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Insights and Commentary from Dentons

On March 31, 2013, three pre-eminent law firms—Salans, Fraser Milner Casgrain, and SNR Denton—combined to form Dentons, a Top 10 global law firm with more than 2,500 lawyers and professionals worldwide.

This document was authored by representatives of one of the founding firms prior to our combination launch, and it continues to be offered to provide our clients with the information they need to do business in an increasingly complex, interconnected and competitive marketplace.

SNR DENTON

Wealth Preservation Strategies™

Winter/Spring 2012

Happy New Year!

2012 should prove to be an interesting year on many fronts as we all watch how the European financial crisis unfolds and participate in another important presidential election, the outcome of which will likely directly affect future US tax policy. What follows is our annual communication to our clients and friends in which we share some of our thinking about important tax and estate planning strategies. The ideas discussed in the newsletter deserve your careful consideration since some of the opportunities may not be available in 2013 and beyond. Best wishes for a successful and healthy year. *— Robert W. Cockren, Head, Trusts and Estates practice*

In the year 2012 there will be a remarkable confluence of (a) relatively large exemptions for federal estate and gift taxes, (b) low federal estate and gift tax rates, (c) historically low interest rates and (d) depressed values of many assets. The large exemptions and low rates are scheduled to disappear at the end of 2012 and interest rates and property values will likely increase over time.

This is a good time, then, to review estate plans and to consider taking advantage of this unique set of circumstances.

For persons dying in 2011 and 2012, the maximum federal estate tax rate is 35 percent. Unless the law is changed, the rate for persons dying in 2013 and later years will become as high as 55 percent. The maximum federal rate on gifts made in 2012 is also 35 percent, but is scheduled to increase to as high as 55 percent for gifts made after 2012. The federal generation-skipping transfer tax is also slated to increase to 55 percent after 2012.

Moreover, exemptions of $5 million, adjusted for inflation, are afforded to estates of persons dying in 2011 and 2012 and to gifts made in those years. Unless the law is changed, these exemptions will revert to $1 million, indexed for inflation. Similarly, the federal generation-skipping transfer tax exemption is now also $5 million. In each case, these exemptions are reduced by the amount of taxable gifts and generation-skipping transfers made in previous years.

Transfers in 2012 will ensure that the current gift tax and generation-skipping transfer tax exemptions are utilized. In addition, gifts made now can shift income and capital appreciation from the donor to the recipient.

Property that is given away during life will also avoid state estate taxes at death for residents of New York, New Jersey, Illinois, Missouri, Kansas and other states that do not have a gift tax.

A number of states have adopted rules that permit trusts to continue for very long periods, enabling families to make gifts of assets in 2012 and thereby avoid estate taxes on those assets for several generations.

Life insurance can be used to provide estate liquidity and to replace estate assets that must be used to pay federal or state estate taxes. If properly structured, the insurance itself will not be subject to estate tax.

Trusts can also provide investment management for younger beneficiaries and protect assets from claims of creditors, including claims of divorcing spouses.

Estate Planning in a Low Interest Rate Environment

The Internal Revenue Service (IRS) publishes a table each month prescribing the interest rate (the Applicable Federal Rate or AFR) that taxpayers must use to determine whether certain transactions are taxable as gifts. Those interest rates are now at or close to their historic lows, presenting a number of estate planning opportunities.

The simplest way to take advantage of the current low interest rates is by making loans to family members. If the stated interest rate on a loan is at least equal to the AFR, no gift is imputed to the transaction. Right now, the interest rate for a loan for up to three years can be as low as 20 basis points or 0.2 percent. If the loan calls for interest at that rate, the lender will not be making a gift. If the borrower can invest the loan proceeds at a higher rate of return, he or she may keep the difference. AFRs for loans for longer than three years are somewhat higher, but rates for loans for more than nine years are currently under 3 percent.

If the lender first creates a trust of which he is treated as the owner (a grantor trust) and then lends to the trust, the benefits of the transaction are amplified. The grantor, rather than the trust or its beneficiaries, will be taxable on the income of the trust, and any payment of interest by the trust to the grantor will be disregarded for income tax purposes. The result is that the trust and its beneficiaries will receive the benefit of all of the investment proceeds, while the grantor will pay the tax on any income of the trust.

The grantor trust arrangement can also be utilized by having the grantor sell property to the trust on an installment basis. All future appreciation on the property and all the income it may generate will be shifted to the trust and its beneficiaries, while the grantor-seller will continue to pay the income tax on any income the property may generate. If the interest on the deferred payments is at least equal to the prescribed AFR, and if the sale price is fair, the grantor will not have made a gift. Any interest paid to the grantor on the deferred installments will be ignored for income tax purposes. The IRS has approved this arrangement.

The low interest rate environment also makes the grantor retained annuity trust (GRAT) attractive for estate planning purposes. A GRAT is an irrevocable trust that pays the creator of the trust (the grantor) an annuity for a fixed term of years (e.g., three years). The annuity payment is usually described as a percentage of the initial value of the assets transferred to the GRAT. If the grantor is living at the end of the term, any property remaining in the GRAT will pass to the remainder beneficiaries (usually the grantor's children), either outright or in further trust for their benefit. Since the annuity payment to avoid making a gift is related to the AFR in effect when the GRAT is created, and since the current rates are low, substantial wealth can be transferred to the grantor's children free of both gift tax and estate tax. As with the trust arrangements described above, the grantor will continue to be responsible for the income of the GRAT during its term.

"Portability" of Exemptions

In estate planning for a married couple we generally try to ensure that the estate exemption of the first spouse to die is fully utilized. To accomplish this we frequently recommend that couples allocate their assets between them so that each of them has sufficient assets to fully utilize his or her exemption. Often this requires that assets be transferred from one spouse to the other or that property held jointly be divided. It also requires diligence to ensure that the proper balance of asset ownership is maintained during the lives of the spouses.

Federal legislation adopted in 2010 may simplify estate planning for married persons by allowing the federal estate tax exemption to be "portable" between spouses. That is, if a married individual dies in 2011 or 2012 and has not fully utilized his or her federal estate tax exemption, the unused exemption may be added to the surviving spouse's exemption. If, for example, the first spouse dies at a time when the allowable federal estate tax exemption is $5 million, and uses only $3 million of that amount, the unused $2 million of his or her exemption will be added to the allowable exemption of the surviving spouse. Under current law, then, a married couple can utilize each party's federal estate tax exemptions without reallocating their assets between them.

While portability of the federal estate tax exemption is a welcome innovation, there are limitations on its effectiveness. For example, it will continue to be advantageous to set aside assets equal to the available federal estate tax exemption at the death of the first spouse so that any appreciation in their value at the death of the surviving spouse is not added to the survivor's estate. To accomplish this, the spouses should have well-drawn wills and they should maintain a proper division of their assets. Utilizing the available estate tax exemption through a trust can also provide investment management and creditor protection for the surviving spouse.

Portability does not apply to the federal generation-skipping transfer tax and, of course, does not apply to state estate taxes. If the surviving spouse remarries, the unused exemption of his or her deceased prior spouse is lost.

Finally, while portability is a part of the federal law for persons dying in 2011 and 2012, it may or may not continue to be available for persons dying after 2012.

Disclosure of Unreported Foreign Accounts

United States citizens and permanent residents must pay federal income tax on their worldwide income, including interest and dividends received on foreign bank accounts and foreign brokerage accounts. In addition, they must file a Report of Foreign Bank and Financial Account each year. A failure to report the income or to file the reports can lead to serious civil and criminal penalties.

In 2009, and again in 2011, the IRS conducted voluntary disclosure programs, which, in most cases, assured taxpayers who participated in them that they would not be criminally prosecuted and would pay lesser civil penalties than might otherwise be imposed. In all, 33,000 voluntary disclosures were made under the 2009 and 2011 programs. The IRS announced on January 9, 2012, that the voluntary disclosure program has been reopened and will remain open for an indefinite time.

The penalty structure will be essentially the same as under the 2011 program, although the IRS reserves the right to increase the penalties from time to time and to end the program entirely at any point. Participants must file amended returns and pay back taxes on income from their accounts for up to eight years, together with accuracy-related and delinquency penalties. Taxpayers who feel that the penalties are disproportionate may opt to have their amended tax returns examined in the usual way without any assurance as to maximum penalties.

In order to make a voluntary disclosure at this time, it must be done (1) before the IRS initiates a criminal investigation of the taxpayer, (2) before announcement by the IRS of an audit of the taxpayer's income taxes and (3) before the IRS receives information from a third party, such as an informant or another government agency, about the taxpayer's noncompliance with the tax laws.

A team of SNR Denton tax lawyers, estates lawyers and corporate lawyers has guided many clients through the voluntary disclosure programs and has represented many individuals being investigated or prosecuted in connection with their offshore accounts. Taxpayers should consult counsel to consider whether their voluntary disclosure would be appropriate at this time.

About SNR Denton's Trusts and Estates Practice

Our Trusts and Estates practice is substantial and among the most well-respected in the nation. Combining our knowledge and technical expertise with attention to each client's unique personal issues, we assist a broad group of individuals and families in accomplishing their estate-planning goals by tailoring creative and tax-sensitive estate plans designed with an appreciation of each client's unique objectives, family dynamics and values. While we have handled many large and complex projects for some of the nation's wealthiest and most well-known individuals and families, most of our clients are entrepreneurs; family business owners; professionals, such as doctors, accountants and lawyers; corporate executives; investment bankers; real estate developers; authors; and artists. Our lawyers also have expertise and experience advising high-net-worth US and non-US persons with respect to the US and international estate, gift and generation-skipping tax consequences of their US and non-US investments.

We regularly represent financial institutions and individuals who serve as executors, trustees and personal representatives in connection with the administration of estates and trusts and with litigated or contested matters. Members of the Trusts and Estates practice have decades of experience in all aspects of US and international estate planning, estate and trust administration, and related litigation.

Areas of Focus

- Counsel individuals regarding their estate plans and prepare wills, trusts and other documents that carry out individual wishes in a tax-efficient manner, taking into account current and anticipated changes in the tax law.
- Create business succession plans for family-owned businesses.
- Advise on the use of lifetime gifts and generation-skipping transfer tax planning.
- Implement clients' charitable intent through creation of remainder trusts, lead trusts and private foundations.
- Prepare and file complicated tax returns each year, including federal and state estate tax returns, income tax returns for estates and trusts, and gift tax returns. Our lawyers have handled hundreds of audits initiated by the IRS and various state tax authorities.
- Represent fiduciaries, beneficiaries and other interested parties in litigated matters, including tax disputes, will and trust construction cases, will contests, contests of trust instruments and contested accountings.
- Negotiate and draft pre- and post-nuptial agreements. Plan for distributions from IRAs, qualified retirement plans and non-qualified plans.
- Assist clients who have alternative lifestyles, who can benefit from estate tax reduction methods not available to married couples.
- Devise and implement plans for clients who have used or are using assisted reproductive technology, taking into consideration the future use and disposition of frozen embryos and other genetic materials and ensuring the inheritance rights of their children.
- Design estate plans for clients with multinational ties, taking into account the unique tax rules that apply.

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