle substantial wealth with no strings attached — consider more sophisticated strategies, which may provide benefits beyond added control:

Trusts. An irrevocable trust allows you to take advantage of the favorable tax environment without giving beneficiaries unfettered access to your assets. Low applicable federal rates (AFRs) make it an ideal time for "leveraged" gifts, using vehicles such as grantor retained annuity trusts (GRATs) and charitable lead annuity trusts (CLATs).

These trusts shift wealth free of transfer taxes to the extent they generate returns in excess of the AFR. So they're most effective when AFRs are low.

Dynasty trusts. If your goal is to leave a lasting legacy, consider establishing a "dynasty" trust in a state that allows perpetual trusts. A dynasty trust provides your heirs with income for generations to come, but the trust assets are never included in anyone's taxable estate. And so long as you allocate enough of your GST exemption to cover your contributions, no part of the trust assets or distributions will ever be subject to GST tax.

ILITs. Life insurance is a powerful wealth creation tool. By using an irrevocable life insurance trust (ILIT) to hold a policy, you can keep the death benefits out of your taxable estate.

Ideally, you'd have the ILIT purchase the policy and make gifts to the trust to cover the premiums. But if you have an existing high-cash-value policy that you'd like to transfer to an ILIT, now may be the time to do so. Keep in mind that the proceeds will be subject to estate tax if you die within three years after the transfer.

FLPs. A properly structured and operated family limited partnership (FLP) can be an effective vehicle for transferring assets such as a business, real estate or marketable securities. You contribute assets to the FLP, retaining a small general partnership interest and transferring limited partnership interests to your beneficiaries. This allows you to maintain control over the assets while taking advantage of valuation discounts that minimize the value of the gifted limited partnership interests for tax purposes.

But care must be taken in setting up and administering the FLP. Otherwise, it might not survive IRS scrutiny.

Act now

Although it's uncertain what the future will bring, there's a chance that the $5.12 million exemption will turn out to be a limited time offer. Consult your estate planning advisor to discuss your options before time runs out. ▮

Beware the clawback

What happens if you give away $5.12 million this year, but the exemption is less when you die? Some people are concerned about the possibility of a "clawback" — that the IRS will attempt to impose estate tax on previous gifts to the extent they exceed the date-of-death exemption amount. A clawback also would mean that, if you pay tax on a gift at today's 35% rate but the estate tax rate is higher at your death, your estate could owe additional tax on the gift.

There's a difference of opinion among experts about whether the clawback is a real issue. Some believe that, absent additional legislation, current law will produce a clawback if the exemption amount decreases or the tax rate increases next year. Others argue that a careful reading of the 2010 Tax Relief act's sunset provisions and the version of the tax code that will take effect in 2013 leads to the conclusion that clawback isn't a legitimate concern.

Most experts believe that Congress didn't intend a clawback when it increased the exemption amount and reduced the tax rate for 2011 and 2012. If the exemption amount goes down next year and the tax rate goes up, it's likely that Congress will pass a law clarifying this intent. But there's no guarantee.

Keep in mind that, even with a clawback, you'll be no worse off if you max out your exempt gifts or even pay tax on gifts this year. And you'll still enjoy the benefit of sheltering future appreciation from gift and estate taxes.

Keep family harmony when transferring a vacation home

The Smith's mountain retreat has been in the family for many decades, passed down from one generation to the next. Bob and Judy wish to continue the tradition by giving the vacation home to their four children. To keep family harmony, it's important that Bob and Judy address the property in their estate plan.

Communicate plans to loved ones

If you find yourself in a situation similar to Bob and Judy's, sit down with your children to discuss your plans for the vacation home. Simply dividing the home equally among your children or other family members may seem like the fairest solution, but it can end up being an invitation to conflict and hurt feelings.

Some family members may care more about keeping the home in the family than about any financial benefits it might provide. Others may prefer to sell the home and use the proceeds for other needs.

One solution is to leave the vacation home to the family members who want it and leave other assets to those who don't. Alternatively, you can develop a buyout plan that establishes the terms under which family members who want to keep the home can buy the interests of those who want to sell. The plan should establish a reasonable price and payment terms, which might include payment in installments over several years.

You also may want to put together a usage schedule for nonowners whom you wish to allow to continue enjoying the vacation home. And to help keep the vacation home in the family, consider setting aside assets that will generate income to pay for maintenance, repairs, property taxes and other expenses.

Estate planning strategies

After determining who will receive your vacation home, there are several traditional estate planning tools you can use to transfer it in a tax-efficient manner. In light of the $5.12 million gift tax exemption and the fact that, without congressional action, the amount will go down to $1 million beginning in 2013, it may make sense to transfer interests in the home to your children or other family members now. (See "Conditions favorable for gifts" on page 2.)

But if you're not yet ready to give up ownership, there are other strategies you can use, such as a qualified personal residence trust (QPRT). With a QPRT, you transfer a qualifying home to an irrevocable trust, retaining the right to occupy the home during the trust term.

At the end of the term, the home is transferred to your beneficiaries (though it's possible to continue occupying the home by paying them fair market rent). The transfer is a taxable gift of your beneficiaries' remainder interest, which is only a fraction of the home's current fair market value.

You must survive the trust term, and the vacation home must qualify as a "personal residence," which means, among other things, that you use it for the greater of 14 days per year or more than 10% of the total number of days it's rented out.

Another option is a qualified terminable interest property (QTIP) trust. A QTIP trust can be an effective way to provide for your spouse for life and preserve the trust assets for your children, while minimizing gift and estate tax. In blended families, a QTIP trust can provide a life interest in a vacation home to your spouse, while ultimately transferring ownership to your children from a previous marriage.

To help keep the vacation home in the family, consider setting aside assets that will generate income to pay for maintenance, repairs, property taxes and other expenses.

Ease the process

As Bob and Judy discover, there's much to consider when deciding to pass their vacation home down to their children. To make the process easier, be sure to communicate your wishes to loved ones and discuss your estate planning options with your advisor. ▮

Transfer business ownership or remain boss?

Nonvoting stock lets you share the wealth without losing control

For family business owners, estate planning can be a challenge. Often, most if not all of their wealth is tied up in the business, which creates a conflict between the desire to transfer ownership to the next generation and the desire to stay in control. One potential solution is to recapitalize the business into voting and nonvoting shares. It allows you to separate ownership succession from management succession.

Reaping the benefits

From an estate planning perspective, the sooner you transfer ownership of your business to the next generation, the better. That way, future appreciation and income are removed from your estate and avoid gift and estate taxes.

Transferring ownership may be particularly tax-efficient this year, because the gift tax exemption

is at an all-time high ($5.12 million). Plus, the values of many businesses are depressed. (See "Conditions favorable for gifts" on page 2.)

Recapitalization can allow you to reap the tax benefits of gifting without ceding control of your business to your children.

From an estate planning perspective, the sooner you transfer ownership of your business to the next generation, the better.

For example, you might retain 10% of the company in the form of a voting interest and allocate the remaining 90% among your children in the form of nonvoting shares. You continue to manage the business while removing a large portion of its value from your taxable estate.

Plus, nonvoting shares typically are entitled to valuation discounts for lack of control and marketability. So for gift tax purposes their value would likely be substantially less than 90% of the company's value.

Avoiding conflict

When the time is right, you can begin the management succession process by transferring your voting shares to your children. But what if you have some children who are involved in the business and some who aren't?

Usually, the best option is to transfer your voting stock to children who are active in the business. But this can create tension between them and the nonparticipating children. The latter will likely be looking for cash distributions while the former may want to reinvest earnings to grow the company.

To avoid this sort of conflict, carefully design a buy-sell agreement that provides for a buyout — at a fair price — of the children who aren't involved in the business. To avoid placing a financial strain on the business, the agreement should call for the purchase price to be paid in installments over a reasonable period of time.

Not just for corporations

Recapitalization is an option for most types of businesses, including corporations, partnerships and limited liability companies. Even S corporations

can have voting and nonvoting stock without running afoul of the rule that prohibits S corporations from having more than one class of stock.

If you're considering recapitalizing your business into voting and nonvoting shares, be sure to consult your legal and tax advisors. Generally, a properly structured recapitalization is not a taxable event for the company or its shareholders. But careful planning is required to ensure the desired tax treatment. ▮

Estate Planning Pitfall

You're donating real estate to charity

In the current real estate market, donating a property to charity may be an attractive alternative to selling it. But beware of these potential tax traps:

- If you donate real estate to a public charity, you generally can deduct the property's fair market value. But if you donate it to a private foundation, your deduction is limited to the lower of fair market value or your cost basis in the property.
- If the property is subject to a mortgage, you may recognize taxable income for all or a portion of the loan's value. And charities might not accept mortgaged property because it may trigger unrelated business income tax. For these reasons, it's a good idea to pay off the mortgage before you donate the property or ask the lender to accept another property as collateral for the loan.
- Failure to properly substantiate your donation can result in loss of the deduction and overvaluation penalties. Generally, real estate donations require a qualified appraisal. You'll also need to complete Form 8283, *Noncash Charitable Contributions*, have your appraiser sign it and file it with your federal tax return. If the property is valued at more than $500,000, you'll generally need to include the appraisal report as well.
- If the charity sells the property within three years, it must report the sale to the IRS. If the price is substantially less than the amount you claimed, the IRS may challenge your deduction. To avoid this result, be sure your initial appraisal is accurate and well documented.
- If the charity sells the property to someone who is related to you or with whom you negotiated a potential sale, the IRS may argue that the sale was prearranged and tax you on any capital gain.

If you decide to donate real estate to charity, plan carefully and consult your advisor to ensure that you avoid these traps.

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